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## The Failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya

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# The Failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya

Kiarie Mwaura

## **Abstract**

This Article argues that the initiatives adopted in order to make parastatals more efficient are inadequate and will not realize the intended objectives unless the chief executives of parastatals are hired on a competitive basis, given more autonomy and the government is committed not only to designing performance contracts that set realistic standards, but also enforcing them strictly. It also contends that there is a need to streamline the multiple regulations that govern parastatals and reform the corporate regulatory framework of the private sector in order to raise standards of corporate governance and, as a result, ensure that the privatized services are managed prudently.

# THE FAILURE OF CORPORATE GOVERNANCE IN STATE OWNED ENTERPRISES AND THE NEED FOR RESTRUCTURED GOVERNANCE IN FULLY AND PARTIALLY PRIVATIZED ENTERPRISES: THE CASE OF KENYA

*Kiarie Mwaura\**

## INTRODUCTION

Parastatals<sup>1</sup> are deeply implicated in most fiscal problems of African governments because of their inefficiency, losses, budgetary burdens, and provision of poor products and services.<sup>2</sup> Occasionally, they achieve some non-commercial objectives, which are used to justify their poor economic performance.<sup>3</sup> Due to the economic crisis facing Kenya since the mid 1970s,<sup>4</sup> the country has been dependent on financial assistance from the World Bank and the International Monetary Fund ("IMF").<sup>5</sup> To resolve

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1. Parastatals are statutorily authorized corporate entities which earn their revenue from the sale of goods and services and in which the government holds a majority of shares. See The State Corporations Act, (1986) Cap. 446 § 2. (Kenya). They are also referred to as State Owned Enterprises. See, e.g., SRI INT'L, PARASTATALS IN KENYA: ASSESSMENT OF THEIR IMPACT AND AN ACTION PLAN FOR REFORM: FINAL REPORT PREPARED FOR KENYA ASSOCIATION OF MANUFACTURERS I (1992).

2. African governments are keen to privatize parastatals because of the losses resulting from their inefficiency. By 1997, the World Bank had documented more than 2700 privatizations in Africa. See Leon Louw, *Making Privatization Work in South Africa*, 2 ECON. REFORM TODAY 24-25 (1999), available at [http://www.cipe.org/publications/ert/e32/e32\\_7.pdf](http://www.cipe.org/publications/ert/e32/e32_7.pdf).

3. See John Nellis, *Public Enterprises in Sub-Saharan Africa*, in BARBARA GROSH, PUBLIC ENTERPRISE IN KENYA: WHAT WORKS, WHAT DOESN'T, AND WHY 7 (1991).

4. Despite the government's massive investment in the parastatal enterprises, the Treasury received only UK£2.2 million as dividends between 1978 and 1979. Although the government had invested in more than 300 enterprises, this amount was paid by only six enterprises. See REP. OF KENYA, THE 1982 WORKING PARTY ON GOVERNMENT AND EXPENDITURE 40-41 (1982).

5. The World Bank and the International Monetary Fund ("IMF") are the most influential donor agencies in Kenya. The IMF's relationship with Kenya started when it lent the country funds to purchase the land occupied by colonial settlers in order to resettle Africans. Attempts to initiate policy reforms by the agencies have not been successful. For instance, the liberalization of the agricultural sector has led to the de-

the economic crisis facing the country, these two lending agencies, in 1980, successfully urged the Kenyan government to adopt structural adjustment programs, which would reduce government participation in productive activities.<sup>6</sup> Although the government agreed to reduce its participation in the economy, some government intervention was deemed necessary for the purposes of guiding appropriate development of the country. The intervention was preferred in order to ensure a stable, conducive economic environment for private sector activities and to provide administrative and social services, such as health and water, which the private sector could not readily offer.<sup>7</sup> The international lending agencies were also keen to advocate the privatization of parastatals in order to enhance their efficiency.<sup>8</sup> In spite of the pressure on the Kenyan government to privatize them in order to improve their productivity, the change of government in 2002 and the better provision of public services have given rise to the possibility of improving the performance of parastatals without privatizing all their services.<sup>9</sup> While the conditions imposed in the past by the donors might have been justified because there was no other means of redeeming parastatals from mismanagement, the current government feels that donors need to change their stance given that the new administration is committed to economic reforms and is not as marred by corruption as the former. Rather than divesting its entire stake in parastatals, the government has sought to privatize some selected services and give priority to local investors rather than foreign ones.<sup>10</sup> To do so, it has enacted the Privatization Act of 2005

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cline of the sector, as Kenya's produce has not competed effectively with foreign produce. See Matin J. Keng'ore, *Why We Should be Wary of the World Bank, IMF*, E. AFR. STANDARD (Kenya), Oct. 1, 2001, at 7.

6. The structural adjustment program was meant to enhance the role of the private sector and market forces, reduce government expenditure and its level of participation in the economy, further budget austerity, liberalize both domestic and external trade, and reform exchange rate management. See SRI INT'L, *supra* note 1, at 10.

7. See REP. OF KENYA, *supra* note 4, at 42.

8. See SRI INT'L, *supra* note 1, at 9.

9. The current National Rainbow Coalition ("NARC") Government came into power in December 2002 after defeating the Kenya African National Union ("KANU") Party. See *New Kenyan President Vows to Deliver on Economic Promises*, N.Y. TIMES, Apr. 10, 2003, at A15.

10. See Muna Wahome, *World Bank Goes Easy on Privatization*, DAILY NATION (Kenya), Feb. 18, 2003; see also *Tread Softly on Parastatals*, DAILY NATION (Kenya), June 20, 2003; *Go Slow on Privatization*, DAILY NATION (Kenya), June 19, 2003.

which, among other targets, seeks to involve the private sector in order to improve the infrastructure and the delivery of public services.<sup>11</sup> It has also entered into performance contracts with directors of parastatals whereby they have promised to achieve set targets within a particular period and the government has increased their remuneration and promised to award a bonus when the targets are met or to replace them when they are not.

It is against this background that this Article assesses the effectiveness of the measures that have been initiated in order to improve the productivity of parastatals. An examination of their development, effect on the economy, and reasons for their poor performance will shed light on the adequacy of the measures introduced to improve their efficiency. This Article argues that the initiatives adopted in order to make parastatals more efficient are inadequate and will not realize the intended objectives unless the chief executives of parastatals are hired on a competitive basis, given more autonomy and the government is committed not only to designing performance contracts that set realistic standards, but also enforcing them strictly. It also contends that there is a need to streamline the multiple regulations that govern parastatals and reform the corporate regulatory framework of the private sector in order to raise standards of corporate governance and, as a result, ensure that the privatized services are managed prudently.

## I. BACKGROUND

### A. *Theoretical Framework*

Parastatals were first established in Kenya by the colonial government to provide services that were not provided by the private sector.<sup>12</sup> They control key sectors such as agricultural exports, transport and communications, manufacturing and agricultural trade.<sup>13</sup> The government exercises immense control over parastatals, as it has powers to appoint directors and issue directives of a general nature.<sup>14</sup> The need for privatization is

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11. The Privatization Act, (2005) Cap. 2 § 10. (Kenya).

12. See GROSH, *supra* note 3, at 11.

13. See *id.* at 1.

14. For example, Legal Notice No. 59 of February 25, 1987 exempted parastatals including the Kenya Commercial Bank, the National Bank of Kenya, the Kenya National Assurance, and the Kenya Re-Insurance Corporation.

attributable to the failure of the State, as an owner of enterprises, to motivate the firms to realize competitive business standards.<sup>15</sup> However, it is notable that most parastatals were not set up to make profits and, as such, profit maximization ought not to be the sole basis for measuring their efficiency.<sup>16</sup> Although profits can be realized from privatization of public services, the resultant social cost borne by the public is often enormous. For instance, the privatization of water services in Ghana in 2000 resulted in the price of water rising by ninety-five percent which was beyond the reach of the poor.<sup>17</sup> South Africa experienced an outbreak of cholera in 2000 when water services were privatized.<sup>18</sup> In Kenya, the privatization of water services has resulted in the private sector concentrating its services in urban areas where sales and profits are guaranteed.<sup>19</sup> Privatization has also resulted in labor layoffs, insecurity and an increment of temporary and casual labor.<sup>20</sup> Although such policies affect the standards of living of the public and violate their socio-economic rights, neo-classical economists<sup>21</sup> argue that such measures are justifiable because the net gain from them is greater than the net loss.<sup>22</sup> The benefits gained by shareholders are seen to outweigh

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15. See Saul Estrin, *State Ownership, Corporate Governance and Privatisation*, in CORPORATE GOVERNANCE, STATE OWNED ENTERPRISES AND PRIVATISATION 11 (Org. Econ. Cooperation & Dev. ("OECD") ed., 1998).

16. Opponents of privatization argue that social welfare ought not to be measured in exclusively economic terms. See Cass Sunstein, *Well-Being and the State*, 107 HARV. L. REV. 1303, 1304 (1994).

17. See Sara Grusky, *Privatization Tidal Wave: IMF/World Bank Water Policies and the Price Paid by the Poor*, MULTINATIONAL MONITOR (2001), available at <http://www.multinationalmonitor.org/mm2001/01september/sep01corp2.html>.

18. See Ginger Thompson, *Water Tap Often Shut to South Africa Poor*, N.Y. TIMES, May 29, 2003, at A1.

19. See *Change Water Act to Encourage Investors*, DAILY NATION (Kenya), May 16, 2003.

20. Between 2000 and 2003, 40,000 civil servants and 20,000 employees of parastatals (including public universities) were retrenched. See KENYAN SOC. WATCH COAL., *PRIVATIZATION: THE STARK REALITIES OF AN IDEOLOGICAL ORTHODOXY*, <http://www.socwatch.org.uy/en/informesNacionales/175.html> (last visited Oct. 1, 2007).

21. This term is used interchangeably with economic contractarian theorists. See generally DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* (3d ed. 1986); Armen Alchian & Harold Demsetz, *The Production, Information Costs and Economic Organizations*, 62 AM. ECON. REV. 777 (1972); Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Frank Easterbrook & Daniel Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425 (1993); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

22. This is referred to as the Kaldor-Hicks efficiency. See generally John Hicks, *The*

the losses suffered by workers and other stakeholders and the transaction is therefore considered to be efficient because those who gain can compensate the losers and still remain better off.<sup>23</sup>

The failure to measure performance by profitability is regarded by neo-classical law and economics theorists as the main cause of the inefficiency of parastatals, as it deprives them of the incentive to increase gains, cut costs, and operate efficiently.<sup>24</sup> It is for this reason that proponents of the neo-classical law and economics theory regard privatization as a requirement for achieving a free capitalist market economy and as the best way to enhance operational efficiency because the need to increase individual gains or wealth maximization in a free market results in efficiency and therefore contributes to the general social welfare and economic benefits.<sup>25</sup> The competition and efficiency arising from privatization is justified on the basis that it leads to the better provision of services at a lower cost and therefore enhances the enjoyment of socio-economic rights.<sup>26</sup>

On the other hand, opponents of privatization are of the view that it does not lead to enhanced efficiency and economic growth because privatization often leads to the creation of monopolies, as parastatals are often sold to a few rich individuals or foreign investors. Although the inequality resulting from the concentration of resources in the hands of a few individuals has been justified on the basis that people are inherently unequal,<sup>27</sup> it clearly renders services expensive and beyond the reach of the poor and thus contravenes the non-contentious constitutional reform measures that Kenya seeks to adopt and which guarantee the provision of basic public services, such as water, housing, sanitation, social security and freedom from hunger.<sup>28</sup>

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*Valuation of the Social Income*, 7 *ECONOMICA* 105 (1940); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549 (1939).

23. See Hicks, *supra* note 22, at 111; Kaldor, *supra* note 22, at 550.

24. See Danwood Mzikenge Chirwa, *Socio-Economic Rights and Privatization of Basic Services in South Africa: A Theoretical Framework*, 4 *ECON. SOC. RIGHTS REV.* 1, 3 (2003).

25. They also regard the capitalist system as the best method of promoting the general welfare because it is the most efficient economic system. See, e.g. GARY BECKER, *THE ECONOMIC APPROACH TO HUMAN BEHAVIOR* 3-14 (1976); RICHARD POSNER, *THE PROBLEMS OF JURISPRUDENCE* 353 (1990).

26. See Chirwa, *supra* note 24, at 3.

27. John Rawls has argued that the inequality may be used to benefit the least advantaged members of the society. See JOHN RAWLS, *A THEORY OF JUSTICE* 7-10 (1999).

28. See Draft Constitution, arts. 60-65 (2004) (Kenya), available at <http://kenya.rcbowen.com/constitution/chap5.html#70>; see also Godfrey Odongo, *Socio-economic*

It is true to observe that state ownership of parastatals might be in the best interest of the public, even when some of them are not as efficient as businesses in the private sector.<sup>29</sup>

Neo-classical economists regard a company as a unit for all bargaining arrangements which the participants in a company seek to use with a view to maximizing wealth through beneficial bargains.<sup>30</sup> According to them, all participants in a company enter into contracts with corporate management. It is these contracts which stipulate the extent of their claims against the assets of the company.<sup>31</sup> The firm is, therefore, seen as a "nexus of contracts" where the board of directors, being the agent for shareholders, purchases managerial services and monitors the implementation of managerial policies and performances.<sup>32</sup>

The relationship between the participants in a company is usually characterized by conflicts of interests.<sup>33</sup> For instance, conflicts may arise while disbursing dividends or financial losses, allocating responsibility for the performance of tasks, and determining the level of care and skill expected from directors. Contractarian theorists analyze these conflicts from an economic perspective, and thus maintain that an agency relationship arises when one individual relies on another.<sup>34</sup> In such a scenario the person undertaking the duties is the agent and the affected party is the principal. The principal incurs agency costs when the agent fails to act in the best interests of the principal. To reduce agency costs, the principal may opt to incur monitoring costs with a view to ensuring that the agent acts in the best interests of the principal.<sup>35</sup> According to contractarians, there is an agency relationship between shareholders and directors because the principal (shareholder) engages another person (director) "to

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*Rights in the Draft Constitution of Kenya: Prospects for Their Judicial Enforcement, Community Law Centre*, 6 *ECON. SOC. RIGHTS REV.* 1, 6-7.

29. Developed countries also limit foreign investment in some industries, such as airline and telecommunications, which are considered risky to be in the hands of foreigners.

30. See generally Jensen & Meckling, *supra* note 21, at 3-9.

31. See *id.* at 9.

32. See Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 *J.L. & ECON.* 301, 302-11 (1983).

33. See George Stigler, *The Economics of Conflict of Interest*, 75 *J. POL. ECON.* 100, 101 (1967).

34. This concept is referred to as the "agency cost." See Jensen & Meckling, *supra* note 21, at 5.

35. See *id.*



perform some service on their behalf which involves delegating some decision-making authority to the agent.”<sup>36</sup> Given that shareholders rely on directors to run a company efficiently in order to derive profits, any misconduct on the part of directors imposes agency costs on shareholders.<sup>37</sup>

The poor performance of the board of directors of parastatals has been attributed to the existence of multiple agents.<sup>38</sup> Unlike a private company, which has a single principal (shareholders) and agent (managers), a parastatal is governed by multiple agents, namely managers and the state or public officials. Voters who elect public officials are considered to be the principals of both the board of directors and the State. Inefficiency of the boards of parastatals arises because the agents (public officials) who have the powers to appoint board members and issue managerial directives do not always act in the best interest of parastatals, but in the interest of voters who can vote them out.<sup>39</sup>

#### B. *The Impact of Parastatals on the Kenyan Economy*

Kenya’s Gross Domestic Product (“GDP”) growth rate of more than five percent in 2005 is a great improvement from the negative GDP growth rates it has had in the past.<sup>40</sup> In the past, the poor state of the economy has contributed to the country’s heavy dependency on international lending agencies.<sup>41</sup> Despite this dependency, the continuous structural adjustment of the extension of credit to the country by the donor agencies has had little impact on the economy of Kenya.<sup>42</sup> Increasing internal debts have reduced the creditworthiness of the country and, in-

36. *Id.*

37. *See id.*

38. *See* Jim Brumby & Michael Hyndman, *State Owned Enterprise Governance: Focus on Economic Efficiency*, in *CORPORATE GOVERNANCE, STATE OWNED ENTERPRISES AND PRIVATISATION*, *supra* note 15, at 33, 38-41.

39. *See id.* at 38-41.

40. It had a 2.4% growth rate in 2000. *See* WORLD BANK, *WORLD DEVELOPMENT REPORT: BUILDING INSTITUTIONS FOR MARKETS* 232 (2002), *available at* <http://www.worldbank.org/wdr/2001/>.

41. *See generally* CENT. INTELLIGENCE AGENCY, *THE WORLD FACTBOOK* 2004, *available at* <http://www.cia.gov/library/publications/the-world-factbook/geos/ke.html>.

42. By November 2000, Kenya’s external debt had increased from UK£16.2 million at the end of 1998 to UK£93.6 million. In 1998, the World Bank’s Operations Evaluation Department said only slightly more than half of its projects in Kenya were satisfactory. *See* Peter Okong’o, *An Economy at War with Itself*, *E. AFR. STANDARD* (Kenya), Apr. 25, 2001, at 1.

deed, debts owed by parastatals have paralyzed operations of some local creditors.<sup>43</sup> For example, in 2001, Reli Co-operative Savings and Credit Society sought the help of the government to recover 591 million Kenyan shillings from the Kenya Railways Corporation (a parastatal).<sup>44</sup> Similarly, another parastatal, the Tana River and Athi River Development Authority ("TARDA"), which was on the verge of insolvency at that time, also sought the assistance of the government to recover debts owed to it by another parastatal, the Kenya Power and Lighting Company.<sup>45</sup>

Although parastatals accounted for about eleven percent of GDP between 1986 to 1990, they were responsible for a net outflow of three billion Kenyan shillings, equivalent to 0.9% of GDP in 1991, from the central government.<sup>46</sup> As a result of such debts, international lending agencies have been urging the government to privatize parastatals in order to reduce public spending and improve their general performance.<sup>47</sup>

To reverse the deteriorating performance of parastatals, the government sought to increase the role of the private sector in order to foster dynamic economic growth. The belief that resources are likely to be used more efficiently if they are transferred to the private sector led the government to adopt a privatization program.<sup>48</sup> Although the program had started with the idea of reducing state spending and enforcing market discipline, some investors have been reluctant to conduct business in Kenya and, indeed, some have, in the past, relocated their enterprise away from the country due to the poor prospects of economic

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43. According to the World Investment Report by the United Nations Conference on Trade and Development ("UNCTAD") for the year 2001, the foreign direct investment flows to sub-Saharan Africa decreased from UK£5.6 billion in 1999 to UK£4.6 billion in 2000. See U.N. CONF. ON TRADE & DEV., WORLD INVESTMENT REPORT 2001: PROMOTING LINKAGES 20 (2001). Other factors contributing to lack of foreign investment are: slow pace in privatizing parastatals, general bureaucracy, bad infrastructure, crime, high power tariffs, heavy duties, and regulatory constraints. Some companies, such as Pfizer and Johnson & Johnson, cited some of these reasons as contributing to their decisions to depart from Kenya. See Daniel Akoko & Ogova Ondego, *Pfizer to Pull Out of Kenya*, DAILY NATION (Kenya), Sept. 6, 2001, at 1-2.

44. See Margaret Were, *Arrest Warrant for KR boss*, E. AFR. STANDARD (Kenya), Feb. 6, 2002, at 10.

45. See Biketi Kikechi, *Tarda on Verge of Collapse*, E. AFR. STANDARD (Kenya), June 27, 2001, at 12.

46. See INST. OF ECON. AFFAIRS, PROMOTING COMPETITIVENESS & EFFICIENCY IN KENYA 15 (2002).

47. See *Tread Softly on Parastatals*, *supra* note 10.

48. See *id.*; Were, *supra* note 44, at 30.

improvement.<sup>49</sup> However, the change of government in 2002 and the willingness of the current government to tackle corruption and adopt other economic reforms have led to an increase in the number of investors willing to invest in Kenya.<sup>50</sup> Thus, the reforms being undertaken are likely to improve governance and attract investment given that investors are not likely to be attracted to countries without stable economic and regulatory systems.

### C. *Development of Parastatals*

As stated earlier, parastatals were first established in Kenya by the colonial government on the understanding that they would be the most appropriate mechanism for providing services that were not provided by the private sector.<sup>51</sup> In addition, it was felt that public enterprises were better placed to curb the exploitation of consumers.<sup>52</sup> Infrastructural services, such as ports, railways, airlines, post and telecommunications fell into this category. Crop marketing boards were also established by settler farmers with a view to marketing their produce.<sup>53</sup> The majority of them resembled co-operatives to a large extent because they had grower representation on the boards of directors.

Before independence, the colonial government adopted the Swynnerton Plan in order to develop a group of progressive middle-class African farmers. As a result, the marketing boards that existed were reorganized to serve large numbers of small

49. According to the UNCTAD World Investment Report for 2001, Kenya is among the ten countries with the highest rate of foreign direct investment outflows in Africa. See U.N. CONF. ON TRADE AND DEV., *supra* note 43, at 22. According to the report, South Africa, Angola, Egypt, Nigeria, and Tunisia attracted investment because of primary extraction, political stability, suitable environment for investment, labor costs, skills, technological advancement, and infrastructure. See Ellud Miring'uh, *Foreign Direct Investment to Africa Drops*, E. AFR. STANDARD (Kenya), Sept. 19, 2001, at 13.

50. See Cathy Majtenyi, *Kenyan President Unveils Plan to Attract Investors*, VOICE AM. NEWS, Mar. 24, 2004.

51. By 1990, the parastatal sector had 255 firms, which employed 115,000 people. Their wage bill represented forty percent of the public sector and twenty-two percent of the national wage bill. See SRI INT'L, *supra* note 1, at v.

52. See GROSH, *supra* note 3, at 11.

53. For instance, the Land and Agricultural Board was established in 1931 to provide credit to settler farmers. Other boards included the Agricultural Regulatory and Commodity Boards, which were mainly established in the 1940s and 1950s for the purposes of marketing and regulating their respective markets. See SRI INT'L, *supra* note 1, at v.

holders.<sup>54</sup> Additional boards, such as the Cotton Lint and Seed Marketing Board and the Kenya Tea Development Authority, were created to cater for the expansion.<sup>55</sup>

Given that most Africans were peasant farmers, agricultural workers in settlers' plantations, and workers in the state sector, the government sought to finance their agricultural, commercial, and industrial entrepreneurship through Development Finance Institutions (parastatals). These included: the Agricultural Finance Corporation of Kenya ("AFC"), the Industrial and Commercial Development Corporation ("ICDC"), and the Industrial Development Bank ("IDB"). Although these parastatals were all successful in the 1960s and 1970s, some, such as the AFC, started experiencing liquidity problems when politically connected farmers, with large farms, took loans with insufficient collateral and continuously defaulted on payments.<sup>56</sup>

After independence, the Kenyan government established similar parastatals with the intention of providing services of a monopolistic nature, Africanizing the sector, and redistributing regional income.<sup>57</sup> As such, the growth of parastatals in Kenya can be attributed to economic as well as social and political objectives.<sup>58</sup> Given that there was a shortage of local entrepreneurs with adequate capital and skills at independence, the government considered it necessary to be involved both directly and indirectly in the economy rather than relying on foreign capital.<sup>59</sup> This enabled the government to play the role of entrepreneur through the medium of parastatals. For example, the Kenya Industrial Estate and the ICDC were established to assist local entrepreneurs to increase their participation in the industrial

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54. See GROSH, *supra* note 3, at 13.

55. See *id.*

56. On November 20, 2001 unsecured loans owed to the Agricultural Finance Corporation of Kenya ("AFC") were two billion Kenyan shillings. See *Government to Write off AFC Debt*, E. AFR. STANDARD (Kenya), Nov. 20, 2001.

57. By the 1980s there were 223 parastatals, which increased to 255 by 1990. By 2001, they had been reduced to 207. Of the 255 in 1990, the government was a majority shareholder in 135 and minority shareholder in 120. Parastatals established between 1963 and 1978 included the Development Finance Corporation, the Agricultural Finance Corporation, the Agriculture Development Corporation, the Maize and Produce Board, the Kenya Industrial Estates, the National Bank of Kenya, the Transport Licensing Board, and the Kenya Reinsurance Board. See GROSH, *supra* note 3, at 12.

58. See SRI INT'L, *supra* note 1, at 5.

59. See *id.*

sector.<sup>60</sup> The Kenyan government deemed it necessary to establish more parastatals in order to facilitate development in sectors which were not attractive to private investors. Such sectors often carried higher investment risks or low returns and, therefore, did not attract investors unless the government reduced risks by participating in joint ventures.

After independence, most foreign investors were wary of investing in Kenya due to the risk of nationalization.<sup>61</sup> As a result, they required the government to be a joint partner in most ventures, which the government agreed to so as to attract foreign capital, technology, and management skills.<sup>62</sup>

Although nationalization of the existing parastatals was not the main objective of the government, most parastatals created after independence assisted in the Africanization of the economy.<sup>63</sup> The main players were firms that provided credit and technical assistance. Such firms helped Africans enter commerce. These included: the Kenya National Trading Corporation ("KNTC") that helped in development of farms, the ICDC, and the National Construction Corporation ("NCC") that helped local people enter the construction industry.<sup>64</sup>

Since the government pursued a mixed economic strategy which allowed both the public<sup>65</sup> and private<sup>66</sup> sectors to supplement each other, it had a commitment to promoting rapid growth, "equitable distribution of incomes, more balanced equi-

60. *See id.*

61. *See id.* at 6.

62. To protect foreign investors, the government enacted the Foreign Investment Act in 1964, which encouraged government shareholding in joint ventures with private partners. *See id.*

63. *See id.* at 6-7.

64. *See SRI INT'L*, *supra* note 1, at 8.

65. It was considered essential for the government to participate in the economy in order to create sensitive controls for the proper utilization of resources. Government participation in the economy was also used as a means of diffusing ownership to the public. This was the case in the large enterprises such as General Motors, Associated Vehicle Assemblers ("AVA"), Kenya Textile Mills ("KTM"), Kenya Breweries Ltd. and Leyland Motors. *See REP. OF KENYA, AFRICAN SOCIALISM AND ITS APPLICATION TO PLANNING IN KENYA 6 (1965).*

66. The creation of a private sector with unrestricted rights was considered a danger as it could lead to the division of the society along class lines. To prevent the growth of private monopolies, the government created parastatals dealing with wholesale trade, such as the Kenya National Trading Corporation ("KNTC") and Uchumi Supermarkets. *See id.* at 12-13.

table distribution of industries,<sup>67</sup> creation of employment opportunities, and the need to supply certain goods and services considered essential to the people."<sup>68</sup> By participating in the economy, the Kenyan government sought to control various economic sub-sectors by, for instance, conserving the scarce public capital resources and offering services at low costs to consumers and producers. This was done with a view to achieving African socialism goals, seeking to give political equality, social justice, and human dignity to all.<sup>69</sup> However, the difficulty in balancing all these interests prompted the government to issue guidelines outlining how it would implement its policies. It observed thus:

The most important of these policies is to provide a firm basis for rapid economic growth. Other immediate problems such as Africanization of the economy, education, unemployment, welfare services, and provincial policies must be handled in ways that will not jeopardise growth. The only permanent solution to all of these problems rests on rapid growth. If growth is given up in order to reduce unemployment, a growing population will quickly demonstrate how false the policy is; if Africanization is undertaken at the expense of growth, our reward will be a falling standard of living.<sup>70</sup>

The government refrained from adopting nationalization policies because of the fear that the process would impede the creation of new assets, absorb state funds, and contribute to the flight of private capital.<sup>71</sup> It was considered that high growth needed higher capital formation that could not be financed through domestic savings alone.

The expansion of parastatals in the 1960s and 1970s illustrates how crucial the parastatal sector was in the development

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67. The government got involved in industries that were considered to be fundamental to industrial development. Sectors regarded as fundamental to the economy included: textiles, chemical and pharmaceutical, mining and construction, machinery and equipment, agro-processing, tourism, finance and banking, electricity and water, and transport and communication. Development finance institutions, such as the Development Finance Corporation and the Industrial and Commercial Development Corporation, were earmarked to help in the establishment of basic industries. They were also supposed to offer professional advice as well as financial assistance to African entrepreneurs venturing into commercial enterprises.

68. See SRI INT'L, *supra* note 1, at 6-7.

69. See *id.* at 7.

70. REP. OF KENYA, *supra* note 65, at 18.

71. See *id.* at 26.

process of the economy. However, their role seems to have changed by the late 1970s and, in turn, the international lending agencies, among other interest groups, started questioning their viability. As a result, Presidential Committees were set up in 1979 and 1982 to investigate the financing of parastatals and they found considerable flaws, including the lack of productivity and increasing foreign ownership and control of key sectors of the economy.<sup>72</sup>

#### D. *Classification of Parastatals*

Parastatals can be divided into four categories, namely:

- Utilities: These are monopolies, which have little or no competition from the private sector.<sup>73</sup>
- Regulatory parastatals: These are semi-monopolies with specific roles to play. Such roles may involve the development of a sub-sector, regulation of production and prices,<sup>74</sup> and marketing by the private sector.<sup>75</sup>
- Commercial or industrial parastatals: These engage in active competition with the private sector.
- Development finance parastatals: These facilitate industrial development and the participation of Kenya nationals in the economy. They achieve this objective by providing funds to industrial and commercial concerns.<sup>76</sup>

#### E. *The Legal Framework*

The majority of commercially-oriented parastatals are incorporated under the Companies Act of 1978 ("Companies Act").<sup>77</sup>

72. See REP. OF KENYA, *supra* note 4, at 42.

73. These include the Kenya Ports Authority, the Kenya Power and Lighting Company, Kenya Railways, and the Kenya Post and Telecommunication Corporation.

74. The Electricity Regulatory Board is endowed with the responsibility of setting consumer prices for electricity.

75. The Cotton Board, for instance, regulates the cotton sub-sector. Others include the National Cereals and Production Board, the Kenya Meat Commission and the Kenya Tea Development Authority.

76. They include the Industrial Development Bank Ltd., the Industrial and Commercial Development Corporation, and the Development Finance Company of Kenya.

77. The Companies Act regulates all companies that are formed or registered under it—this may include companies that are limited by shares or by guarantee and parastatals that are registered under the act. See The Companies Act, (1978) Cap. 486 (Kenya); see also The State Corporations Act, (1986) Cap. 446 § 2(c). (Kenya). On the other hand the State Corporations Act regulates the parastatals in which the government is the majority shareholder. See The State Corporations Act § 2(c). (Kenya).

Others, especially utilities and commercial regulatory bodies, are incorporated under specific enabling legislation.<sup>78</sup> All parastatals, in which the government has controlling equity interests, either directly or through public institutions, are governed by the State Corporations Act of 1986 (“SCA”).<sup>79</sup> However, the President has the power to exempt a state corporation from any or all of the provisions of the SCA.<sup>80</sup> Similarly, the nature of business of a parastatal sometimes necessitates its exemption from the provisions of the SCA. For instance, being involved in financial market dealings may be a reason for exemption, as some measure of confidentiality may be required in order to attract customers who would otherwise be wary of their financial secrets being made public.<sup>81</sup> Although such parastatals are accorded a large measure of autonomy, they are not entirely free from government intervention.

Under the SCA, a parastatal can be established as either a statutory corporation or a company.<sup>82</sup> Parastatals that are established as statutory corporations are not registered under the SCA.<sup>83</sup> However, parastatals that are established as ordinary companies are registered under the Companies Act and are subject to it to the extent that it does not conflict with the SCA.<sup>84</sup>

As opposed to a statutory corporation, the division of powers of parastatal companies is similar to that of private companies established under the SCA. Parastatal companies have, subject to the provisions of SCA, all the powers and privileges of a natural person. Their power flows from the statute creating them and the SCA.<sup>85</sup> Although statutory corporations have all the powers of a natural person, both the statutes establishing them and ministerial directions sometimes limit their powers.

The SCA vests the power of appointing a board of directors in the President and the Minister.<sup>86</sup> The President is also empowered to “give directions of a general or specific nature to a

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78. See, e.g., The Export Processing Zones Act, (1993) Cap. 517, §3. (Kenya) (establishing the Export Processing Zones Authority).

79. See generally The State Corporations Act § 2. (Kenya).

80. See *id.*

81. See *id.*

82. See *id.*

83. See *id.*

84. See *id.*

85. See *id.* § 3(2).

86. See *id.* § 6(1). The President appoints the Chairperson. *Id.* at §6(1)(a). The



board with regard to the better exercise and performance of the functions of the state corporation and the board shall give effect to those directions."<sup>87</sup>

## II. REASONS FOR POOR PERFORMANCE

### A. *Supplementing the Private Sector*

One of the reasons for the poor performance of parastatals is the fact that the objective of some parastatals, as set out by the Kenyan government, is to foster private sector activity rather than their own growth.<sup>88</sup> This often results in conflicts of objectives and can be regarded as a source of inefficiency. The need to assist the private sector partly undermines the efficiency and solvency of parastatals, as the need to have high profits is rarely on the agenda of some parastatals.<sup>89</sup> For instance, despite being nearly half-owned by individuals and institutions, Kenya Power and Lighting has continued to perform mandatory social roles, such as the rural electrification program.<sup>90</sup> Since such parastatals hardly compete with the private sector, they lose the benefits that can accrue from competition. The Hilmer Report on National Competition Policy has recognized the need to allow such competition and it has recommended that:

Markets within the state must not be unnecessarily distorted; each GOC [Government Owned Corporation] must whenever possible compete on equal terms with the private sector and to that end any special advantage or disadvantage of the GOC because of its public ownership or its market power must be removed, minimised or at least made apparent; where a GOC has excessive market power there may be a need for structural reform to increase competition and special monitoring may be necessary to prevent market abuse.<sup>91</sup>

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minister appoints the chief executive and other members of the board. *See id.* at § 6(1)(b)-(e).

87. *See id.* § 7(1).

88. *See* GROSH, *supra* note 3, at 16.

89. *See id.*

90. On May 10, 2001, the government owned 55.08% of the company's shares. *See* Muna Wahome, *The Paradox of Money Owed KPLC*, DAILY NATION (Kenya), Nov. 20, 2001.

91. *See* Darryl McDonough, *Corporate Governance and Government Owned Corporations in Queensland*, 10 BOND L. REV. 272, 289 (1998).

### B. *Appointment of Directors*

The SCA gives the President a strong measure of control over appointments. It allows the President to provide for the management of every public corporation established under the SCA.<sup>92</sup> The President is also empowered to determine the composition of the board of directors.<sup>93</sup>

Generally, a board of directors in a parastatal consists of:

- Chairman appointed by the President
- Chief Executive
- The Permanent Secretary of the parent Ministry
- The Permanent Secretary of the Treasury
- Less than seven other members who are not employees of the state corporation. Three of these are required to be public officers, appointed by the Minister.<sup>94</sup>

Due to the political nature of appointments, parastatal boards are composed of many directors who are ex-civil servants with little or no private business experience.<sup>95</sup> As the *Daily Nation* notes:

In this country, as in the rest of Africa, people seek political power, not to implement programmes or ideologies, but to hand out benefits in the form of jobs and lucrative contracts to their relations and political allies. And, what we call political parties here are institutions, which are bereft of programmes and ideologies. They are mere patronage structures organised by the elite of various ethnic communities for the purposes of capturing state resources for members of their ethnic communities.<sup>96</sup>

The appointment of directors by the President and the Ministers politicizes directorships. The directors, who sometimes serve concurrently as nominated Members of Parliament and Assistant Ministers, act in the interests of their appointers rather than the corporation. From an economic perspective, it is true to say that the performance of directors of parastatals is constrained by the many agency problems that arise from their political appointments. Although the directors are appointed by the State, the

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92. See The State Corporations Act, (1986) Cap. 446 §§ 3, 6. (Kenya).

93. See *id.* § 6.

94. See *id.* § 6(1).

95. See SRI INT'L, *supra* note 1, at 119.

96. Jaindi Kiseru, *Political Patronage Mother of Graft*, DAILY NATION (Kenya), Aug. 1, 2001.

State is not the principal because it derives its mandate from the voters. As a result, both the State and the directors are agents of the voters. This makes it difficult for directors to act in the best interests of parastatals because the State sometimes requires them to pursue political interests in order to meet the expectations of a strategic element of the electorate. This explains why ministerial powers are often used to further political motives, such as enhancing the image of a political party. Indeed, in 2000 the interference in the operations of the National Bank of Kenya by directors who were political appointees led the Central Bank of Kenya to intervene and abolish the post of Executive Chairman in finance parastatals.<sup>97</sup>

Irregular appointment of directors has attracted both local and foreign criticism. For instance, the Parliamentary Public Investment Committee in 2000 urged the Attorney General to introduce legislation that would empower Parliament to vet the appointment of parastatal directors.<sup>98</sup> Similarly, the appointment of some three board members to the membership of the Electric Regulatory Board was challenged in 2001 by the World Bank for not meeting the requirements of the Electric Power Act. The World Bank was concerned with the fact that the government ignored the autonomy of the board and removed one of the directors who had vowed to run the company in accordance with the Electric Power Act rather than the SCA.<sup>99</sup>

The poor and ineffective management of parastatals can be attributed, partly, to the appointment criteria, which is based on political influence rather than relevant technical expertise. This has had detrimental effects on the managerial capacity of the boards and on the morale of competent staff.<sup>100</sup> Given that Kenya adopts subjective standards to assess directors' culpability,<sup>101</sup> the courts are bound to consider the individual circumstances of directors while assessing liability. As such, a vast majority of directors are likely to escape liability for breach of their duties of

97. See *Banks to Get Rid of Executive Chairmen*, DAILY NATION (Kenya), Mar. 3, 2000.

98. See Aggrey Ouma, *Age Limit for the Heads of Parastatals*, E. AFR. STANDARD (Kenya), July 28, 2000, at 2.

99. Prior to this the government had removed and replaced the entire board arbitrarily. See Hussein Mohammed, *World Bank Queries Status of ERB*, E. AFR. STANDARD (Kenya), July 28, 2001, at 1-2.

100. See SRI INT'L, *supra* note 1, at 119.

101. See *generally* *Flagship Carriers Ltd. v. Imperial Bank Ltd.*, (1999) L.L.R. 6 (H.C.K.) (Kenya).

skill and care. The appointment of qualified persons would enhance the performance of the boards by raising the standard of care expected from directors.

### C. Remuneration

The implementation of the Ndegwa Committee of 1979 saw the setting of maximum salaries for chief executives. As a result of this review, some wage employees, because of union affiliation, were able to earn higher salaries than the lower cadre of managers supervising them.<sup>102</sup> Such discrepancy, coupled with the setting of salaries of top parastatal executives by the Office of the President, has contributed to lack of managerial motivation, especially in finance parastatals where competition with the vibrant better-paying private sector is intense.<sup>103</sup>

Additionally, in the past, remuneration has been based on a classification system that classifies all parastatals into six categories from A to F. Although the classification is supposed to rank parastatals according to their importance, it is generally believed that the real classification depends on the closeness of the chief executive to the government. Where a chief executive enjoys a particularly good relationship with the government, his parastatal is likely to be given a higher ranking, even when it does not deserve it.<sup>104</sup> Apart from affecting the motivation of directors, low remuneration discourages them from observing strict business ethics.<sup>105</sup>

In order to curb the effects of poor remuneration on productivity, the Kenyan government has increased the salaries of directors and introduced one-year performance contracts,<sup>106</sup>

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102. See generally PRIVATE SECTOR CORP. GOV. TRUST, STUDY OF CORPORATE GOVERNANCE IN PUBLIC CORPORATIONS AND STATE OWNED ENTERPRISES (Discussion Draft 2001), available at <http://www.ccg.or.ke/reports/SOE.doc>.

103. See GROSH, *supra* note 3, at 167.

104. See SRI INT'L, *supra* note 1, at 49-50.

105. The research conducted by SRI International established that the managers of the Industrial Development Bank ("IDB") felt that their terms of service should have corresponded with that of Kenya Commercial Bank ("KCB"). Although both firms are parastatals it was not possible for the directors to have equal pay due to categorisation of IDB as a state corporation and the exemption of KCB from the State Corporation Act. *Id.* at 50.

106. Under performance contracts, directors of parastatals enter into agreements with the government whereby they promise to achieve set targets within a particular period and, on the other hand, the government promises to award a bonus or give other incentives when the targets are met. See Mary M. Shirley & Lixin C. Xu, *The Empir-*

which are renewable if the individual performance of a director is satisfactory.<sup>107</sup> Although this initiative appears to be a prudent step, it is unlikely to improve productivity because some of the directors who are expected to meet the targets agreed upon with the government lack the managerial capacity to perform efficiently, as they were hired on the basis of their close ties with public officials rather than on merit. They are therefore likely to continue enjoying political protection and it might thus be difficult to remove them from office even when they do not meet the targets set under performance contracts.<sup>108</sup>

In addition, the initiative is unlikely to go as far as expected unless employees are also motivated and boards of directors are given more autonomy. Indeed, research has shown that poorly implemented performance contracts do not improve the performance of parastatals. A study conducted by Shirley and Xu<sup>109</sup> in 1997 to investigate the effectiveness of performance contracts in China indicated that they did not on average improve productivity. Whilst rewarding managers with higher incentives was seen as a factor that improved productivity,<sup>110</sup> most contracts failed to enhance efficiency because they had poor provisions which set the performance targets too low. It was also established that managers were not committed because they were able to bargain down the targets set by the government. In addition, the government was reluctant to include provisions that would introduce reforms that were likely to prejudice workers, as doing so could weaken their political support bases.<sup>111</sup> This shows that performance contracts are unlikely to yield good results in Kenya as well; unless they are properly designed, the government is committed to enforcing them, and the directors are hired on merit and given more autonomy. Safeguards are also needed to ensure that directors do not manipulate the information that is

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*ical Effects of Performance Contracts: Evidence From China*, 17 J.L. ECON. & ORG. 168, 168-192 (2001).

107. Basic salaries have risen from a maximum of 250,000 Kenyan shillings per month to 800,000 Kenyan shillings a month. *See Parastatal Chiefs Sign Job Contracts*, DAILY NATION (Kenya), Dec. 22, 2004; *Revealed: Sh1m-a-Month Pay Deal for State Executives*, DAILY NATION (Kenya), Dec. 21, 2004.

108. *See SRI INT'L*, *supra* note 1, at 49.

109. *See Shirley & Xu*, *supra* note 106, at 193.

110. *See id.* at 191.

111. *See id.* at 193-94.

available to them in order to reflect positive growth of parastatals and, as a result, avoid removal from their offices.

#### D. *Lack of Autonomy*

While the Ndegwa Committee of 1979 attributed no responsibility to the central government for the poor financial performance of parastatals, the 1982 Working Party on Government and Expenditure associated many of the financial problems with central government control.<sup>112</sup> However, it offered only a few suggestions. It particularly castigated the presence of public enterprises in strictly commercial sectors. It observed that in a competitive sector such presence might prejudice the financial stability of parastatals. The Working Party recommended that "the Government should not direct a parastatal to carry out policy related activities which might not be financially sound without providing explicit subsidies for those activities."<sup>113</sup>

The Committee, however, favored their involvement in sectors serving important social functions. It is worth noting that the attempts made by the Ndegwa Committee and the 1982 Working Party on Government and Expenditure were not very effective in reforming parastatals. This view was supported by eighty-five percent of the respondents who took part in a survey conducted by the author in 2001 in Nairobi.<sup>114</sup>

Since the board of directors<sup>115</sup> is made responsible for the proper management of the affairs of parastatals, it is accountable for funds and responsible for the financial business and the management of the parastatal.<sup>116</sup> However, unlike private companies, the ultimate internal control of parastatals lies in the government. The government performs the role of the general

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112. See generally PRIVATE SECTOR CORP. GOV. TRUST, *supra* note 102.

113. See REP. OF KENYA, *supra* note 4, at 42.

114. See Kiarie Mwaura, *Regulation of Directors in Kenya: An Empirical Study*, 13 INT'L CO. & COMM. L. REV. 465, 476 (2002).

115. See The State Corporations Act, (1986) Cap. 446 § 6. (Kenya). The number of board members, ranging from six to sixteen, and composition of the board, varies among parastatals. Although the board of directors has private sector representatives, the management role of private representatives is undermined by the heavy government presence. Section 6 of the State Corporations Act provides that the number of directors should be eleven, of which at least four should be private sector representatives, unless the specific enabling statute provides otherwise. See *id.*

116. See *id.* § 15(1).

meeting by appointing directors and issuing directives.<sup>117</sup>

The Inspector of State Corporations plays an important role in the running of parastatals, as he has the duty of advising the government on all matters affecting the effective running of state corporations. He is also obliged to report to the Minister in respect of management practices within any corporation and to report, to the Controller and Auditor General (Corporations), any cases where moneys appropriated by Parliament are not being applied by the state corporation for the purposes for which they were appropriated.<sup>118</sup> Upon conclusion of investigations, the Inspector has powers to disallow any item of account that is contrary to the law or to any direction lawfully given to a state corporation. He can also surcharge the amount of any expenditure on the person responsible for incurring the expenditure.<sup>119</sup>

The State Corporations Act 1986 entitles a person aggrieved by the decision of the Inspector to appeal to the State Corporation Appeal Tribunal. The Tribunal may confirm, vary, or quash the decision of the Inspector and subsequently remit the case to the Inspector with such directions as the Tribunal thinks fit. Appeals from Tribunal decisions lie in the High Court.<sup>120</sup> The fairness of decisions arrived at in the Tribunal are questionable, as the Tribunal is comprised of a chairman who is appointed by the President and two other members appointed by the Minister.<sup>121</sup>

Since the State Corporations Act does not impose any limit on the ability of Ministers to direct the board, the board of directors is not able to question or review undesirable directions. Ministers are also not under any obligation to adopt sound corporate governance practices.<sup>122</sup> As such, the position of parastatal directors differs from that of their counterparts in the pri-

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117. See generally R. W. James & S. Ligunya, *Organizational Relationships and the Control of Parastatals in Tanzania*, 5 E. AFR. L. REV. 39 (1972).

118. See The State Corporations Act, (1986) Cap. 446 § 18(1). (Kenya).

119. See *id.* § 19(1).

120. See *id.* § 21. It is worth noting that the Tribunal has never been constituted since the State Corporations Act 1986 came into force. Similarly, the State Corporations Advisory Committee, which is meant to administer the law, has never been created. See Jaindi Kisero, *Corporations Act Has Outlived Its Usefulness*, DAILY NATION (Kenya), May 30, 2001.

121. See The State Corporations Act § 22. (Kenya). Although the Law Society of Kenya and the Institute of Certified Public Accountants are required to nominate ministerial appointments, the appointment of the chairman is not subject to such requirements. See *id.*

122. See *id.* §§ 22-23.

vate sector. For instance, parastatal directors may escape liability for considering the interests of the government rather than those of the corporation or the wider community. With such a structure in place, the governance of parastatals can hardly be appropriate, as directors are more likely to act in the interests of the government.<sup>123</sup>

To reinforce transparency in the exercise of ministerial powers, the State of Queensland in Australia requires the publication of any ministerial decision affecting Government Owned Corporations ("GOCs").<sup>124</sup> The State therefore has an important role to play in the control of GOCs. However, directors of GOCs have the power to make decisions regarding the use of resources. In fact, the corporatization process has sought to ensure that external controls placed on GOCs are only limited to matters involving major strategic issues.<sup>125</sup>

The GOCs are subject to two systems of governance, namely the Westminster political system and the laws governing corporations. In monitoring GOCs, therefore, Parliament adopts similar checks and balances as it does on the executive and legislature for strategic decisions.<sup>126</sup> This makes the GOCs more accountable than Kenyan parastatals. It is notable that without reinforcing accountability, parastatals can hardly be expected to be profitable. As Hessel notes, "[t]o run a business [enterprise], management must be accorded ample power to manage, but to run it effectively, it must be held accountable for the use of this power."<sup>127</sup> Although parastatals do not have autonomy, some, such as Kenya Power and Lighting, manage to remain in business due to lack of competition and heavy tariff protection,<sup>128</sup> subsidies, and other special privileges. These privileges, in turn, make it impossible for other companies to compete effectively

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123. See *id.* § 19(4).

124. See McDonough, *supra* note 91, at 310. The GOCs share similarities with Kenyan parastatals because they were established to bring about micro-economic reform in the State. In effect, they are meant to improve the "[s]tate's overall economic performance and the ability of the government to achieve social objectives through improving the efficiency, effectiveness, and the accountability of GOCs." *Id.*

125. See *id.* at 285.

126. See *id.* at 289.

127. See Marek P. Hessel, *How Corporate Governance Makes Privatization Succeed*, ECON. REFORM TODAY 25, No. 4, 1995.

128. See Martin Mutua et al., *Sack All Top KPLC Bosses*, E. AFR. STANDARD (Kenya), Nov. 6, 2001. Kenya Power and Lighting Company charges the highest electricity tariffs in Africa. See *id.*



with parastatals. In fact, most of the seed companies in Kenya have already sought liberalization of the seed sector in order to end the monopoly of the Kenya Seed Company.<sup>129</sup>

### E. *Overlapping Regulations*

Parastatals are subject to overlapping regulations. For instance, although all directors and chief executives of the Communications Commission of Kenya ("CCK") are appointees of the minister under the Kenya Communications Act,<sup>130</sup> CCK is still governed by the State Corporations Act 1986 because it is a state corporation. As such, the President is empowered by the State Corporation Act to appoint the chief executives.

Additionally, parastatals are subject to direct regulation by Parliament.<sup>131</sup> Parliament scrutinizes them under the legislation that establishes them. In most cases, the government exercises control of parastatals through ministers. Since all state corporations fall under a ministry, a minister has powers to give directions of a general character to the organization. Such directions may, for instance, be in relation to matters affecting a national interest; in such a situation, a minister shall determine what constitutes a national interest. Unlike private companies, where a board of directors sets the objectives of the company, the ministers are responsible for identifying such objectives in parastatals. They are bestowed with the responsibility of setting both commercial and non-commercial objectives. The parastatal board must answer to the ministers who are in turn accountable to Parliament. As such, accountability of directors is limited to the financial performance of parastatals.<sup>132</sup>

Additionally, excessive regulations, coupled with extensive ministerial intervention in the functioning of the boards, tend to impair their ability to make commercially sound decisions. Parastatals, including the ones with specific enabling legislation, are required to: 1) report directly to the parent ministry because

129. See Tabitha Onyinge, *Companies Demand Liberalisation*, DAILY NATION (Kenya), Sept. 20, 2001.

130. See generally The Communications Act, (1998) § 6. (Kenya). Section 6 (a) and (b) of the Kenya Communications Act 1998 empowers the President to appoint the chairman and the Minister to appoint the directors. The Kenya Communications Act establishes the Communications Commission of Kenya. See *id.* § 3.

131. See The State Corporations Act, (1986) Cap. 446 § 18. (Kenya).

132. See *id.* § 15(1).

the ministry, in conjunction with the Treasury, must approve parastatal establishment and the remuneration system; 2) obtain budget and investment approval from the Treasury; and 3) justify their accounts before the Public Accounts Committee of Parliament.<sup>133</sup> Also, parastatals are subject to review by the State Corporations Advisory, the Controller, the Auditor-General, and the Inspector-General (Corporations).<sup>134</sup>

The numerous approval requirements have the overall effect of constraining the ability of directors to make commercial decisions and to recruit and retain skilled staff. Moreover, the expediency of the decision-making process is also rendered ineffective by requirements of ministerial approval. For example, a minister, in consultation with the State Corporations Advisory Committee, has to give approval for the employment of a chief executive.<sup>135</sup> The delay in obtaining such approvals is one of the main reasons parastatals are unable to make strategic decisions.<sup>136</sup> As such, the process impacts negatively on the general operational performance of parastatals.

The chief executive of a parastatal may be summoned by the Public Investments Committee to answer, on behalf of the board, any question arising from the report submitted to that Committee by the Controller and the Auditor-General.<sup>137</sup>

#### F. *Fraudulent Transactions*

Service on the board of a parastatal poses a heightened risk of conflicting interests for directors due to the excessive control exerted by political actors. Due to this control, directors of parastatals must take extra precautions to ensure they act in the interests of the company. For instance, duties towards parastatals that are public enterprises are made more onerous because of

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133. See SRI INT'L, *supra* note 1, at 47-48. Borrowing by parastatals must be sanctioned by the Treasury. See *id.*

134. See The State Corporations Act § 18. (Kenya).

135. See *id.* § 5(3).

136. See SRI INT'L, *supra* note 1, at 48-49. Borrowing of money can only be exercised with the consent of the Minister. Remuneration and reward system at the parastatal must be approved by the Minister, Treasury, State Corporations Advisory Committee and the Inspector-General (Corporations). A survey of twelve parastatals conducted in October 1991 indicated that delays in obtaining investment decisions extended to over nine months. In other cases, such as the contentious issue of restructuring parastatals, decision takes more than two years. See *id.*

137. See The State Corporations Act § 15(2). (Kenya).

their involvement in price fixing. For some commodities, prices are kept artificially low either to counter inflation or to make some necessities affordable to consumers. Conversely, prices are set to protect “inefficient enterprises or provide resources for cross-subsidization.”<sup>138</sup>

Most of the problems identified by the Ndegwa Committee continue to effect parastatals. For instance, in August 2001, the Parliamentary Public Investment Committee revealed how directors of the National Social Security Fund abdicated their duties when they awarded themselves executive treats. As a result, the parastatal lost three billion Kenyan shillings (US\$55 million) between 1996 and 1998. Similarly, the Kenya Ports Authority paid allowances to board members above the approved rates. Instead of the approved 1,000 Kenyan shillings per session, board members were paid between 5,000 and 10,000 Kenyan shillings per session.<sup>139</sup>

In addition, the Inspector-General (Corporations) declared the National Housing Corporation (“NHC”) insolvent because of mismanagement. The directors had commissioned real estate projects worth 319 million Kenyan shillings without either competitive bidding or approval of the NHC board of directors. The NHC also lost sixty-nine million Kenyan shillings when the managing director deposited the money into the now-collapsed Prudential Bank, despite opposition by the finance director and a Treasury directive requiring parastatal surplus funds to be invested in Treasury Bills and Bonds.<sup>140</sup>

### *G. Conditions Imposed by International Lending Agencies*

In order to restore the confidence of investors and foster high economic growth, the IMF has advised Kenya to implement measures to address problems of governance, the pursuit of macroeconomics policies, and the acceleration of structural reforms such as privatization.<sup>141</sup> However, the privatization pro-

138. See GROSH, *supra* note 3, at 8.

139. See Catherine Gicheru, *MPs Watchdog Finds More State Looting*, DAILY NATION (Kenya), Aug. 16, 2001.

140. See *id.*

141. See Peter Munaita, *We Shall Not Ease Pressure, IMF Tells Kenya*, E. AFR. STANDARD (Kenya), Oct. 22, 2001 (noting that international lenders have halted US\$300 million in aid due to Kenya’s failure to pass anti-corruption legislation); *Promise the IMF Anything*, E. AFR. STANDARD (Kenya), July 14, 1999 (observing that the IMF has made con-

gram has contributed to the collapse of many parastatals. The structural adjustment loans offered by donor agencies have sometimes expressly required governments to privatize parastatals.<sup>142</sup> Failure to comply with the donor conditions results in withdrawal of aid and loans. The use of such conditions is illustrated by the comments made in 1985 by then-U.S. Secretary of State, George Schultz, requesting that United States Agency for International Development (“USAID”) officials raise certain issues with less developed countries (“LDCs”):

Policy dialogue should be used to encourage LDCs to follow free market principles and to move away from government intervention in the economy . . . to the maximum extent practical governments should rely on the market mechanism—on private enterprise and market forces . . . . Parastatals are generally an inefficient way of doing business . . . . In most cases, public sector firms should be privatized.<sup>143</sup>

Similarly, while announcing resumption of assistance to Kenya in 2000, the IMF board set tough new conditions, which Kenya accepted as part of the aid agreement.<sup>144</sup> Unfortunately, before these conditions were imposed, the IMF suspended financial aid to Kenya in July 1997 as a result of the government’s failure to act on high-level corruption and follow key governance criteria.<sup>145</sup> The IMF’s suspension of aid sparked the withdrawal of other donors, resulting in increased interest rates and a pullout

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tinued aid to Kenya contingent upon civil-service reforms, privatization of some parastatals, and transparency with regard to public finances); Mbatawa wa Ngai, *Shareholders Say No to Board Nominees*, E. AFR. STANDARD (Kenya), May 5-12, 1999 (noting that IMF forced permanent secretary of Treasury to resign following US\$104.4 million drug procurement scandal).

142. See generally Abdul Paliwala, *Privatization in Developing Countries: The Governance Issue*, 1 L. SOC. JUST. & GLOBAL DEV. J. 2 (2000). Privatization was prescribed as a condition in seventy-four World Bank loans during 1980 to 1989. See *id.*

143. NASSAU ADAMS, *WORLDS APART: THE NORTH-SOUTH DIVIDE AND THE INTERNATIONAL SYSTEM* 169-70 (1993).

144. See Peter Munaita, *Did We Sell Our Soul to Get Aid from the IMF?*, DAILY NATION (Kenya), Aug. 3, 2000. Some of the conditions included: weekly inspection of the Central Bank balance sheet by Fund officials in Washington, privatizing Kenya Commercial Bank, and seeking approval of the IMF and World Bank before any new project is introduced during the financial year. By agreeing to the conditions, the government has been criticized for selling “away the country’s sovereignty for a song.” *Id.*

145. See Robert Wanyonyi, *Netherlands Stops Funding Projects*, E. AFR. STANDARD (Kenya), Sept. 19, 2001. The government of Netherlands also stopped funding environmental projects in Kenya when the Kenyan Parliament rejected the Kenya Anti-Corruption Authority (“KACA”) Bill. See *id.*

of foreign investments in Kenya.<sup>146</sup>

The pressure to privatize prompts the IMF and World Bank to offer loans with restraints on the public budget; this limitation reduces public investment that contributes to the indebtedness of the government to parastatals.<sup>147</sup> In general, the policies of the international lending agencies have not been effective in helping the country to improve the governance of institutions and reduce poverty.<sup>148</sup> While some measures, such as privatization, may reduce the intervention of the government in the economy, it is not entirely certain that corporate governance would necessarily improve, since private entities can be as inefficient as state corporations.

#### IV. PARASTATAL POLICY REFORM

A lack of autonomy in a board of directors impacts negatively on its effectiveness, as an independent board is key to appropriate corporate governance. To assess how effective the parastatal boards are in discharging their responsibilities, it is important to consider what the functions of an effective board ought to be.

Similarly, the above functions have been recommended by the Capital Markets Authority of Kenya as being integral to prudent management of publicly listed companies.<sup>149</sup> With these functions in mind, it can be seen that the boards of directors in Kenya are not responsible for setting parastatals' goals, as the function is the responsibility of ministers. The President—not the board of directors—appoints chief executives. The board's inability to do so renders the task of imposing performance levels and sanctions difficult.<sup>150</sup> Similarly, the lack of powers to impose sanctions on the chief executive and other senior executives limits the ability of parastatals to meet their goals.

146. See Washington Akumu, *How IMF Will Pump in Funds*, DAILY NATION (Kenya), July 29, 2000.

147. See generally U.N. MILLENNIUM PROJECT, *INVESTING IN DEVELOPMENT: A PRACTICAL PLAN TO ACHIEVE THE MILLENNIUM DEVELOPMENT GOALS* 193-210 (2005).

148. See *id.* The U.N. has criticized the policies of the international lending agencies for not being compliant with the Millennium Development Goals' approach to poverty reduction. See *id.*

149. See CAP. MKTS. AUTH., *GUIDELINES ON CORPORATE GOVERNANCE PRACTICES BY PUBLIC LISTED COMPANIES IN KENYA* 482-83 (2002).

150. See WORLD BANK, *BUREAUCRATS IN BUSINESS: THE ECONOMICS AND POLITICS OF GOVERNMENT OWNERSHIP* 15 (1995).

Directors of parastatals are not able to perform efficiently because the government does not practice effective corporate governance. As a result, it is true to say that “directors are appointed to a position that carries with it all of the liabilities but are not given the power to carry out the roles that the law imposes.”<sup>151</sup>

This demonstrates the difficulty faced by directors of parastatals when performing their duties. The overall inability of directors to perform efficiently leads to lax cost control, poor quality of financial statements, inadequate management information systems, and insufficient plant management and quality control.<sup>152</sup>

In general, the regulation of parastatal directors can hardly be as efficient as that of the private sector due to the government’s intervention. While public companies have shareholders<sup>153</sup> that can buy and sell shares and monitor the activities of a company, the ownership of parastatals by the general public is virtually compulsory by the payment of taxes which help finance the operations of parastatals. Therefore, since the wider community does not buy or sell shares as a reaction to the effectiveness of management, they can only exercise indirect control of parastatals through the ballot box at a general election.<sup>154</sup> Apart from the inability of shareholders to scrutinize parastatals due to a lack of trading in their equity, other factors that deprive parastatals of the vital scrutiny by shareholders include the inability of shareholders to remove directors of parastatals and the lack of analysis of operations of parastatals by external analysts, such as stockbrokers.<sup>155</sup>

#### A. Steps Initiated by the Government

Although past government policy statements<sup>156</sup> have emphasized the need to reform the parastatal sector, the govern-

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151. See McDonough, *supra* note 91, at 310.

152. See SRI INT’L, *supra* note 1, at 100.

153. See Paliwala, *supra* note 142, at 2. Property rights theorists attribute the poor performance of parastatals to a lack of individual stakes in the assets of the enterprises. *See id.*

154. See McDonough, *supra* note 91, at 294.

155. *See id.* at 288.

156. See MBUI WAGACHA, ANALYSIS OF LIBERALIZATION OF THE TRADE AND EXCHANGE REGIME IN KENYA SINCE 1980 5-9 (2000).

ment did little towards this end until 1985 when it established the office of the Auditor General (Corporations) in order to tighten the control of the financial resources of parastatals by reviewing the enterprises speedily.<sup>157</sup> Similarly, the government sought to enhance investigative and supervisory powers of the Inspectorate of State Corporations Advisory Committee by passing the State Corporations Act in 1986. The State Corporations Act 1986 sought to permit parastatal directors to make independent decisions, to hire staff and chief executives, and to determine their wages.<sup>158</sup>

As a result of the success of the privatization programs in other countries, in 1991, the government sought to privatize the commercial parastatals, close failing parastatals, and reform or restructure the essential utilities and strategic parastatals.<sup>159</sup> At this time, privatization of public utilities had been successfully carried out in other countries such as the United Kingdom, under the direction of Margaret Thatcher.<sup>160</sup> Apart from increasing efficiency, privatization in the United Kingdom attracted public interest in state corporations.<sup>161</sup> It is notable that ninety-one percent of the respondents who took part in a survey conducted in 2001 in Nairobi took the view that privatization of parastatals in Kenya would improve accountability and productivity.<sup>162</sup>

While this measure may partly reduce the adverse impact on the economy, it is doubtful whether privatization is the only appropriate step for Kenya to take, given that management and

157. See AFR. DEV. FUND, COUNTRY GOVERNANCE PROFILE 5 (2004).

158. See The State Corporations Act, (1986) Cap. 446 § 27. (Kenya). Other institutions established to facilitate reform included the Parastatal Review Committee, which was established in the 1980s to review the performance and problems affecting all the parastatals in the country.

159. See Gerrishon K. Ikiara et al., *Kenya: Formulation and Implementation of Strategic Trade and Industrial Policies in the Politics of Trade*, in THE POLITICS OF TRADE AND INDUSTRIAL POLICY IN AFRICA: FORCED CONSENSUS? 205-25 (Charles C. Soludo et al. eds., 2004).

160. See SRI INT'L, *supra* note 1, at 73. Much of the public enterprise output came from state enterprises in telecommunications, gas, electricity, water, rail transport, and postal services. See *id.*

161. See Chiara Gratton-Lavoie, *Essays on Privatization*, Ch. 3, table 2 (June 6, 2000) (unpublished Ph.D. dissertation, Virginia Polytechnic Institute and State University), available at <http://scholar.lib.vt.edu/theses/available/etd-09182000-19510041/unrestricted/Chapter3.PDF>. After Amersham International was offered for sale in 1982, it subsequently made a pre-tax profit of UK£22 million in 1987. See *id.*

162. See Mwaura, *supra* note 114, at 476.

operational constraints are not the only factors affecting parastatals. Indeed, without effective regulation of directors, private enterprises can be equally inefficient.

Past attempts to reform parastatals in Kenya emphasized the strengthening of control mechanisms. For instance, in 1992, following negotiations with the World Bank, the Minister for Finance attempted to introduce in Parliament three bills which would have allowed the Treasury to take over control of parastatals from the Office of the President. The Treasury was meant to exercise its powers in parastatals as a shareholder, delegating powers to the directors in order for the corporate structure to be similar to that of the private sector. They also sought to curb the excessive powers of the State Corporations Act 1986 by abolishing the office of the Inspectorate of State Corporations. However, the government rejected the Bills before they were debated in Parliament, as they undermined presidential powers to appoint directors.<sup>163</sup>

Recent attempts to enhance the performance of parastatals have favored partial privatization. The government has sought to implement a comprehensive parastatal reform program, which includes the privatization of all non-strategic parastatal enterprises and the rehabilitation and reform of all strategic enterprises.<sup>164</sup> The objectives behind the reform program include: 1) reduction of the financial and administrative burden that parastatals impose on the government; 2) increasing efficiency through an improvement of the enabling environment for the private sector; 3) raising government revenue from privatization sales and liquidations; and 4) eliminating preferential treatment to allow a level playing field for the private sector.<sup>165</sup>

### B. *Privatization Bottlenecks*

Although the poor performance of parastatals, coupled with pressure exerted by the donor community and the Kenyan pri-

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163. See Jaindi Kisero, *Leakey Rejects Plea to Exempt Telkom from Act*, DAILY NATION (Kenya), Sept. 12, 2000.

164. See REP. OF KENYA, *supra* note 4, at 42. The 1982 Working Party on Government and Expenditure recommended the privatization of parastatals capable of being well managed by the private sector and the liquidation of non-viable parastatals. *See id.*

165. See generally GOV. OF KENYA, KENYA'S PARASTATAL REFORM PROGRAM (1991) (presented for discussion to the Consultative Group Meeting of Kenya's donors in Paris).



vate sector to have parastatals privatized, has increased, it might take a long time to finalize the process of privatization due to constraints, such as: 1) the reluctance of the government<sup>166</sup> to sell or give up profitable enterprises,<sup>167</sup> placing a high priority on unprofitable parastatals which do not attract buyers; 2) opposition from employees arising from fear of retrenchment;<sup>168</sup> 3) intellectual ideologies against privatization;<sup>169</sup> 4) a narrow field of qualified buyers; 5) a lack of developed capital markets;<sup>170</sup> 6) a lack of necessary expertise to support the process;<sup>171</sup> 7) a lack of transparency in the divestiture program;<sup>172</sup> and 8) an uncertain investment climate.<sup>173</sup> Also, parastatals structured as mixed joint stock companies in Kenya contain certain restrictions about the transferability of all or certain classes of shares and provide preemptive rights to existing shareholders, with which shareholders must comply.<sup>174</sup> Besides, the Privatization Act of 2005

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166. See SRI INT'L, *supra* note 1, at 69. By 1991, the Parastatal Reform Policy Committee had made the decision to privatize 139 non-strategic parastatals. A survey conducted by SRI International on privatization plans indicated that the manufacturing company executives were supportive of the privatization plans. Some of them, however, doubted whether the government was committed to implementing the reforms fully. *See id.*

167. See Tom Mogusu, *Privatization Delays Due to Lack of Political Will*, E. AFR. STANDARD (Kenya), Sept. 11, 2001. The Nairobi Stock Exchange Chief Executive, Kibuga Kariithi, recently attributed the delay in the privatization of Telkom and Mumias companies to lack of political will. *See id.*

168. See generally INDEPENDENT EVALUATION GROUP, WORLD BANK, INDUSTRIAL RE-ORIENTATION IN EAST AFRICA (2003), available at <http://lnweb18.worldbank.org/oed/oeddolib.nsf/DocUNIDViewForJavaSearch/588204F63D0AAC14852567F5005D8869>.

169. See Ernest Harsch, *Privatization Shifts Gears in Africa*, AFR. RECOVERY, Apr. 2000, at 8.

170. See MBUI WAGACHA, KENYA'S CAPITAL MARKET: TO LIST OR NOT TO LIST 1-2 (2001).

171. See *Government Scraps Reform Body*, DAILY NATION (Kenya), Sept. 26, 2000. In 2000, the government virtually scrapped the Executive Secretariat and Technical Unit ("ESTU") which used to regulate the parastatal reform program in Kenya. The unit is now comprised of only two people. It was scrapped as a result of pressure from donors, most of whom preferred to have advisers from the World Bank rather than local ones. As a result of the lack of expertise, some institutions, such as the Mumias Sugar Company, Chemelil Sugar Company, and Kenya Reinsurance Corporation, have managed their own privatization. *See id.*

172. See Harsch, *supra* note 169, at 16-17.

173. See U.S. TRADE REPRESENTATIVE, 2005 NATIONAL TRADE ESTIMATE REPORT ON FOREIGN TRADE BARRIERS 357 (2005); see also CHRISTOPHER BLATTMAN ET AL., KENYA: ENHANCING THE COMPETITIVENESS OF KENYA'S MANUFACTURING SECTOR: THE ROLE OF THE INVESTMENT CLIMATE 62-64 (2004).

174. See The Companies Act, (1978) Cap. 486 § 74(1). (Kenya). Section 74(1) of the Companies Act states that holders of not less, in the aggregate, than fifteen percent

seems to favor commercialization of public services rather than entire privatization of parastatals. In addition, the utilities—which are likely to be retained in the long run because they are profitable—will still have a sizeable amount of shares owned by the government.<sup>175</sup> These obstacles will take time to overcome; meanwhile, parastatals will continue to exist in the Kenyan market.

Miscreant directors may continue to benefit from parastatals as a result of the lack of adequate safeguards assisting in the privatization process.<sup>176</sup> At present, there is no law dealing with sensitive privatization issues, such as the valuation of parastatals, the procedure for selecting buyers, the use of specific sale techniques, the financing of share purchases, and the allocation of privatization process.<sup>177</sup> The current government had halted further privatization until a law to guide the process was enacted.<sup>178</sup> This was a step in the right direction because, prior to this initiative, there was nothing to prohibit concentration of ownership of privatized state assets in the hands of well-connected individuals and multinational corporations,<sup>179</sup> hence creating monopolies that do not improve the services previously provided by parastatals.<sup>180</sup> For example, the acquisition of East Kenya Bottlers by a South African company, Coca-Cola Sabco, and the plans to acquire two other companies were criticized by the President in 2001 for giving Coca-Cola Sabco a seventy percent stake in the entire carbonated soft drinks market, contrary to the monopoly laws.<sup>181</sup>

In the past, it was not possible to safeguard shareholders'

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of the issued shares of a special class of shares may apply to court to have the variation cancelled if they did not consent to or vote in favor of the resolution of variation. *See id.*

175. *See* U.S. TRADE REPRESENTATIVE, *supra* note 173, at 354.

176. *See* Jaindi Kisero, *Privatisation Law is What Kenya Needs*, DAILY NATION (Kenya), Jan. 10, 2001.

177. *See generally* Saulo Wanambisi Busolo, *Transparency Required in the Privatisation of the Sugar Industry*, E. AFR. STANDARD (Kenya), Oct. 16, 2001.

178. *See* U.S. TRADE REPRESENTATIVE, *supra* note 173, at 355-56.

179. *See* Kisero, *supra* note 176.

180. Few indigenous Kenyans have bought the privatized firms to date. *See* Poul Ove Pedersen & Dorothy McCormick, *African Business Systems in a Globalising World*, 37 J. MOD. AFR. STUD. 109, 114-15 (1999); *see also* Anna Gelpern & Malcolm Harrison, *Ideology, Practice and Performance in Privatization: A Case Study of Argentina*, 33 HARV. INT'L L.J. 240, 252 (1992) (discussing similar problems in Argentina).

181. *See generally* Mutahi Mureithi, *Okemo, Kijirah in Dilemma*, FIN. STANDARD (Nig.), Sept. 4, 2001.

and employees' rights to buy shares in parastatals as politicians manipulated the program.<sup>182</sup> The following transactions illustrate such manipulation: 1) the free take-over of National Milling Corporation by the Premier Flour Mills of Nakuru; 2) the selling of Kericho Tea Hotel to MS Sololo Investments for a paltry fifteen million Kenya shillings (US\$225,129); and 3) the selling to politicians of Golf Hotel of Kakamega, Kisumu Sunset Hotel, Homa Bay Hotel, and Marsabit Hotel.<sup>183</sup>

Although the Privatization Act of 2005 has some positive aspects that seek to streamline the process of privatization, it concentrates too much power in the hands of the Minister for Finance, as he is given the powers to appoint the Executive Director of the Privatization Commission,<sup>184</sup> which has the exclusive power to administer the Privatization Fund.<sup>185</sup> The Appointment of the Executive Director ought to be subjected to parliamentary scrutiny in the same manner as the appointment of other commissioners of the Privatization Commission so as to ensure that the Executive Director does not owe allegiance to the minister.

### C. *Private Sector Versus Parastatals*

Corporate governance in the private sector differs significantly from that of parastatals. In the private sector, sanctions and incentives are used to make directors perform their duties with a view to maximizing profits.<sup>186</sup> For instance, the market for shares is a sanction used against directors in the sense that shareholders can sell their shares if they are dissatisfied with the management.<sup>187</sup> Outside shareholders also provide a sanction against directors because directors may be dismissed in the event that a lower share price may lead to a take-over.<sup>188</sup> In addition, the threat of insolvency might discipline directors because such a threat may provide incentives for directors to manage the business of a company prudently and, in turn, this will safeguard

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182. See generally Kiseru, *supra* note 176.

183. See *id.*

184. See The Privatization Act, (2005) Cap. 2 § 10. (Kenya).

185. See *id.*

186. See Estrin, *supra* note 15, at 14.

187. See *id.*

188. See *id.*

their reputations and jobs.<sup>189</sup> Moreover, the efficiency of a company may be promoted by rewarding directors with handsome remuneration when their performance is sound.<sup>190</sup>

Although some of the above sanctions may be effective in some instances, some have limitations. For instance, despite the possibility of transferring shares by shareholders when they are dissatisfied with the performance of the management, a transfer of shares would not be effective if the amount of shares transferred is not substantial.<sup>191</sup> Indeed, it might be difficult and costly for shareholders to collect the necessary information that would enable them to convince other shareholders concerning the failings of the entity.<sup>192</sup> Undoubtedly, in the event of such limitation the prospects of deterring pursuit of personal objectives by the management would be minimal.

The State, as the principal shareholder, contracts with the management to run parastatals.<sup>193</sup> From an economic perspective, it can be argued that weaknesses in the governance of parastatals arise as a result of a lack of sufficient market incentives and disciplines.<sup>194</sup> Unlike the private sector, the public sector does not have a market for shares imposing sanctions on poorly performing management.<sup>195</sup> As such, shareholders in parastatals have no exit options. Given that the market for corporate control is absent, the parastatal is never under the threat of takeover; likewise, the board is not under the threat of replacement. This contributes to the poor performance of the board of directors due to lack of incentives to perform effectively. In addition, since parastatals are often bailed out by the State, it can be argued that the lack of the threat of insolvency also contributes to weak governance.<sup>196</sup> This problem is compounded further by the fact that civil servants are not rewarded as a result of improved performance. The recent initiative by the Kenyan government to hire directors of parastatals on the basis of performance contracts and to reward them handsomely when they im-

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189. *See id.*

190. *See id.*

191. *See id.*

192. *See id.*

193. *See id.* at 15.

194. *See id.*

195. *See id.*

196. *See id.* at 14.

prove the performance of parastatals<sup>197</sup> is likely to boost their motivation and, in turn, enhance the efficiency of parastatals. It is notable, however, that the lack of a similar initiative to motivate employees can be a major factor contributing to inefficiency.

While the private sector has a single principal and agent, namely the shareholders and the managers, there are multiple agents in parastatals. Since the State derives its mandate from the voters, the State and the board of directors are both agents of the voters. Serious agency problems arise as a result of this complexity.<sup>198</sup> For instance, given that politicians are accountable to voters, they are likely to lose sight of the commercial goals of a parastatal whilst attempting to please strategic parts of the electorate.<sup>199</sup> The economic efficiency of parastatals is also undermined by the fact that the politicians do not have a personal equity stake in the entities.<sup>200</sup> As a result, they have no financial incentive to ensure parastatals are managed effectively.<sup>201</sup>

Due to the fact that public enterprises adopt political settings/policies, it is generally believed that the public nature of parastatals makes them inherently inefficient and unprofitable due to inefficient controls.<sup>202</sup> As a result, there is a popular belief that privatization is a panacea for their inherent problems. Darryl McDonough addresses the problem of using a state corporation as a means for improving a state's economic performance:

By creating a hybrid company/statutory corporation the government has left open the issue of corporate governance. The model does not allow for the directors to act as they should—as fiduciaries of the organization that they are appointed to direct. Adopting the corporate structure in the context of GOCs should mean embracing and applying it within a government context with all its imperfections.<sup>203</sup>

The failure to adhere to effective corporate governance can

197. See generally *Parastatal Chiefs Sign Job Contracts*, DAILY NATION (Kenya), Dec. 22, 2004.

198. See Brumby & Hyndman, *supra* note 38, at 33.

199. See *id.* at 40-41.

200. See *id.* at 41.

201. See *id.*

202. See YAIR AHARONI, *THE EVOLUTION AND MANAGEMENT OF STATE-OWNED ENTERPRISES* 161-216 (1986) (measuring performance of state-owned enterprises).

203. See McDonough, *supra* note 91, at 310.

largely be attributed to the present state of parastatals. Parastatal banks, until very recently, have remained profitable and efficient despite the presence of competing local and multinational banks and their success can be attributed to being subject to less influence from the Ministry of Finance, as ministerial influence has made the business sector so wary of government's involvement in business. As such, government's attempts to regulate business are being rejected. For instance, the attempt to introduce a bill in Parliament that would empower a parastatal, the Horticultural Crops Development Authority, to regulate<sup>204</sup> the horticultural sector<sup>205</sup> was opposed by the Fresh Produce Exporters Association of Kenya. The Association claimed that sufficient regulation is already being carried out by the private sector and that the involvement of government would result in inefficiency—as observed in other sectors regulated by the government such as the tea and coffee industries.

Apart from the strong past performance of parastatal banks, agricultural parastatals also performed well for two decades after independence. Being large and complex organizations, they served large numbers of smallholder farmers.<sup>206</sup> Although privatizing public utilities might amount to the exploitation of a public interest, often guaranteed by parastatals, it can be argued that the flotation of shares might help ailing parastatals to boost their efficiency and profitability by raising capital and creating an interest group that would demand transparency and accountability. The adoption of this strategy has enabled Kenya Power and Lighting Company to remain profitable for a long time.<sup>207</sup> Since

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204. See Michael Njuguna, *KAM Opposes New Electricity Company Plan*, DAILY NATION (Kenya), Sept. 10, 2001. Similar attempts to create an additional parastatal to manage rural electrification was opposed by Kenya Association of Manufacturers because it would have increased production costs of electricity and, in turn, increased electricity tariffs. See *id.*

205. See Washington Akumu, *Industry Says No to New Law*, DAILY NATION (Kenya), Sept. 7, 2001. The horticultural sector is the second highest foreign exchange earner in Kenya. Flowers, fruits and vegetable exports earned 14 billion Kenyan shillings in 2000. See *id.*

206. See GROSH, *supra* note 3, at 52.

207. See Mutua, *supra* note 128. The company is, however, experiencing liquidity problems and the government has proposed to bail it out. Although the Minister for Energy maintains that the liquidity problems are not as a result of mismanagement, opposition Members of Parliament have opposed initiatives to save the company. Most of the companies' debts were accrued before it was exempted from the 1987 State Corporations Act. In November 2001, the government and related organs owed the company 3.1 billion Kenyan shillings. See *id.*

some parastatals appear to have failed as a result of subsidizing some class of producers and consumers, the government would have to stop subsidizing such groups for their performance to improve. This being the case, the resulting improvement can be attributed to policy reform rather than privatization *per se*. It remains true that such policy reform is achievable even without privatization. Although the privatization of some parastatals has enhanced their performance,<sup>208</sup> privatization can hardly be said to be an end in itself, as private monopolies have the capacity of being as inefficient as parastatals in the absence of a strict regulatory framework. For instance, the failure to plan effectively before the liberalization of the Kenya economy has affected some sectors, such as agriculture. Farmers have attributed the decline in rice production in the country to the unplanned takeover of the government schemes. As the Provincial Commissioner of Central Province once stated, "Kenya has managed to liberalise policy but not practice. When we were under the controlled system, it was easy to blame the Government. Under liberalisation, there is no one to blame."<sup>209</sup> Thus, it is notable that protection of some sectors of the economy might be in the national interests of the country. Such protection might forestall the outward flow of resources, which has been accelerated by the ownership of privatized companies by foreign companies.<sup>210</sup> Policies designed to protect the national economy of a country are already being used by a vast majority of countries.

#### D. *The Need to Reform the Corporate Regulatory Framework of the Private Sector*

While privatization can enhance efficiency and profitability, it is also possible for the process to impact negatively on private companies' liquidity, labor, and social stability. Indeed, in the absence of sufficient safeguards, it is not inconceivable that some imprudent directors might find their way to the boardrooms of privatized companies. To avoid such an eventuality, the govern-

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208. See generally *KR to Go Public*, DAILY NATION (Kenya), Mar. 15, 2000 (noting Kenya Airways privatization led to profits instead of further losses for company).

209. See generally *Free Market Destabilises Agriculture*, DAILY NATION (Kenya), Sept. 25, 2001.

210. Foreign companies own most of the privatized companies because the locals have limited capital and skills. See *How Anglo-Saxons Continue to Enslave Africans*, E. AFR. STANDARD (Kenya), June 3, 2001.

ment must streamline the privatization process. A lack of transparency in the privatization process increases political and social costs, as it makes the selection of buyers less efficient and contributes to the loss of public confidence in the process.

For privatization to be successful, there must be a stable corporate governance structure for privatized firms to ensure an efficient provision of services. The Companies Act, the main regulatory framework for companies, is outdated as it is based on the English Companies Act of 1948.<sup>211</sup> For instance, it is not efficient in disqualifying miscreant directors who abuse their fiduciary positions, as it only disqualifies directors who are in breach of their duties in the course of winding up but not when a company is a going concern.<sup>212</sup> Directors who have been responsible for the insolvency of several companies in Kenya are also not precluded from acting as directors,<sup>213</sup> unless they have been disqualified following bankruptcy<sup>214</sup> or conviction for fraud.<sup>215</sup> It is necessary to bar such directors from assuming other directorships for a specified time in order to safeguard against abuse of companies they might mismanage.

The standard of skill and care expected from company directors is very low, as a director is not required to give continuous attention to the affairs of the company. Instead, competent performance by himself or his delegate in periodical board meetings suffices.<sup>216</sup> There is no statutory provision requiring directors to have expertise and experience in the management

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211. See generally U.S. DEPT. OF STATE, 2006 INVESTMENT CLIMATE STATEMENT—KENYA, available at <http://www.state.gov/e/eeb/ifd/2006/62005.htm>.

212. See Kiarie Mwaura, *Disqualification of Company Directors in Kenya*, 54 N. IR. LEGAL Q. 118, 125 (2003).

213. See The Companies Act, (1978) Cap. 486 § 323. (Kenya) (imposing personal liability for debts of company and other liabilities on persons knowingly party to fraud).

214. See *id.* § 188(1). Under § 189 of the Companies Act, a disqualified director is precluded from being involved in the management of companies for a period not exceeding five years. See *id.* § 189. In England, the Company Directors Disqualification Act imposes a minimum disqualification of two years and a maximum of fifteen years for unfit conduct. See The Company Directors Disqualification Act, 1986, c. 46, § 6 (Eng.).

215. See The Companies Act, (1978) Cap. 486 § 189(1). (Kenya). It is an offense in the U.K. for a director of a wound up company, within five years, to be a director or concerned in the management of a company known by the same name or so similar a name to suggest an association with the liquidating company. See The Insolvency Act, 1986, c. 45, § 216(3) (Eng.).

216. Courts in other jurisdictions have curbed neglect of duty by finding liability for non-attendance of board meetings and entrusting delegates to carry out the affairs



of companies. Instead, directors are expected to exhibit a degree of care and skill that can reasonably be expected from persons of their knowledge and experience. Thus, the courts assess their liability subjectively<sup>217</sup> and take into account the knowledge, skill and experience of directors when considering their liability. It is, therefore, possible for directors to go unpunished as a result of negligence arising from their ignorance or inexperience.<sup>218</sup> Having a minimum level of expertise for directors would raise the standards of skill expected from directors of privatized enterprises.<sup>219</sup>

Another shortcoming of the company law is the fact that there is no effective enforcement of liability against company directors, as the company is the only body that is entitled to sue a miscreant director given that his duties are only owed to the company. It is possible for directors to escape liability when they form and control a majority of the shareholders because minority shareholders are precluded from pursuing enforcement suits unless the company has been a victim of a fraud or the conduct complained of is oppressive to the interests of some shareholders.<sup>220</sup> Thus, minority shareholders of privatized enterprises will continue to be unprotected unless a statutory provision is enacted to enable them to enforce the rights of the company.<sup>221</sup>

Reform of the company law is also needed in order to facilitate the role of the private sector in the provision of social services given that this would go some way towards filling the gap

of the company. See generally *Bowerman v. Hammer*, 250 U.S. 504 (1919); *Kavanaugh v. Gould* 223 N.Y. 103 (1918).

217. See Andrew Hicks, *Directors' Liability for Management Errors*, 110 L. Q. REV. 390, 390 (1994). According to Judge Hoffman, "a director who undertakes the management of the company's properties is expected to have reasonable skill in property management, but not in off-shore tax avoidance." See *Norman v. Theodore Goddard*, [1992] B.C.C. 14 (U.K.).

218. The application of both the subjective and the objective standards has been favored in other jurisdictions, as it raises the standards expected from directors. See *Re D'Jan of London Ltd.*, [1993] B.C.C. 646 (U.K.); *Norman v. Theodore Goddard*, [1992] B.C.C. 14 (U.K.).

219. See Kiarie Mwaura, *Company Directors' Duty of Skill and Care: A Need for Reform*, 24 COMPANY LAW. 283, 287 (2003).

220. See The Companies Act, (1978) Cap. 486 § 211. (Kenya).

221. Courts in other jurisdictions, such as Australia and New Zealand, have shown the tendency of not applying the rule in *Foss v. Harbottle*, when it stands in the way of justice. See generally *Foss v. Harbottle*, (1843) 2 Hare 461 (Eng.); The Corporations Act, 2001, §§ 236-242 (Austl.); The Companies Act, 1993, § 165 (N.Z.); *Thomas v. HW Thomas Ltd.*, [1984] 1 N.Z.L.R. 686, 693 (C.A.).

left after privatization of some services provided by parastatals. The present corporate law framework is ineffective in this regard because directors of a company owe duties of good faith to the company.<sup>222</sup> Thus, directors do not have an obligation to take into consideration the interests of employees or other stakeholders.<sup>223</sup> This position focuses on the narrow interest of members rather than the long-term interest of the enterprise. It fails to appreciate that it is for the general benefit of the corporate entity to "consider itself as a citizen with a role to perform in a social as well as in an economic context."<sup>224</sup>

It is apparent that the taking over of public utilities or services by private corporations without reforming the regulatory framework of private companies will not be a panacea to the managerial problem as envisioned by the Privatization Act 2005.

## V. CONCLUSION

The poor performance of parastatals has had adverse effects on the economy of Kenya. Although the initial objective of having parastatals was to foster the development of the private sector and the provision of public services, the current state of parastatals' management, and the way that they are regulated, militate against the attainment of such objectives.

It is clear that the regulatory framework in place is ineffective. Having been adopted at independence, the framework can hardly be effective in regulating today's business environment, which has become sophisticated due to technology and globalization. As such, the failure on the part of the government to adopt workable solutions to resolve inefficiency can only make the crisis worse.

The overlapping regulations governing parastatals, coupled

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222. See *Percival v. Wright* (1902) 2 Ch. 421 (Austl.). Directors may, however, stand in a fiduciary relationship to the members if members authorize them to negotiate on their behalf. See *Briess v. Woolley* (1954) A.C. 333 (U.K.).

223. In Germany, for instance, the duty of directors is broadly expressed to include employees and the public interest. The U.K. Companies Act also obliges directors of a company to have regard to the interests of company employees. See *Companies Act, 1985, c. 6, § 309* (U.K.).

224. Although there are no requirements in the Kenya Companies Act for companies to take into consideration interests of employees, some companies encourage employees to purchase shares and offer gratuities and medical attention. See PHILIP THOMAS, *PRIVATE ENTERPRISE AND THE EAST AFRICAN COMPANY 200* (1969); see also *The Companies Act, (1978) Cap. 486*. (Kenya).

with the political appointment of directors, make it difficult to ensure that there is accountability in the sector, as directors' impartiality and integrity are often compromised.

Although it is true to some extent to say that the poor performance of parastatals has been caused by their role in supplementing the private sector, poor remuneration, and the policies of international lending agencies, a vast majority of parastatals experience liquidity problems as a result of the presidential and ministerial control of their operations. This results in the parastatals being run, not in the interests of the corporation, but for political interests. Thus, empowering another independent body, such as Parliament, to vet the appointment of directors, can protect the corporation. Given that the arbitrary ministerial directions play a role in limiting parastatals' powers to pursue their objectives, requiring ministers to present such directions in Parliament can also reinforce accountability, as Parliament would demand accountability and require ministers to adopt corporate governance practices. Having such an arrangement in place would facilitate the appointment of qualified persons, and in turn, enhance the performance of the boards by raising the standard of care expected from directors.

Given that parastatals are likely to be present in Kenya for a long time, there is a need to streamline the overlapping regulations in order to give parastatals some autonomy, which would enable them to meet targets set under the performance contracts they have entered into with the government. Reforming the regulations relating to appointment in order to ensure that directors are appointed transparently and on the basis of their competence, rather than closeness to public officials, is necessary because incompetent directors are unlikely to achieve the targets set under the performance contracts. Transparency is also needed in the process of drafting performance contracts in order to ensure that the targets set by the government are realistic.

Apart from the dire need of streamlining the multiple regulations governing parastatals in order to give them autonomy, the government also needs to reform the regulatory framework governing the private sector before it brings into force the Privatization Act of 2005 and starts partial privatization of services because the failure to do so would defeat the achievements of the objectives of privatization since the privatized corporations or

services would still be open to abuse. This is because the lack of effective regulation of directors that occurs in the private sector is not only mirrored in parastatals, but its detrimental effects are even more obvious.