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**Institutional Infrastructure to Support 'Super Growth' in Kenya:
Governance Thresholds, Reversion Rates and Economic Development**

Mwangi S. Kimenyi
University of Connecticut

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341 Mansfield Road, Unit 1063
Storrs, CT 06269-1063
Phone: (860) 486-3022
Fax: (860) 486-4463
<http://www.econ.uconn.edu/>

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Abstract

Kenya Growth Vision 2030 proposes policy and institutional reforms that make it possible for the country to achieve development status of a middle income country by 2030. This paper outlines the institutional framework necessary to achieve Super Growth, which describes the character of growth required to meet targets stipulated in the Vision. The paper provides evidence confirming the importance of improving the quality of governance to the achievement of the Vision. The paper also demonstrates that the country is characterized by a high probability of reverting to poor governance. It is argued that, to achieve super growth, the country must attain an institutional tipping point which associates with low reversion rates to weaker institutions. The paper provides suggestions for institutional reforms that result in the achievement of an institutional tipping point and super growth.

Journal of Economic Literature Classification: O10, O20, O55

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Institutional Infrastructure to Support ‘Super Growth’ in Kenya: Governance Thresholds, Reversion Rates and Economic Development

I. Introduction

For lack of a better word, I coin the term “super growth” to imply the character of growth necessary to meet the targets set forth in Kenya’s Growth Vision 2030. The primary target of Vision 2030 is for Kenya to achieve development status of a middle income country such as Malaysia or Mauritius. These countries have been able to achieve much higher income levels than Kenya as result of sustaining high rates of economic growth over many years. In addition to rapid growth, the countries have made significant progress in terms of overall human development—increased levels of education, life expectancy, substantial reduction in maternal and child mortality and rapid reductions in poverty rates. The economies of these countries are also characterized by heavy investments in infrastructural services that support long-term growth. Over the last four decades, these countries have greatly diversified their economies especially to manufacturing and services, effectively insulating the countries from adverse commodity price shocks.

The first feature of “super growth” as used in this paper is that annual growth of gross domestic product must be much higher than Kenya’s recent growth performance record. In 2005, Kenya’s income per capita expressed in dollars at purchasing power parity was \$1,140 placing Kenya among the poorest countries in the world (Human development Report 2006). To achieve middle income status by 2030, Kenya’s per capita income would have to increase by a factor of about 10 from its 2005 income level. Table 1 shows what Kenya’s per capital income would be in 2030 assuming some

growth rates maintained over 25 years.¹ Some “mirror” countries whose current level of development reflects how Kenya would be like in 2030 are also listed. It is evident that achieving the targets of Vision 2030 necessarily requires annual growth rates of at least 9%. Note for example that if Kenya were to maintain its current good economic performance of about 5% annual growth, its income per capita in 2030 would be about \$3,600, comparable to Ecuador’s income in 2006. To be comparable to the current development status of Mauritius, Kenya’s gross domestic product must grow at a rate of 10% annually. As is obvious, the other key features of “super growth” is that the high rates of growth should be maintained over long periods of time, hence not just sporadic growth.

Finally the growth necessary to meet vision 2030 targets must not only be high but must also be broad-based- implying that growth must reach all income groups, regions and economic activities. This is because growth can occur without increasing the levels of human development substantially if gains from growth do not reach all the groups of people in all regions.² Thus, growth must also benefit the poorest segments of the society such that their quality of life and capabilities increase. Growth cannot be sustainable if capabilities of the poor do not increase substantially. In essence, super growth must also embody features of pro-poor growth (Kimenyi 2007a). Growth that does not meet any of these features is likely to associate with adverse outcomes thereby neutralizing progress towards Vision 2030 targets. In short, super growth entails high rates of growth and also overall improvements in human development.

Economic growth implies the creation of value from a given set of resources. Some important ingredients for growth include increases in levels of investment, advances in technology, and

¹ Future per capita income is simply computed using the compounded growth formula as follows: $PY_{2030} = PY_{2006} (1 + \text{growth rate})^{25}$

² South Africa and Equatorial Guinea are classic examples of high-income, low-human development countries. Although South Africa and Equatorial Guinea had (2005) incomes of \$10,346 and \$19,780 respectively, they level of human development is much lower than other countries with similar or even lower incomes. In terms of Human Development, South Africa was ranked 120th and Equatorial Guinea 121st while Malaysia with an income of \$9,512 was ranked 61st.

improvements in the quality of the labor force through investments in human capital. But at the core of achieving and sustaining economic growth is getting the fundamentals right—macroeconomic stability—inflation, interest rates and openness to trade, etc. Simply, value creation requires some key fundamentals that provide the necessary incentives for market actors to enter into gainful transactions. Thus, as a starting point, for Kenya to achieve high rates of economic growth, it must at least have in place the fundamentals right.

While good policies are central to the achievement of economic growth, it is now well established that such growth requires some quality institutions. Evidence shows that good policies alone are not sufficient to yield sustained growth and likewise good institutions cannot result in growth unless backed by good policies. In essence, growth is the result of the interaction between policies and institutions. In other words, institutions and policies are to an extent interdependent, with good policies reinforcing institutions and vice versa. Empirical literature has demonstrated a positive and significant relationship between the quality of institutions and economic growth. In fact recent advances in the economic literature suggest that institutional arrangements are the most important determinants of economic growth and development (see for example: Kimenyi 2007(c); 2007(d); de Haan and Siermann 1995; Rodrik 1998; Nkurunziza and Bates 2003;. North 1990; Keefer 2004; Olson 1993, 1997; Kimenyi and Mbaku 1999; Kaufmann, Kraay and Zoido-Lobaton 1999) This is particularly so because institutions also influence the type of policies that governments adopt. In other words, the pro-growth policies highlighted above are maintained under some distinct institutional infrastructure.

This paper focuses on institutional aspects of growth, and specifically in regard to Kenya Growth Vision 2030. In the section that follows, I focus on the role of institutions on economic performance. Here the relationship between quality of institutions, policy and economic growth is discussed. In section III, some empirical evidence on the relationship between institutions and

policy in economic growth is presented. The evidence supports the now well accepted view that the quality of institutions play a crucial role in determining long-term growth performance.

Notwithstanding the high returns in terms of economic growth that associate with transitioning from weak to strong institutions, there is a tendency for countries to revert to poor governance. Countries make improvements in the quality of institutions and then backslide on such reforms with a high degree of frequency. In Section IV, I look at the tendency for countries to revert to weaker institutions and demonstrate that when institutions are weak, reversion rates are very high but the rates decline as governance improves. Beyond some threshold values, reversion rates are very low and governance becomes self-reinforcing. I suggest that achievement of “super growth” requires attainment of governance levels that are self-reinforcing—that is, the probability to retain or improve quality of institutions dominates tendencies to revert to weaker institutions. In Section V, I look at Kenya’s institutions of governance and propose some reforms that are necessary for the country to achieve an “Institutional Tipping Point” at which reversion rates to weak governance decline rapidly. Section VI provides some concluding remarks and observations concerning the likelihood of Kenya meeting the 2030 targets.

II. Institutions and Economic Performance

Traditionally, economic growth has been expressed by a simple production function of the following general form:

$$\text{Economic Growth} = f(\text{Capital}, \text{Labor}, \text{Technology})$$

In this specification, labor is expressed both in terms of quantity and also quality—that is the human capital embodied in workers. This simple production function assumes that combining capital and labor, and given some production technology yields some deterministic level of economic growth. Simply, more capital and labor and improvements in technology result in higher levels of growth

and, overtime, cumulative growth results in economic development. Thus, low levels of economic development can be explained by shortages of capital, low levels of human capital and lack of technological progress.

An implication of this simple traditional model is that growth can be “imported”. Through the process of capital and technology transfer and the use of foreign expertise, a country can achieve accelerated growth. Thus, soon after independence, development economists advocated for capital and technological transfers in the form of foreign investment. Foreign borrowing was also seen as a solution to capital supply constraints. Governments invested heavily in education in order to raise the levels of human capital and also took an active role directing resource allocation through the implementation of various forms of controls and regulations.

Economic growth in post-independence Africa was nevertheless disappointing. Many of the economies were growing very slowly and some were even regressing. The problem then was seen not as one of resource constraint but rather a problem of poor policies. Most countries had adopted a “government led” development paradigm that constrained private sector development. Heavy intervention in the economy through government production, control of prices and exchange rates, over-regulation of the economy and the adoption of import substitution strategies that included severe import controls and foreign exchange rationing constrained economic growth. Thus the focus of growth turned to an emphasis on quality of policy and the growth process was expressed as follows:

$$\text{Economic Growth} = f(\text{Capital}, \text{Labor}, \text{Technology}, \text{Policy})$$

International development organizations then proposed policy reforms that were supposed to deal with mal-aligned prices which were at that time blamed for poor economic performance. The main focus of the policy reforms was to reduce the role of the government in influencing resource allocation and instead allow markets to operate freely. Therefore, reforms focused on the removal of

interest rate controls, deregulation of domestic prices, exchange rates and also downsizing the government. In many cases, the policy reforms were undertaken as conditionalities for aid and were rarely owned by the implementing countries.

Although policy reforms yielded some gains in terms of economic growth, these gains were small and far apart. Of particular concern was that for the majority of countries, the reforms instituted had serious adverse impacts on the wellbeing of the majority of the citizens. Poverty rates tended to increase and also the policies magnified inequalities in the distribution of income. As a result, there were frequent policy reversals resulting in stagnation. In some cases, dissatisfied citizens engaged in violent protests and in others, poor economic outcomes and the increasing inequality were used to justify military takeovers. Evidently, many of the policies instituted were not sustainable. Through the 1980s, most Sub-Saharan African countries regressed in many of the dimensions of welfare.

By early 1990s, there was increased disillusionment with the growth paradigms and especially the reforms recommended by the international development organizations. An increasing volume of empirical and theoretical literature showed that inputs and policy variables only explained a small part of the variations in growth across countries. These studies showed that differences in institutional arrangements were a more important determinant of variations in growth performance across countries. As a matter of fact, many African countries that were richly endowed with natural resources were performing very poorly because their institutions were not conducive to growth. The new institutional economics revolution as advanced by Douglas North and others emphasized that, while it is true that inputs and good policy are an important component of the economic growth process, it is largely the quality of institutions that determine wealth accumulation. Thus, according to the institutionalists, the growth process is better expressed as follows:

$$\text{Economic Growth} = f(\text{Capital, Labor, Technology, Policy, Institutions})$$

North defines institutions as “rules of the game” that include formal and informal constraints on political, economic and social interactions (North 1990). Good institutions create incentive structures that reduce uncertainty and promote efficiencies that are necessary for economic growth. In particular, good institutions provide for appropriate incentives to exploit market opportunities and also promote policy stability and predictability. The constraints on leaders limit discretionary powers, self-interest, arbitrary policies and violation of property rights. In general, good institutions promote production and discourage the natural tendency to predation (Usher 1987, Olson 2000). Other aspects of institutions that impact economic growth are organizational forms, procedures and regulatory frameworks that influence the quality of policy. Some important indicators of the quality of institutions which I broadly refer to as “governance” in this paper include:

- Political and civil liberties;
- Extent of corruption;
- political stability and violence;
- public sector efficiency’
- regulatory quality’
- rule of law ;
- Legal protection of property;
- Institutional constraints on leaders;
- Independence of the judiciary;
- Independence of the central Bank;
- Economic freedom.

All these indicators define a country’s institutional infrastructure in terms of political, economic and policy climate. Viewed from the institutional perspective, economic growth and development has

little to do with resources or geography but rather it is mainly a function of these features of institutions that determine incentives and value creation.

Figure 1 provides a simple representation of the linkages between institutions and economic growth. The figure shows that institutions influence the quality of policies and the policies in turn influence economic growth and development. Of critical importance is that economic development reinforces the quality of institutions. Thus, reforms that improve governance are reinforcing. On the other hand, poor institutions lead to poor policies, low development and this in turn weakens the institutions further resulting in a *poor governance-low development trap*.

III. Institutions and Growth: Empirical Results

Figure 2 and 3 provide a casual view of the relationship between governance and rates of real growth of GDP.³ The data are based on an aggregate governance indicator for the period between 1996 and 2005. Although there is a wide dispersion, it is evident that there is a general positive relationship between governance and growth as shown by the regression line. Also of note is that the dispersion of the observed growth rates is large at lower levels of governance. In addition, we observe that countries that had negative growth rates were mostly those at the lower end of the governance rankings. Even in this casual presentation, it is indicative that better governance associates with higher rates of economic growth and this relationship becomes more stable at higher levels of governance.

Ideally, the impact of governance on economic growth can be evaluated by estimating a growth model that includes country specific characteristics, policy, and also indicators of the quality of institutions. Country specific characteristics that have been found to be important in explaining variations in growth across countries include population characteristics such as ethnic diversity,

³ For this study, I rely on the World bank Governance Indicators compiled by Kaufman et al. See <http://www.worldbank.org/wbi/governance/datasets.htm#dataset>

geography (location, whether landlocked or not), legal and other history, etc. Policy variables that are important determinants of economic growth include inflation, exchange rate over-valuation, trade openness, current account openness, government size and extent of financial development, among others. The most common indicators of institutional quality include the aggregate governance indicator which is an average of six measures—voice and accountability, political stability, regulatory quality, government effectiveness, rule of law and control of corruption. Other measures of institutional quality include extent to which executive power is constrained and measures of protection of property rights. Studies using different data sources generally find that governance has a positive and significant impact on growth.

Estimating the empirical relationship between growth and institutional quality is however complicated by the problem of endogeneity. Specifically, institutions and policy are not completely independent. Thus, unbiased estimates of the empirical relationship between governance and growth require the use of appropriate instruments. For simplicity and because of data limitations, I follow a simple approach to investigate the link between governance and economic growth primarily focusing on the links shown in Figure 1 starting with the relationship between economic growth and policy expressed as:

$$(a) \quad GROWTH = f(POLICY)$$

Table 2 reports regression results of the role of policy variables on economic growth.⁴ The dependent variable is the annual growth rate of GDP. We use the share of exports to GDP as a measure of trade openness. The size of the public sector is measured by the aggregate government consumption as a share of GDP (Government Size) and spending on public employment as percentage of total government spending. Both of these variables are expected to have a negative effect on economic growth. Inflation rate captures the stability and quality of monetary policy while

⁴ Data for policy variables are obtained from the World Bank online data. See <http://web.Worldbank.org/WEBSITE/EXTERNAL/DATASTATISTICS/0,,Content.mdk>

tax rates proxy the business environment. High corporate tax rates are expected to have a negative impact on economic growth. By and large, the results are as expected. Growth is dependent on good policies such as trade openness, prudent monetary policy and also policies that are good for business. Very large governments lower growth probably because of crowding out and also associated high rates of taxation and regulatory burden. Although this specification is rather simple, the results are largely consistent to other studies that have used various specifications and data sets.

Having confirmed the link between policy and economic growth, we turn to investigating how policy is influenced by quality of governance expressed as follows:

$$(b) \quad POLICY = f(GOVERNANCE)$$

As a casual test, we look at the correlation between governance and policy variables. Table 3 reports the correlation coefficients between the aggregate governance indicator and a number of policy variables and also the significance levels of these relationships. The simple correlations show that quality of policy improves with the quality of governance. For example, countries that score better in terms of governance have overall lower rates of inflation, lower corporate and custom taxes, smaller bureaucracies and overall lower cost of doing business. On the other hand, better governance tend to associate with higher levels of trade openness. Contrary to expectation, the correlation between governance and government size is positive indicating that better governance associates with larger governments. This is not totally surprising. What might be more important in terms of economic growth is the quality of spending. Higher spending on infrastructure, human capital and security could associate with growth. On the other hand, larger bureaucracies associate with lower growth outcomes.

Finally, we estimate the impact of governance on growth as follows:

$$(c) \quad GROWTH = f(GOVERNANCE, POLICY, COUNTRY \\ CHARACTERISTICS)$$

Table 4a reports the results of regressing economic growth on some country specific controls including governance. The dependent variable is the country growth rate for the period between 1975 and 2005.⁵ We use longer period in order to identify those variables that are key to influencing long-term growth. The aggregate governance variable is the average of six governance indicators in the Kaufmann, et al data set. As noted previously, this reduced form specification is an oversimplification of the growth process. Initial income is used to capture the convergence effect and so the coefficient of initial income is expected to be negative. I include natural resource abundance and also the inflation rate as independent variables.

Results show that quality of governance has a positive and significant effect on growth. As expected, the coefficient for the initial income variable is negative in all the specifications and it is statistically significant in two of the specifications. The natural resource abundance variable has a negative effect on growth probably indicating the dominance of a “resource curse” phenomenon in many developing countries.⁶ The coefficient on the inflation rate variable is positive but not statistically significant.

Although the empirical tests presented here are based on rather simple models, they do nevertheless confirm the importance of the quality of institutions in influencing economic growth and development. The emerging consensus is that institutional reforms that improve the institutions of governance generally translate in improved economic performance and also overall improvement in human development. For example, Kaufmann et al (1999) observes that:

An improvement in governance—such as an improvement in the rule of law from the low level in Russia to the high level in Czech Republic, or a reduction in corruption from the high level in Indonesia to that in the Republic of Korea—leads to a two-to-four fold improvement in per capita incomes and in infant mortality rates, and about a 20 percent improvement in adult literacy. These results are not just simple correlations

⁵ Data on growth come from Human Development Reports. Other estimates to be conducted for the periods 1985-1995 (Table 4b) and 1995-2005 (Table 4c).

⁶ If we drop the developing countries from the sample, natural resource abundance has a positive impact on growth. In other words, under quality institutions, natural resource abundance promotes growth.

between better governance and better development outcomes. Rather, the causality is from governance to these selected measures of development.⁷

Thus, as Kenya prepares to institute reforms to achieve the targets of Growth Vision 2030, governance reforms must take center stage. In fact, based on the recent evidence, improvements in governance may be the critical determinant as to how well the country meets the targets.

IV. Governance Thresholds and Reversion Rates

It is fairly obvious that quality institutions are crucial to achievement of high rates of economic growth. Improving governance associates with predictable dividends in terms of economic growth and overall development. Simply, no country can expect to sustain high rates of economic growth without concomitant quality institutions.

Although the importance of improving governance in raising the development status of a country is well known, transition towards good governance is rather slow and it seems that there are powerful obstacles that hinder progress to improving institutional quality. As data reveals, countries tend to backslide on governance improvements with a high degree of frequency. The implication is that to the extent that reversion to weaker institutions is a real possibility, sustaining high rates of economic growth is likely to be a mirage.

Consider Kenya for example. Table 5 shows the country's relative performance in terms of institutional quality as proxied by the six measures of governance: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption. Each indicator is based on a score that ranges from -2.5 to +2.5 with increasing scores reflecting better governance. In all cases, Kenya's scores are negative, indicating that the country was in the lower end of the governance rankings. The RANK is the percentile ranking for each indicator (1-100). In

⁷ See also Rodrik 1998, 1999; Mauro, 1995, 1998.

2005, the country ranked in the bottom one fifth in terms of political stability and violence (14.6), rule of law (18.4), control of corruption (14.8), and only marginally better in terms of government effectiveness (25.4). The country's best rankings were in voice and accountability (43) and regulatory quality (42.1). Based on the data, Kenya improved governance between 1996 and 2005 in areas of voice and accountability, regulatory quality and control of corruption. In terms of voice and accountability, the country improved from a score of -0.56 in 1996 to -0.12 in 2005. During the same period, regulatory quality improved from a score of -0.43 to -0.32 while control of corruption improved from -1.12 in 1996 to -1.01 in 2005. However, political stability and violence, score deteriorated from -0.65 to -1.16. Likewise, in terms of government effectiveness, the score was -0.64 in 1996 and -0.78 in 2005. Even in those areas that the country generally improved, there were periods of reversion. For example, in 1996, the score for voice and accountability was -0.56 but this score was -0.89 and -0.88 in 1998 and 2000, respectively. In 1998, the score on regulatory quality was -0.17 but in 2002 the score had deteriorated to -0.55. In regard to control of corruption, Kenya scored -1.03 in 1998 and improved to -0.88 in 2004 but then worsened to -1.01 in 2005. The evidence here is that improvements in quality of institutions are frequently eroded.

As far as tendency to revert to weaker institutions is concerned, Kenya is not unique. In fact many countries make improvements in governance and then slide back to poor governance thereby eroding the gains. As a matter of fact, many of the countries in the lower end of governance rankings are notorious in regard to gravitating towards weaker institutions after making some progress. Based on the evidence of the relationship between growth and governance, such high likelihood to revert to weaker institutions cannot be consistent to achievement and sustenance of high rates of economic growth. Thus, although Kenya has been able to achieve moderate rates of economic growth over the past few years, the governance reversion rates are not consistent to achievement of long-term growth.

Using the governance data for the period 1996-2005 for all the six indicators, we compute the likelihood of a country reverting to poor governance. The computation is based on 194 countries and changes in the six indicators of governance for the period 1996-2005. Any negative change from one year to another is considered as a reversion. The computation of the likelihood of reversion also takes into account the magnitude of these negative changes.

Table 6 reports the computed governance reversion rates for different countries depending on their governance ranking. The reversion rate is simply the computed likelihood that a country reverts back to weaker institutional quality in any given year. The Table also reports the governance reversion rates of the ‘mirror’ countries identified earlier. The mean reversion rate for the entire sample is 48 percent. However, the reversion rates are much higher for countries in the lower end of the governance ranking scale at 81 percent for the lowest 40 countries and 72 percent for those in the 41-80 range. The reversion rate falls rapidly as the quality of institutions increases. For countries with the best governance (161-194), the probability of reversion is only 4%. The reversion rates suggest that there are strong forces that pull countries to poor governance when institutions are already weak while the opposite is true when institutions stronger.

Figure 4a shows the relationship between reversion rates and the governance rankings. Figure 4b shows the same relationship and also the best fit regression curve. These figures clearly show that reversion rates are very high in weaker institutions but drop dramatically after reaching the 60th percentile ranking. At this point, it does appear that good governance becomes self-sustaining. Notice that in Figure 4b, most countries in the lower end of governance rankings have higher reversion rates than predicted (above the regression line) and those in the higher end of governance rankings have reversion rates that are lower than predicted (below the regression line).

Figure 5a shows the relationship between reversion rates and per capital income and Figure 5b shows the best fit regression curve for this relationship. Evidently, the relationship between

reversion rates and income is not as clear cut as the relationship between reversion rates and governance. Although reversion rates fall with higher income levels, there is quite a bit of dispersion. Generally, low income countries (below \$7,000) have high reversion rates. However, several of the higher income countries also have high reversion rates.⁸ Nevertheless, it is clear that the best economic performers have generally low reversion rates. Furthermore, reversion rates seem to drop sharply after countries attain per capita incomes of \$10,000.

The foregoing analysis provides some important insights concerning institutional quality and achievement of “super growth”. The first insight is that weak institutions are prone to remaining so—that is they are in a “low-governance trap.” Second, governance tends to be self-reinforcing after some critical threshold level when reversion rates decline substantially. Finally, the analysis shows that high levels of income associate with lower reversion rates indicating that development itself does reinforce the quality of governance.

V. Institutions and Development in Kenya: Towards an Institutional Tipping Point

Earlier, we identified a number of countries whose current state of economic development would be reflective of Kenya’s income status in 2030 depending on the rate of economic growth sustained for the next 25 years. Figures 6-11 show governance rankings for those countries in 2005. The indicators shown are Voice and Accountability, Political Stability and Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. As previously noted, large values of these indicators reflect better governance. Although country rankings on governance indicators vary, we observe some clear pattern with higher income countries scoring better on those indicators. In particular, the countries that Kenya seeks to be like in 2030—Mauritius and Malaysia—perform best in most of the governance indicators. Kenya on the other hand performs

⁸ This is particularly the with high income oil exporting countries that are also characterized by poor governance.

poorly on all the indicators, only consistently outperforming Haiti, a country that has experienced turmoil over the last two decades.

It has already been demonstrated that there is a strong link between quality of institutions and economic performance. Comparing Kenya with Mauritius and Malaysia in terms of institutional quality, it is observed that Kenya is far below these two countries in terms of the quality of governance. To reach the development status of these countries, Kenya must move up the institutional quality curve as shown in Figures 6-11. This is easily said but hard to achieve. Currently Kenya is characterized by a 77 percent governance reversion rate while Malaysia and Mauritius have computed governance reversion rates of 21 percent and 14 percent, respectively. Thus, both of these two countries have reached a level of institutional quality that is self-reinforcing. Kenya on the other hand is still prone to “poor-governance trap” that associates with high reversion rates.

To achieve and sustain “super growth”, Kenya’s institutional quality must reach that threshold level at which good governance becomes self-reinforcing. This threshold level can be referred to as an institutional “tipping point.” Once the country’s governance reaches this level, the probability of reversion to poor governance falls dramatically. I contend that institutional tipping is crucial to achievement and sustaining super growth.

It is easy to understand why institutional tipping is crucial to long-term economic growth. As already noted, institutions support growth by providing a stable and predictable policy environment and guarantees on security of property rights. There are many signals that provide information to market participants as to the probability of reversion to weak institutions. In fact, most of the governance indicators used in this paper are based on evaluations by local investors and other opinion leaders and organizations. Thus the changes in governance scores do in fact reflect the perceived probability of reversion to weaker institutions or progression to better institutions. If investors consider probability of reversion to be high, they will then place a high risk premium on

investment with the result that investment levels decline. Likewise, perceived or actual probability of deterioration in political stability, corruption, or the security of property, etc. impacts on the choices that market actors make and have a direct bearing on economic growth.

Strong institutions as characterized by good governance generally benefit the society at large and reward production and market exchange while weak institutions concentrate benefits on a few through predation. Consequently, improvements in institutions naturally erode the benefits that accrue from predation and instead reward production and market exchange. Thus, it is the case that groups that benefit from weak institutions have an interest in blocking improvements in governance. Governance reversion therefore largely reflects the dominance of power by “predators” over other groups. Evidently, the dominance of predatory behavior—and therefore high probability of governance reversion—largely depends on the distribution of power in the society.

I argue that an “institutional tipping point” is reached when power is sufficiently diffused in society. This means not only distribution of powers between the arms of government but also to economic interests groups, labor, producers, consumers, civil society, etc. Power to these groups provides the necessary countervailing force to counter those who seek to reverse gains in governance. Simply, institutional tipping requires that all groups in the society have sufficient leverage over the policy making process. Thus reversal to weak institutions that benefit a few is effectively blocked by other groups. It is such diffusion of power that has been shown to associate with durable economic growth elsewhere in the world (Powelson 1994).

Absent sufficient and enforceable institutional constraints, those in positions of power will seek to institute policies that best serve their interests. In essence, without institutional constraints, leaders will more often than not act in a predatory manner.⁹ Put in another way, the behavior of

⁹ It is important that institutional constraints on the behavior of leaders and members of society come from many sources. For example, at one level, such constraints could be through a formal constitution that limits the actions of

leaders depends on the principal-agent relationships in a society. These relationships are largely dependent on the institutional arrangements and the power distribution in society. As such, adoption of good policies is not the result of “good” people but primarily because of “good” institutional constraints that limit the predatory nature of leaders.

Historically, the emergence of institutions with centralized leadership has started with a high concentration of power amongst a few individuals who comprise a ruling class. In many cases, this ruling class has been royal families or a group of families that monopolize power. In other cases, power has been concentrated amongst landed class and military juntas or even with religious leadership. For so long as power is concentrated with a few individuals or organs of government, the probability to revert to weak institutions that benefit those in power remain high. In terms of economic growth, it does not matter which group has the power: for so long as power is concentrated, the ruling coalition has no interest in broad pro-growth policies that would benefit all members of the society.

The basic argument is that “institutional tipping” requires power diffusion in society. Institutions where power is sufficiently diffused are characterized by a “balance of power” amongst the arms of government and also various interest groups (Powelson 1994). Separation of powers between the Executive, Judiciary and Legislative arms of government is an especially important institutional arrangement for accelerating the diffusion of power. But power must also be spread broadly in the society with various groups having some leverage over outcomes. This means that each of the groups in society has some degree of ‘veto power’ over public policy outcomes. For groups to be able to influence policy, they must have leverage—that is they must be able to block adoption governance reversals that weaken institutions.

leaders. However, constraints could also be more informal ranging from customs to actions based on reciprocity and trust.

A particularly important vehicle for accelerating power diffusion is the National Constitution. Power diffusion that is entrenched in a constitution tends to be durable especially through constitutional constraints imposed on the branches of government and also the distribution of powers amongst these branches. It is therefore an opportune time for Kenya: both the constitutional making process and the formulation of strategies to achieve Growth Vision 2030 are ongoing at the same time and the two activities must be seen as complementary. As we have observed, improvements in governance have direct positive impact on economic growth and development and such development in turn strengthens the institutions. Adoption of a constitution that provides for sufficient power diffusion and ensures the full participation of various groups in the society is, in my opinion, critical to achievement of the “institutional tipping point.”

A constitution is but one vehicle to achieve power diffusion and a good constitution alone may not be sufficient to achieve extensive diffusion of power. Of key importance is the extent of trust amongst members of a group. Trust is necessary for people to form strong cohesive groups that are capable of advancing a common purpose. But even more important is that different groups must trust each other in order to form horizontal and vertical alliances that are necessary to impart leverage on those who may seek to monopolize power. Trust is one key component of social capital that influences power diffusion.

Unfortunately, Kenya performs poorly in terms of trust amongst groups. Kimenyi (2006a) finds that ethnicity in Kenya is a major constraint to power diffusion. In a more recent study, Kimenyi (2007e), computes an index of ethnic polarization and concludes that ethnic polarization between specific groups is extremely high, an outcome that shows low levels of trust among groups. Such an outcome is not consistent to achievement of an institutional tipping point as discussed in this paper. It is therefore necessary to take seriously institutions that tend to harmonize ethnic claims such as constitutional decentralization.

VI. Concluding Remarks

This paper has discussed the importance of governance in achieving what I have referred to as “super growth”—growth that is necessary to meet the targets of Vision 2030. It has been demonstrated that improving the quality of institutions is a necessary condition to meet the growth targets. A particular innovation of this paper is the introduction of the concept of “Governance Reversion” and the implications of such reversion to long-term economic growth. I have argued that Kenya is prone to high governance reversion which is not consistent to the achievement of Growth Vision 2030. The paper makes the claim that for Kenya to achieve the targets set forth in the Vision, it must also reach an “institution tipping point” which associates with self-reinforcing institutions. It is suggested that the process of constitutional making is crucial to reaching the institutional tipping point.

As a final note, I make a few observations about the likelihood of Kenya achieving Vision 2030 targets. Kenya can indeed achieve the targets outlined in Growth Vision 2030. But this is not a small feat. To be realistic, the core economic drivers necessary to achieve rates of economic growth of about 10% annually are not in place. In addition, there are some core fundamental institutional changes that must be in place if such high rates of growth are to be achieved and sustained and those changes cannot be reasonably implemented within a period of a few years. Likewise, human capital elements necessary to support such growth rates will take time to develop. Furthermore, weak sectoral linkages within the economy make it difficult to achieve and sustain those growth rates.

I take the view therefore, that the most feasible strategy is to get the fundamentals for economic growth—both policy and institutions—in place. This means that the initial focus should be on laying the foundations for durable economic growth rather than a concentration on a certain growth rate. If Kenya could reach an “institutional tipping point” then good policies and strong institutions

would be reinforcing and growth would be durable. Therefore, I find it more realistic to focus on institutional building from which we can expect growth to be durable and incremental. It is possible to institute policies that yields high growth rates in the first few years but the fundamentals are not in place and such growth cannot be sustained.

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Table 1: Kenya's Income Level in 2030 Assuming Different Economic Growth Rates

Annual Rate of Economic Growth Rate (%) maintained over a period of 25 years	Income (expressed in purchasing power parity terms) in 2030	In 2030, Kenya would be comparable to the way this country was in 2006
1	1,461.93	Uganda
2	1,870.28	Haiti
3	2,386.81	Cambodia
4	3,039.01	Vanuatu
5	3,860.04	Ecuador
6	4,892.65	Paraguay
7	6,187.23	Fiji
8	7,806.72	Tunisia
9	9,830.32	Malaysia
10	12,351.55	Mauritius

Figure 1: Institutions and Economic development

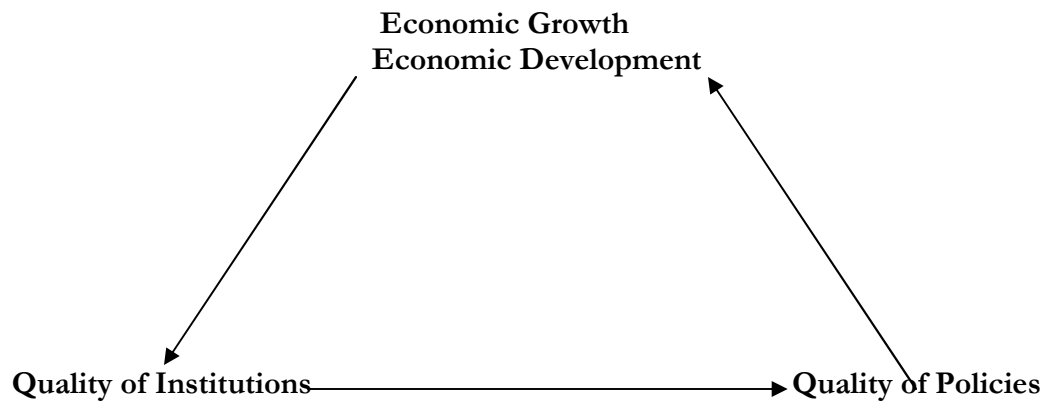


Figure 2: Relationship Between Growth and Governance: Quadratic

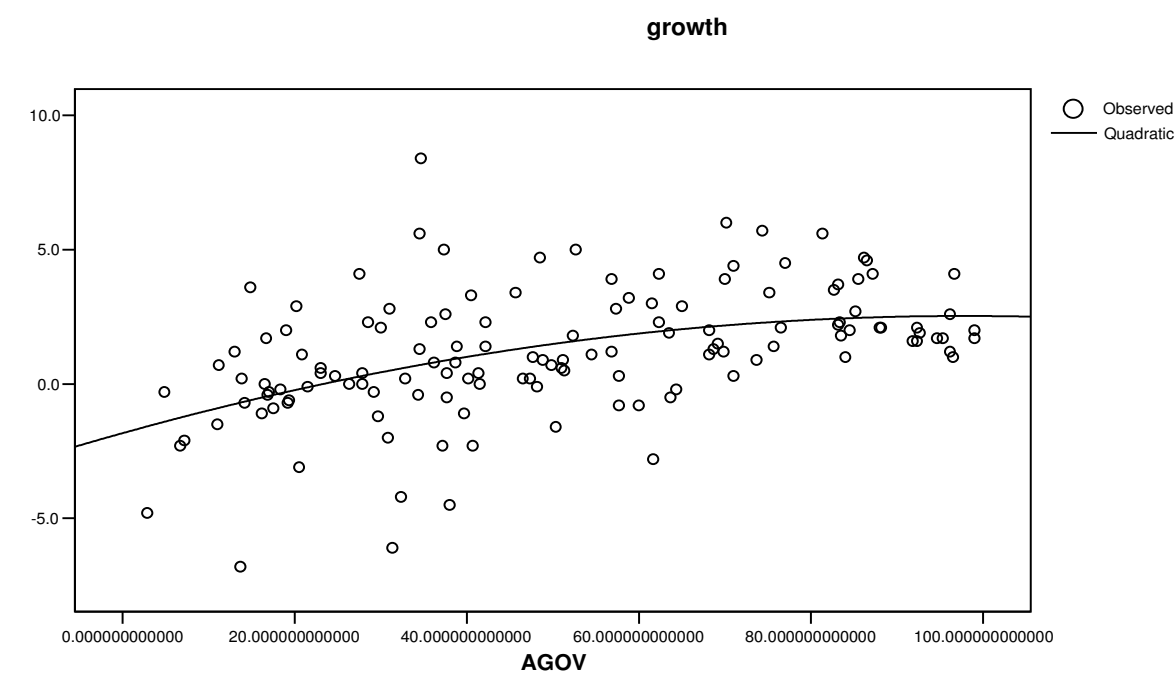


Figure 3: Relationship Between Growth and Governance: Logarithmic

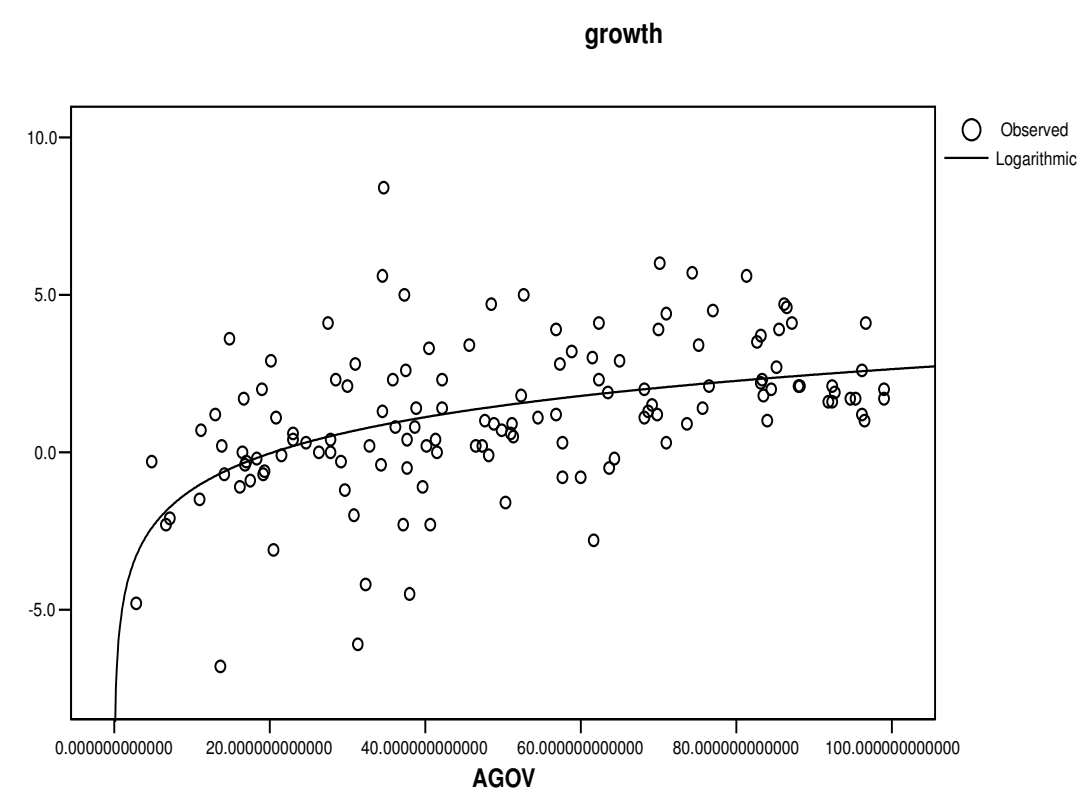


Table 2: Regression Results for Role of Policy on Economic Growth

Independent Variable	Model	Model	Model
Constant	5.66 (14.30)***	3.705 (7.78)***	7.111 (8.40)***
Trade Openness	0.010 (1.93)*	0.009 (1.11)	0.005 (0.82)
Government Size	-0.106 (-4.79)***		-0.108 (-5.05)***
Government Employment		-0.003 (-0.24)	
Inflation	-0.24 (-5.33)***	-0.018 (-3.84)***	-0.029 (-3.87)***
Highest Corporate Tax rate			-0.056 (-2.77)***
R-Square	0.224	0.204	0.310
Number of observations	918	393	446

Table 3: Correlation Between Aggregate Governance and Policy Variables

Policy Variable	Correlation Coefficient	p-value	Number of Observation
Inflation	-0.95	0.002	1096
Highest Corporate Tax	-0.126	0.003	540
Government Size	0.193	0.000	1050
Government Employment	-0.245	0.000	435
Cost of Doing Business	-0.331	0.000	447
Trade Openness	0.273	0.000	1096
Custom duties	-0.251	0.000	406

Table 4: Regression Results for the role of Governance on Economic Growth

Independent Variables	Model	Model	Model	Model
Constant	-0.876 (-2.23)**	-1.201 (-2.84)***	-0.755 (-1.69)*	-0.759 (-1.62)*
Aggregate Governance	0.041 (5.94)**	0.058 (5.24)***	0.049 (4.37)***	0.050 (4.25)***
Initial Income		-0.000 (-1.97)*	-0.000 (-2.69)	0.000 (-1.30)
Natural Resource Rich			-1.52 (-2.69)**	-1.528 (-2.65)**
Inflation				0.000 (0.027)
R-Squared	0.458	0.482	0.522	0.521
Number of Observations	134	134	134	133

Table 5. Governance Indicators for Kenya: 1996-2005

Year	Voice and Accountability		Political Stability/No Violence		Government Effectiveness		Regulatory Quality		Rule of Law		Control of Corruption	
	Rank	estimate	Rank	Estimate	Rank	Estimate	Rank	Estimate.	Rank	Estimate	Rank	Estimate
1996	31.7	-0.56	24.1	-0.65	29.0	-0.64	28.4	-0.43	21.1	-0.83	6.8	-1.12
1998	23.7	-0.89	15.6	-1.03	12.9	-0.98	38.4	-0.17	14.9	-1.02	8.8	-1.03
2000	23.2	-0.88	13.2	-1.15	25.4	-0.72	35.5	-0.26	12.5	-1.03	6.4	-1.14
2002	26.6	-0.69	17.0	-1.11	24.4	-0.71	32.0	-0.55	13.9	-1.08	8.3	-1.09
2003	39.1	-0.29	16.0	-1.10	28.7	-0.65	43.8	-0.27	15.4	-1.06	15.7	-0.94
2004	40.1	-0.31	17.0	-1.07	29.2	-0.72	44.3	-0.25	15.9	-1.01	18.6	-0.88
2005	43.0	-0.12	14.6	-1.16	25.4	-0.78	42.1	-0.32	18.4	-0.94	14.8	-1.01

Data Source: Kaufmann, Kraay and Mastruzzi (2006), Governance Matters V. Governance

Indicators for 1996-2005.

Table 6: Governance Reversion rates

Governance Rank	Mean Reversion Rate	Mean Income
1-194	48.03	10,341
1-40	81.35	2,141
41-80	72.65	3,837
81-120	57.20	7,385
121-160	26.71	13,610
161-194	4.14	27,029
Uganda	81	1,461
Haiti	81	1,870
Cambodia	82	2,386
Vanuatu	26	3,039
Ecuador	75	3,860
Paraguay	68	4,892
Fiji	50	6,187
Tunisia	50	7,806
Malaysia	32	9,830
Mauritius	14	12,351
KENYA	77	1,141

Figure 4a: Governance Reversion rates

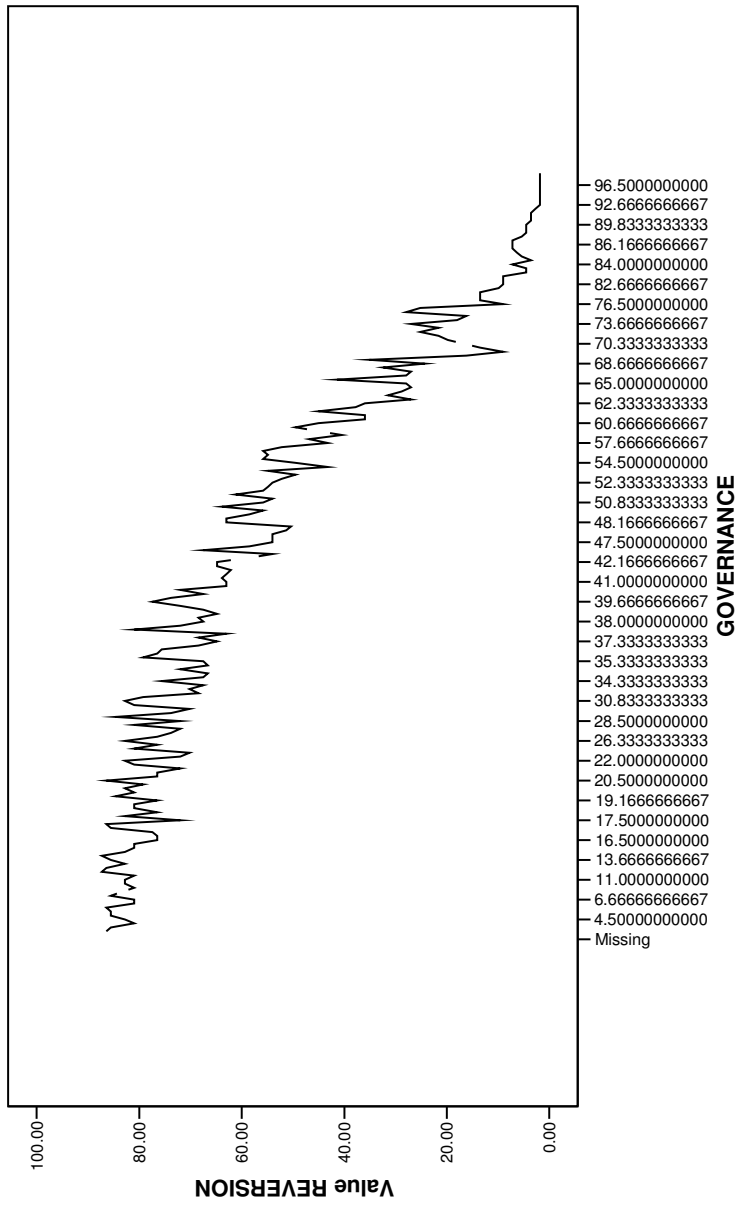


Figure 4b: Governance Reversion Rates

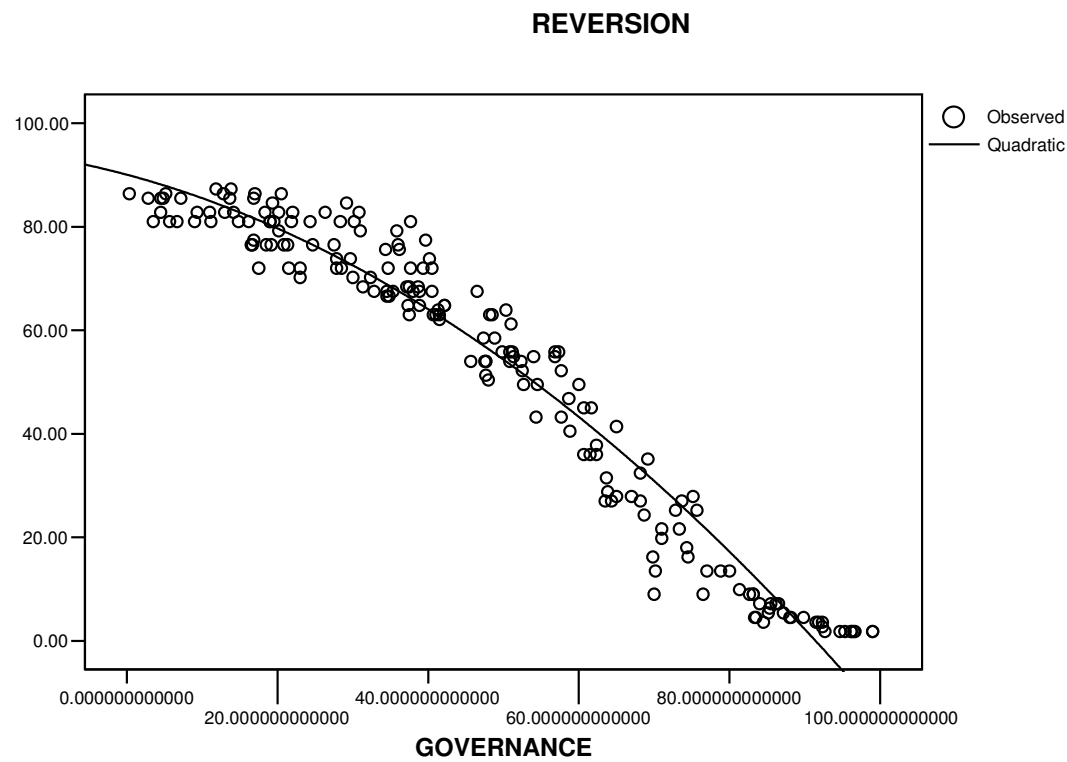


Figure 5a: Governance Reversion Rates and Income

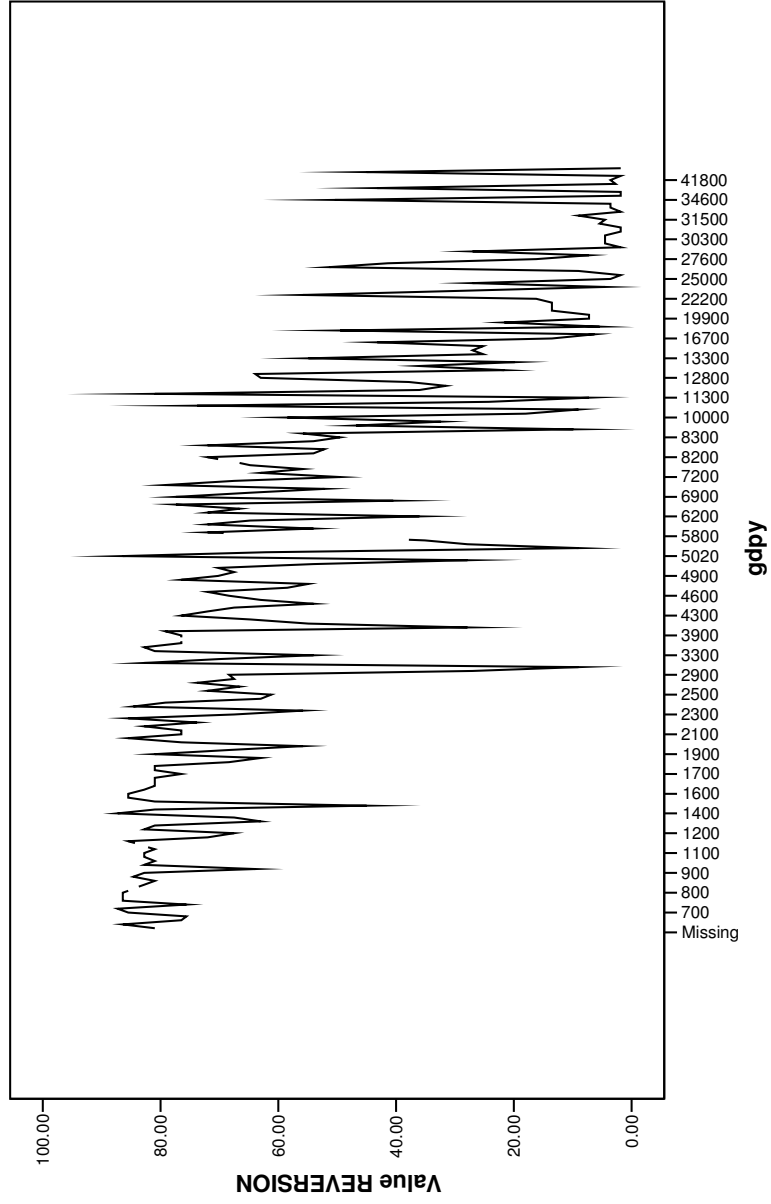


Figure 5b: Governance Reversion Rates and Income

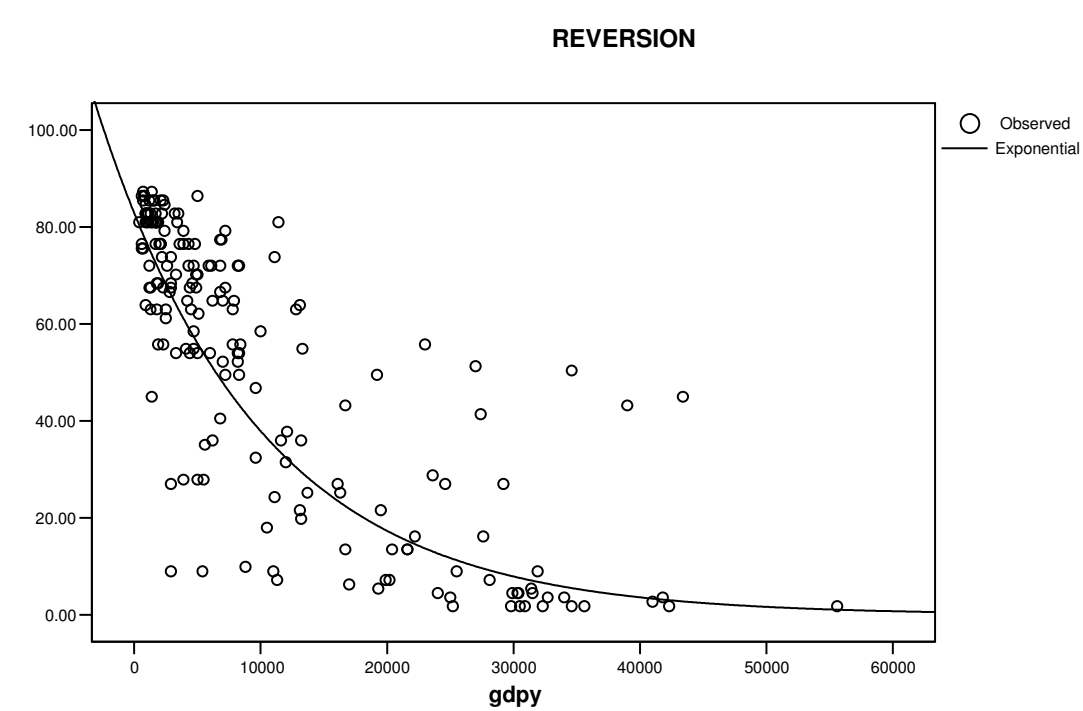
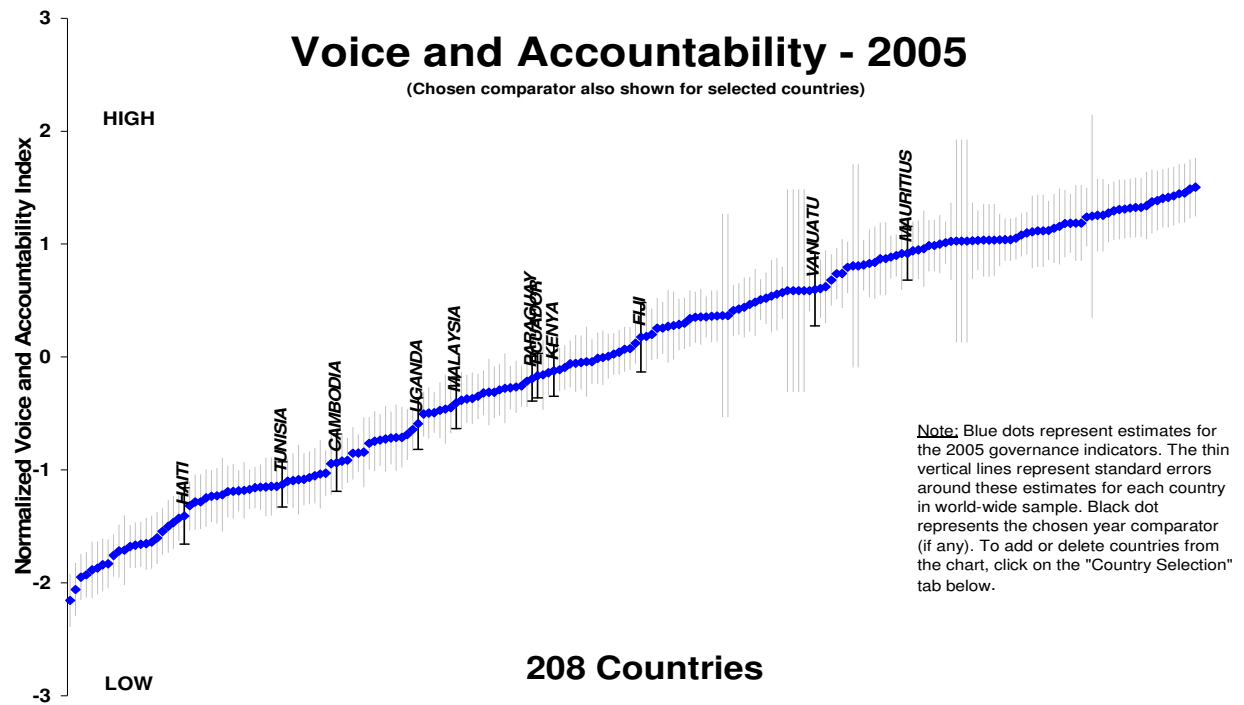


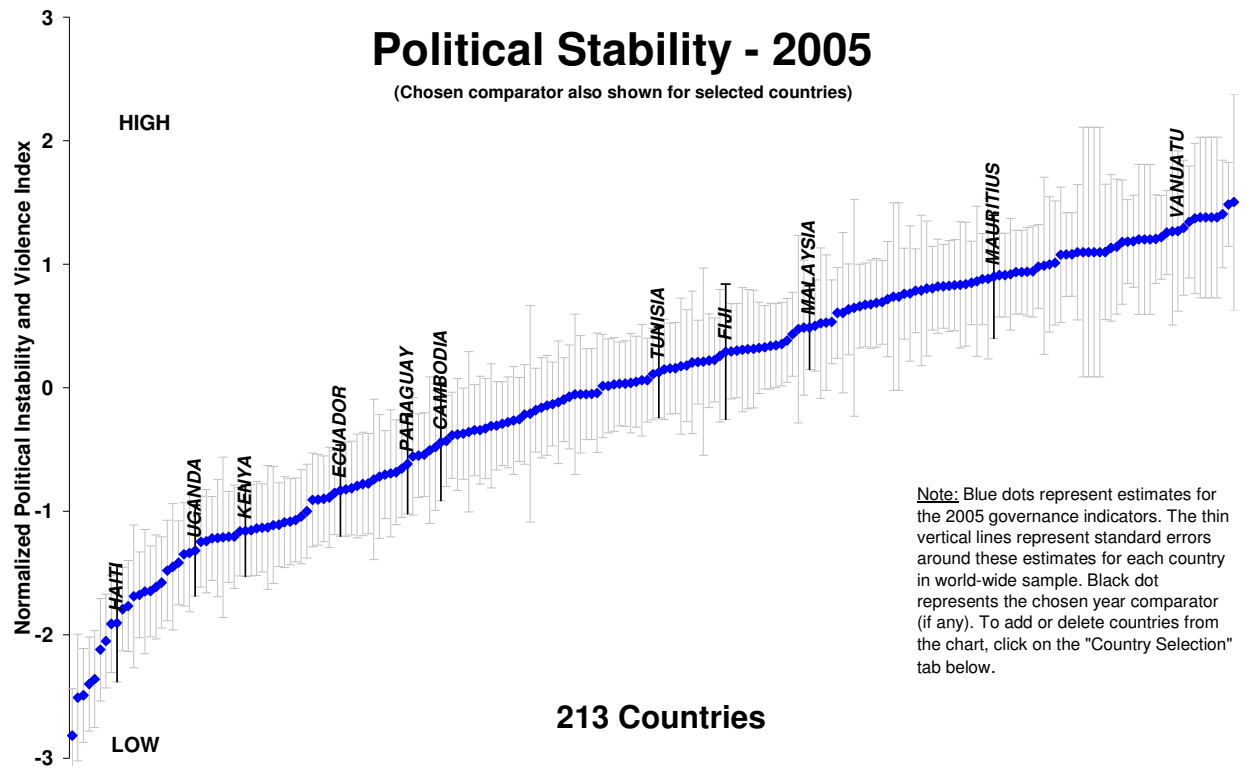
Figure 6:



Source: "Governance Matters V: Governance Indicators for 1996-2005 " by Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi.

Disclaimer: The governance indicators presented here reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators in no way reflect the official position of the World Bank, its Executive Directors, or the countries they represent. As discussed in detail in the accompanying papers, countries' relative positions on these indicators are subject to margins of error that are clearly indicated. Consequently, precise country rankings should not be inferred from this data.

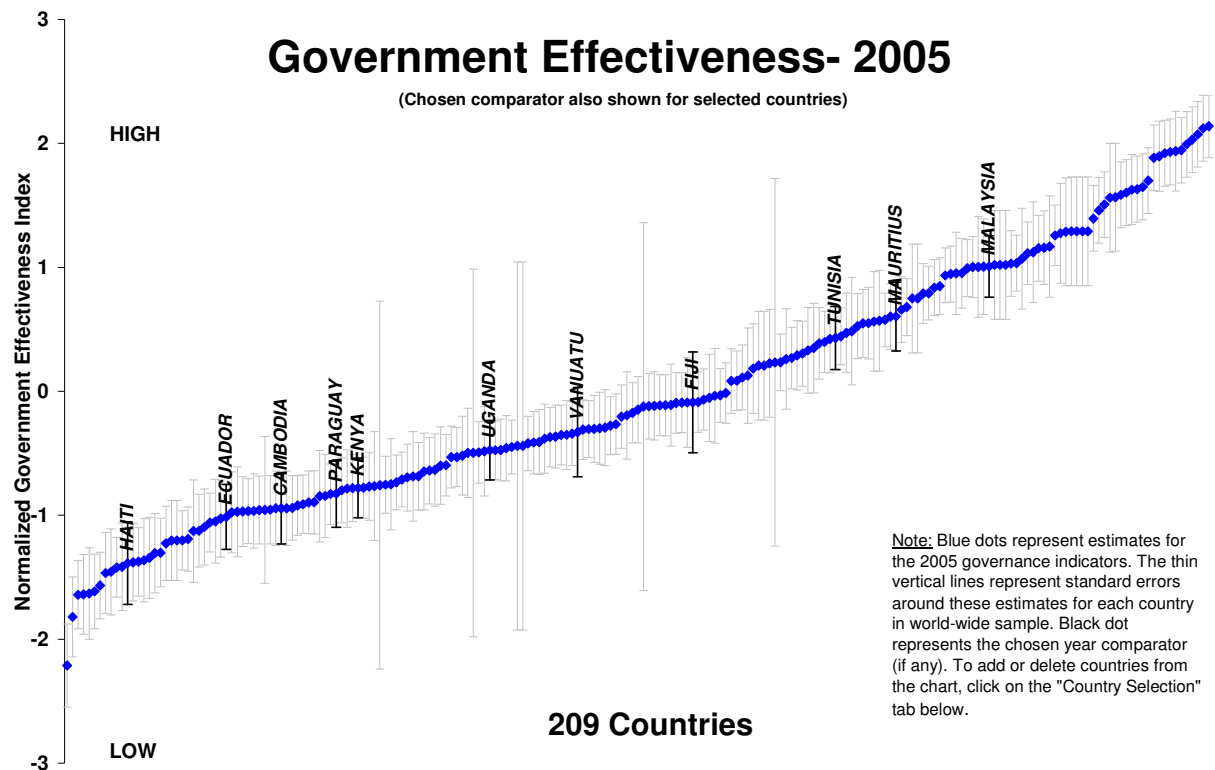
Figure 7:



Source: "Governance Matters V: Governance Indicators for 1996-2005 " by Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi.

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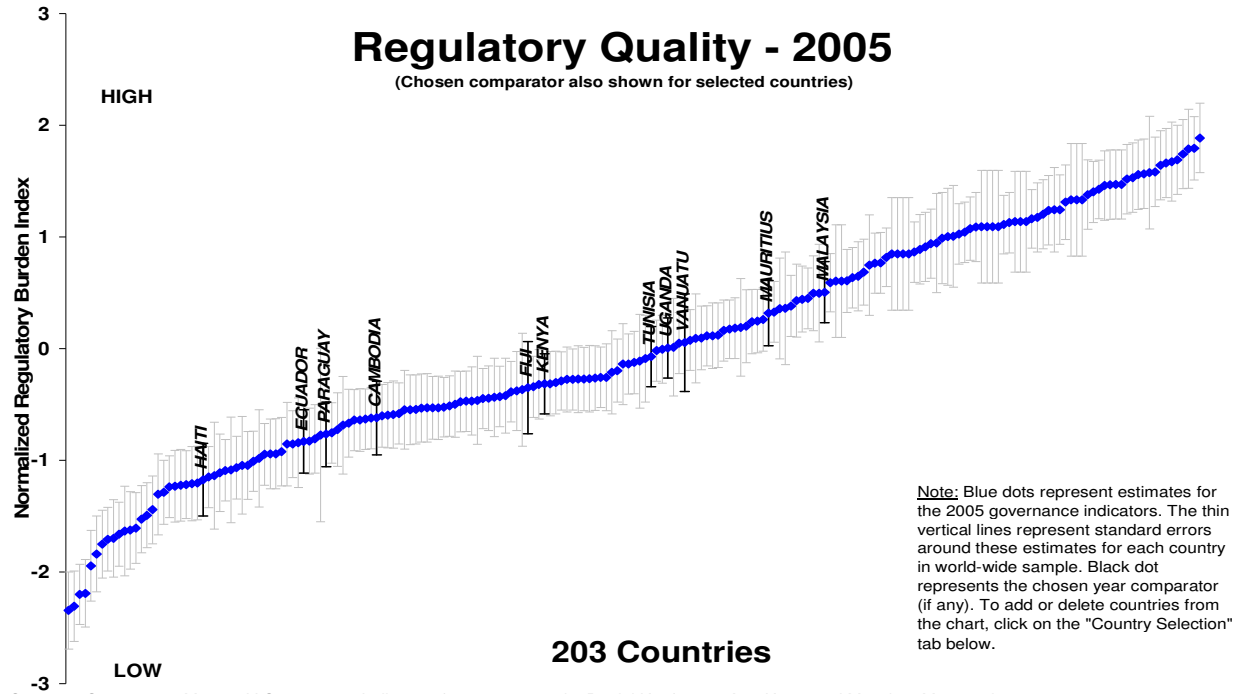
Figure 8:



Source: "Governance Matters V: Governance Indicators for 1996-2005" by Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi.

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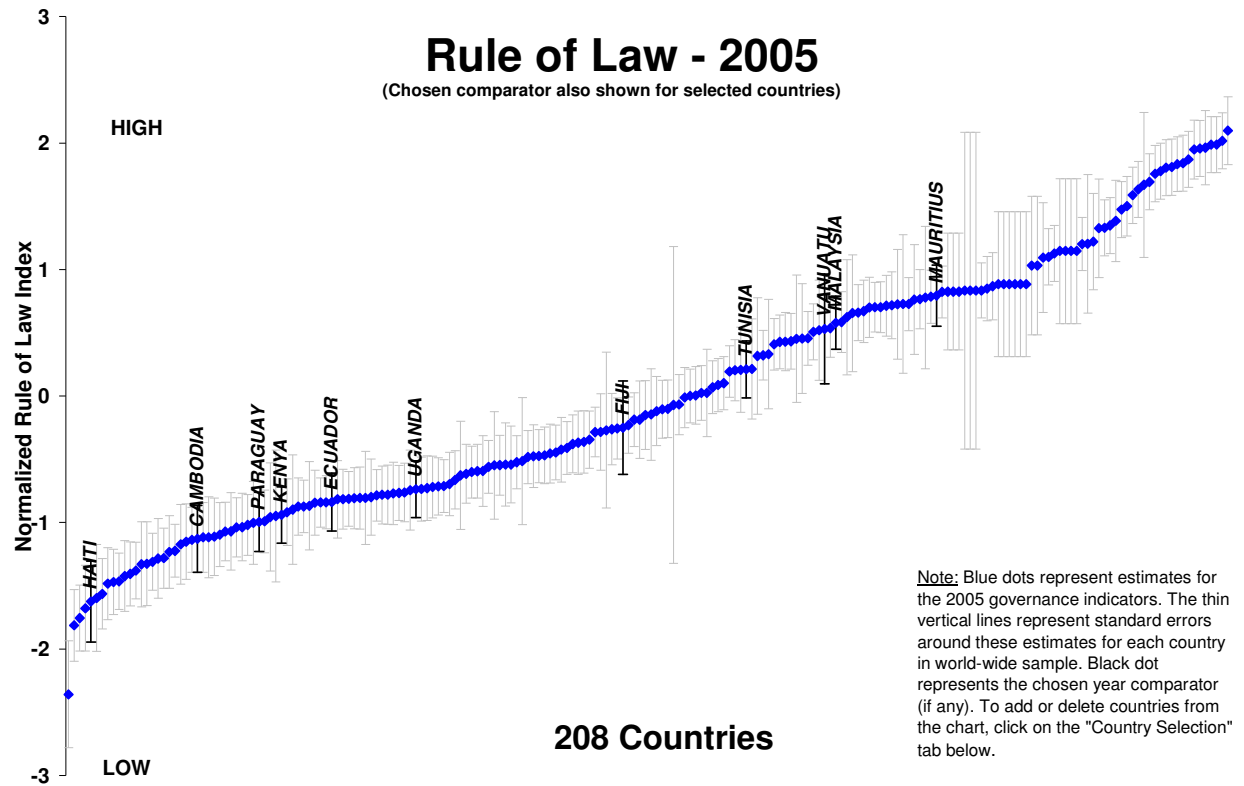
Figure 9:



Source: "Governance Matters V Governance Indicators for 1996-2005 " by Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi.

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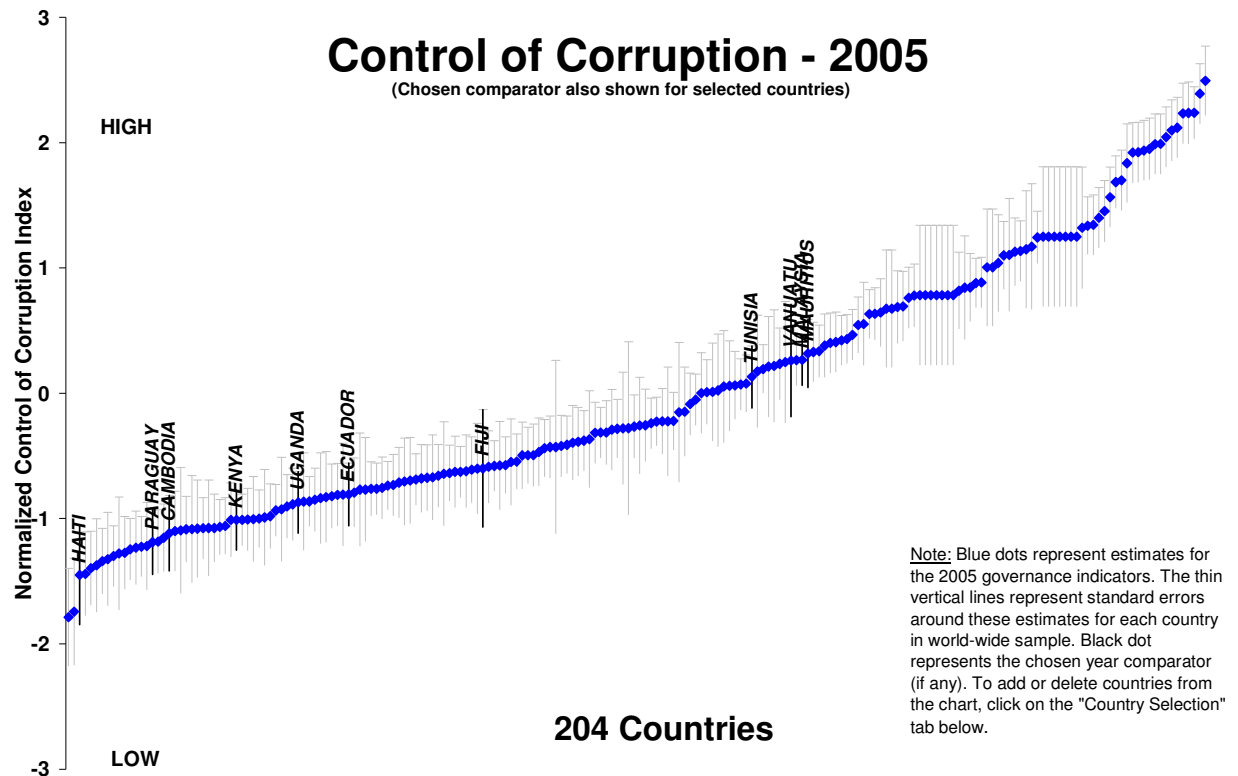
Figure 10:



Source: "Governance Matters V: Governance Indicators for 1996-2005 " by Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi.

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Figure 11:



Source: "Governance Matters V: Governance Indicators for 1996-2005 " by Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi.

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