

**Policy Shifts and Foreign Direct Investment in Kenya with
Reference to the Industrial Sector**

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**A dissertation presented to the Institute of Diplomacy and
International Studies in partial fulfilment of the requirements
for the award of the Degree of Master of Arts in International
Studies, University of Nairobi.**

2011

DECLARATION

This dissertation is my original work and has not been submitted for a degree in any other university.

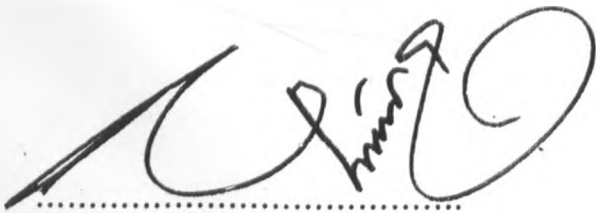


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This dissertation has been submitted for examination with my approval as university supervisor.



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Dedication

This study is dedicated to my father Stephen Katumo Kavuu who could not live long enough to see me through it but was ever inquisitive and curious on my progress.

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List of Abbreviations

DFCK	Development Finance Company of Kenya
DFI	Development Finance Institution
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
FIPA	Foreign Investment Protection Act
GDI	Gross Domestic Investment
GDP	Gross Domestic Product
GDS	Gross Domestic Savings
ICDC	Industrial and Commercial Development Corporation
IDB	International Development Bank
IMF	International Monetary Fund
KIE	Kenya Industrial Estates
MNC	Multinational Corporation
OECD	Organization for Economic Cooperation and Development
SOE	State Owned Enterprises
SAP	Structural Adjustment Program
UNCTAD	United Nations Convention on Trade and Development
WIR	World Investment Report

Appendix

Table 4.1: Foreign Companies Registered and Removed from Register: 1963-2008

Table 4.2: Net FDI Inflows to Kenya, 1970-2009 (US \$ million)

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Acknowledgments

I recognize the contribution of my supervisor, Dr. Ludeki Chweya for his insight, intuitive guidance and unrelenting co-operation which made undertaking this study an exciting endeavour.

This study would not be complete without data. I am most grateful to the library staff of the University of Nairobi, Jomo Kenyatta Memorial Library (JKML), Kenya Investment Authority (KenInvest) particularly Ruphina and Wesley, Kenya National Bureau of Statistics and Ministry of Planning and National Development for enabling me to access the invaluable resource material during the data collection stage.

I also profoundly appreciate the audacity of my wife Mary for her zealous encouragement and her never-ending desire to see me through this study.

Finally, my appreciation goes to my children Stephen, Pearl and Rael whose innocent smiles and joyous childish games refreshed and rejuvenated me to write one more sentence to the completion of this study.

Abstract

The amount of Foreign Direct Investment (FDI) inflow to Kenya has fluctuated since independence with adverse repercussions upon the growth of the industrial sector. FDI inflows have dropped to as low as US \$ 0.39 and risen to as high as US \$ 729 in the year 1988 and 2007, respectively. This study sought to explain the fluctuation from the stand point of national policy orientation regarding the contribution of FDI in national development. The study has in so doing discussed the factors that curtail FDI inflows and thereby shed light on the influence of FDI in the national economy.

The study is preceded on the view that FDI transcends national boundaries and hence blurs the distinction between national and international affairs. As a result the relationship between host-governments and FDI is dynamic and open-ended with regards to the future trajectory. Therefore, the form and function of the State are compelled to adapt as host-governments seek coherent strategies of engaging with FDI in a more interconnected world. The study analyses the content in primary documents specifically the government policy papers and statements and statistical abstracts to obtain the levels and identify the policy on FDI.

The study concludes that the policy of Kenya government, since independence has consistently been to promote FDI. Specifically the government has displayed four main policy objectives in promoting FDI in the country's industrial sector: investment incentives, liberal FDI entry regime, moderate nationalization and privatization of the economy. The government selects FDI undertakings that it considers beneficial to the nation. This explains the annual variations of FDI inflows to Kenya.

CHAPTER ONE

Foreign Direct Investment (FDI) in Kenya's Development Policy

Introduction

Kenya's economic structure is predominantly agricultural. Agriculture contributes to Gross Domestic Product (GDP), foreign exchange and employment creation. Currently, agriculture represents 24 per cent of GDP. More than one third of its produce is exported, accounting for 65 per cent of Kenya's total exports. The agricultural sector accounts for 18 per cent of total formal employment. Further, the agricultural sector provides raw materials to the 95 per cent of industries that are agro-based.¹ This stimulates large indirect growth effects in non-farm incomes and employment as well. The reliance on agriculture in the economy has resulted in dwindling foreign exchange earnings due to unpredictable crop yields, unfavourable terms of trade and unfavourable balance of payments. Industrialization helps in diversification and cushioning the economy against such shocks.

This chapter aims to examine the prominence of Foreign Direct Investment (FDI) as a source of international investment capital in Kenya's industrialization-based economic development and to set the background as well as the framework for the study of the significance of FDI in Kenya's development policy and its outcomes with special reference to the industrial sector. In this regard, the chapter will define the research problem and objectives, give an expose` of the main issues in the literature on this subject, specify the conceptual framework of analysis and describe the methodology used in the study.

¹ Government of Kenya: *Kenya Vision 2030; A Globally Competitive and Prosperous Kenya* (Nairobi: Government Printer, 2007) pp 39 and 60

The Research Problem

Kenya's economic development process has been influenced by external forces since the colonial era. The external forces with significant influence on the economic structure include international trade and international capital such as Foreign Direct Investment (FDI) and bilateral and multilateral lending. These factors have made significant impact on Kenya's economy especially increased international debt burden; unfavourable balance of payments; dominance of foreign ownership and control in the economy; the contentious Structural Adjustment Programmes (SAPs) and other conditionalities². The importance of FDI has been in ascendance as a means of transforming Kenya's economic structure through industrialization relative to other sources of international capital. Nevertheless, the amounts of FDI inflows to Kenya have not only been unsteady but highly unsustainable.

The completion of the Kenya-Uganda railway in 1902 opened Kenya's hinterland to European settler farming. Colin Leys has explained further that the colonial administrators sought to make the Railway repay for cost of construction.³ This was achieved by making land productive through alienation of high-altitude land that appeared virtually unused to Europeans. These European farmers were granted monopolistic incentives without which farming would have been unprofitable. Some of these incentives include monopoly of the high-potential land in the 'white-highlands'; monopoly of production of the more profitable cash-crops, especially coffee and tea which Africans were prevented from growing; monopoly of agricultural wage-labour

² Maria Nzomo: 'External Influences on the Political Economy of Kenya: The Case on MNCs' in Walter O. Oyugi (ed) *Politics and Administration in East Africa*. (Nairobi: East African Educational Publishers Ltd., 1994) pp. 429- 467.

³ Collin Leys: *Underdevelopment in Kenya: The Political Economy of Neo-Colonialism 1964-1971* (Nairobi: East African Educational Publishers Ltd, 1975)

provided by Africans who had no reason to work for the European farmers but were compelled to work, partly by force, partly through taxation particularly the hut- and poll-tax system and partly by preventing them access to enough land or more profitable cash-crops that would have enabled them to pay taxes without working for wages. Finally, the European farmers also monopolized government services. For example the railway carried European-grown exports such as coffee, tea, maize and wheat at a lower rate than African-grown exports such as cotton. These incentives encouraged the Europeans farmers to cultivate the land and grow crops such as coffee and tea that were required as inputs in Europe specifically Britain. Thus, the railway opened up and effectively facilitated Kenya into the international trade as a net primary agricultural produce exporter to the industrialized countries of Europe. Consequently, 'Kenya began to play the classic role of a country at the periphery of the capitalist system, exporting primary commodities and importing manufactures.'⁴ This clearly exemplifies the influence of the external forces specifically international trade and bilateral loans that gave way to agricultural dominance in Kenya's economic structure.

During the decade following Kenya's independence, the pattern of agricultural growth was highly positive in terms of the choice of produce that yielded great return. Kenya's agricultural policymakers utilized the principle of comparative advantage to improve economic well being by producing agricultural commodities such as coffee and tea for export.⁵ Indeed, the changes in Kenya's agricultural policies as experienced from the 1980s has not been a shift from the general pro-agricultural position but rather a shift in priority within the agricultural sector. For example, there has been a shift in emphasis

⁴ Ibid pp. 28

⁵ Michael F. Lofchie: 'The Politics of Agricultural Policy' in Joel D. Barkan (ed): *Beyond Capitalism vs. Socialism in Kenya and Tanzania* (Nairobi: East African Educational Publishers Ltd. 1994) pp 129-173

from export-oriented crops such as coffee to grain production such as wheat and maize for self-sufficiency in food grains.⁶ The effect was an abrupt shift of resources away from the coffee sub-sector and diminishing support for the export sector in favour of domestic consumption. However, other factors such as unfavourable terms of trade and unpredictable crop yields that resulted to unfavourable balance of payments necessitated the review of Kenya's reliance on the export of primary agricultural produce. For instance, there was a coffee and tea boom which produced a temporary abundance in foreign exchange in the mid-1980s followed by a collapse in international prices for coffee and tea in 1987 that drastically reduced foreign exchange earnings. Thus, unpredictability of the crop yields and the unstable international prices for primary agricultural produce led to the shift in emphasis from agriculture to industrialization. Due to its dominance, agriculture has been the base but industrialization is the main engine that would drive the economy, in the view of the government.

Kenya has held that industrialization is crucial to development through its 'contribution to foreign exchange, labour training, and relief of unemployment.'⁷ Therefore, the incidences of meagre foreign exchange earnings from exports of her primary agricultural products that have culminated in unfavourable balance of payments and low per capita income can be minimized by exporting industrial products⁸, particularly processed agricultural products. Currently, industrialization is considered key to the realization of *Kenya vision 2030* which is 'to transform Kenya into a newly industrialized middle income country by the year 2030.' In particular, the manufacturing

⁶ For the politics behind this shift see Ibid pp.157-164

⁷ Republic of Kenya: *Sessional Paper No. 10 of 1965 on African Socialism and its Application to Planning in Kenya*. (Nairobi: Government Printer, 1965) pp 43

⁸ Republic of Kenya: *Sessional Paper No. 2 of 1996 on Industrial Transformation to the year 2020* (Nairobi: Government Printer, November, 1996) pp 2.

sector is expected to increase its contribution to the Gross Domestic Product (GDP) by a minimum of at least 10 per cent per annum in order to contribute to the aspirations of the *Kenya Vision 2030* of maintaining a sustained economic growth of over 10 per cent per annum over the next 20 years. Therefore, not only has Kenya embraced industrialization as a means of structural economic transformation as elsewhere in the continent⁹ but to enhance the realization of *Kenya Vision 2030*.

At the time of Kenya's independence in 1963, the industrial sector was effectively under the control of non-Africans.¹⁰ The capacity of the economy was limited by lack of indigenous managerial and technical skills as well as sufficient capital for further investment.¹¹ Manufacturing firms were run and controlled by Kenyan-Indian industrialists, local Europeans or foreign investors.¹² Therefore, in the mid 1960s, the emphasis of official policy had been to induce large foreign companies to 'go public', and thus enable indigenous citizens to become shareholders.¹³ In the absence a Kenyan-African capitalist class, the real effect of this policy was that foreign companies divested by selling old shares and expatriated the receipts whereas the Kenyan-Indians' shareholding enlarged rather than Kenyan-Africans', since the former possessed so much of the spare cash.¹⁴ The dominance of Kenyan-Indian capitalists in the control of industries constituted a basis for anxiety and resentment based on a combination of class

⁹ Eric E. Ronge and Hezron O. Nyangito: 'A Review of Kenya's Current Industrialization Policy' Kenya Institute of Public Policy Research and Analysis, *Discussion Paper No. 3*, March 2000.

¹⁰ Chweya Ludeki: 'Resources and Political Transition' in Peter Wanyande, Mary Omosa and Chweya Ludeki (eds) *Governance and Transition Politics in Kenya*. (Nairobi: University of Nairobi Press, 2007) pp 235-279 and Colin Leys: *Underdevelopment in Kenya* op.cit. pp 146

¹¹ Daniel Katete Orwa: 'Continuity and Change: Kenya's Foreign Policy from Kenyatta to Moi' in Walter O. Oyugi (ed) *Politics and Administration*, op. cit. pp. 297-330

¹² David Himbara: *Kenyan Capitalists, the State and Development*. (Nairobi: East African Educational Publishers Ltd., 1994) pp 22-25; Colin Leys: *Underdevelopment in Kenya* op. cit. pp 118.

¹³ Republic of Kenya: *Sessional Paper no. 10 of 1965* op.cit.

¹⁴ Colin Leys: *Underdevelopment in Kenya* op. cit pp. 129

and race considerations.¹⁵ The government dealt with this by buying a controlling interest in what it considered a strategic industry, owned by a foreign firm and tacitly preferred an alliance of Western capital with the budding African 'auxiliary bourgeoisie.'¹⁶ The object of this position was to increase Kenyan-African shareholding in manufacturing while checking foreign dominance in terms of ownership, control and management.¹⁷

Due to the shortage of domestic capital, the development of Kenyan-African capitalists was facilitated by international capital in the form of bilateral and multilateral loans and grants to financial parastatals such as Development Finance Company of Kenya (DFCK) and Industrial and Commercial Development Corporation (ICDC)¹⁸. These parastatals were the main instruments for government's investment in equity participation with foreign companies and lending of money to them, creation of State Owned Enterprises (SOEs)¹⁹, in addition to running loan schemes for Kenyan-African industrialists. However, the creeping in of the challenges associated with international state and non-state lending and donor agencies such as the increased international debt burden, the controversial SAPs and other conditionalities²⁰ coupled with the poor performance of SOEs these sources of capital for industrial investment have been reviewed.²¹ There is now a shift in emphasis on the forms of international capital flow from bilateral and multilateral loans to FDI.

FDI occurs when a parent firm incorporated in another country undertakes investment that involves management rights and control of a firm in the host country.

¹⁵ Chweya Ludeki: 'Resources and Political Transition' op. cit. pp 265

¹⁶ That is 'auxiliary' to international capital see Colin Leys: *Underdevelopment in Kenya* op. cit. pp 119

¹⁷ Republic of Kenya: Sessional Paper No.10 of 1965 op. cit. pp 13.

¹⁸ Ibid pp. 29

¹⁹ Rwekaza Symph Mukandala: 'The State and Public Enterprise' in Walter O Oyugi (ed): *Politics and Administration*, op. cit. pp129-149

²⁰ Maria Nzomo: 'External Influence on the Political Economy of Kenya: op. cit

²¹ Republic of Kenya: *Ministry of Industrialization Strategic Plan 2008-2012* pp. x

FDI is mostly carried out by Multinational Companies (MNCs). MNCs are large firms that control productive assets in more than one country. FDI overcomes the espoused challenges of scarcity of domestic capital, lack of trained, educated and experienced manpower to operate the firm, and international debt burden notwithstanding the nationalist's claim of foreign economic control and domination.

Attracting FDI has been a key economic objective in Kenya since independence.²² However, the trend of FDI inflows to Kenya has not been steady and sustainable since independence. For instance, FDI inflows have dropped to as low as US \$ 0.39 and risen to as high as US \$ 127 in the year 1988 and 2000, respectively. Therefore, FDI as a source of capital for industrial investment is crucial but its inflow is highly unsteady. What are the factors that determine FDI inflows to Kenya? The most common response to this question has been to study the factors that undermine FDI inflows. For example, studies have attributed this trend to unfavourable business environment,²³ that Kenya lost her competitiveness on attracting FDI to the United Republic of Tanzania and Uganda in the 1990s due to foreign investor's relatively negative perception on Kenya regarding crucial factors in attracting FDI such as corruption, inadequate infrastructure supply, crime and theft²⁴ and that FDI through MNCs have had negative impact and are indeed 'unreliable agents for Kenya's industrialization.'²⁵ This study moves this debate a step further towards a more pragmatic and strategic perspective on not only attracting quantity FDI inflows but how FDI fits in the national economy. That is, what benefits does the

²² Republic of Kenya: *Sessional Paper no. 10 of 1965*-op. cit. and Republic of Kenya: *Kenya vision 2030 for a Globally Competitive and Prosperous Nation* (Nairobi: Government Printer, 2008)

²³ Francis Mwega and Rose Ngugi: *Foreign Direct Investment in Kenya*. A Paper presented During African Economic Research Consortium Special Workshop on Sub-Saharan Africa, 2005

²⁴ Andrew Mulei: *Stimulating Investment in Kenya*. A Paper presented at the National Investment Conference, Kenyatta International Conference Centre (KICC) Nairobi, November, 20, 2003.

²⁵ Maria Nzomo: *External Influence on the Political Economy of Kenya: The Case of MNCs* op. cit. pp 459.

Kenya government intend to derive from FDI inflows? How does the Kenya government to realise these benefits? Finally, how do the benefits and the methods used to achieve them affect the trends of FDI inflows to Kenya?

The objective of this study is to examine Kenya's policy orientation on FDI and the official argument behind the policy choice in order to explain the trends of FDI inflows to Kenya since independence. The study will pursue this objective in three stages. The first stage involves an assessment of Kenya's industrial development objectives that make the determination of the sources of capital a central concern. The second stage involves an examination of the status that the government of Kenya has assigned to FDI as a source of capital for development in the context of the overall development policy and the rationale behind the chosen status. The third stage is an assessment of the impact of Kenya's policy orientation on the trends of FDI inflows.

Trends in Contemporary Literature

The aim of this section is to review the scholarly works done on sources of capital to finance investment for economic development in Kenya. First, the study will review the work on post-colonial capitalist development highlighting the contentions on the presence of indigenous bourgeoisie. Secondly, we shall review the literature on State-Owned Enterprises pointing out the rationale for their establishment and evaluate their performance. The quest for economic liberalization specifically in terms of the movement of international capital will be reviewed in relation to the emergent prominence of FDI as a source of investment capital.

Colonial Origins of Capitalist Formation

Colonial capitalism in Kenya, specifically settler agricultural capitalism up to the 1940s has been a subject of concern to scholars such as van Zwanenberg²⁶ who brings out colonial capital accumulation as a process whereby the settlers struggled to establish a plantation or estate system of agricultural production such that by 1919, European-owned estates and plantations rather than African peasant production had been developed as a method of producing export crops. He further shows how economic development was characterized by European settlers' dominance whereas the Africans were made to be dependent, underdeveloped and proletarianized. This method ensured that the modes of production were effectively in the hands of the Europeans.

The absence of a well built indigenous bourgeoisie is developed further by Leys²⁷ in the post-colonial period. Leys refer the post-colonial indigenous capitalists as 'auxiliary bourgeoisie'. He places Kenya's economy at the periphery of a capitalist system thus portrays the indigenous bourgeoisie as dependent on international capital flows. This view is strongly refuted by Swainson²⁸ who provides evidence of the existence of an 'embryonic African bourgeoisie' that emerged from the 1920s onwards. She shows that the indigenous bourgeoisie had its root in new forms of commodity production which were founded on the direct employment of wage labor. As a result, a local capitalist class developed originally based on merchant capital and gradually moved into manufacturing. She further points out that far from this bourgeoisie being auxiliary to international capital; it has used its connections with the Kenya state successfully to

²⁶ R.M.A. van Zwanenberg: *'Colonial Capitalism and Labour in Kenya 1919-1939'* (Nairobi: East African Literature Bureau, 1975)

²⁷ Colin Leys: *Underdevelopment in Kenya* op. cit

²⁸ Nicola Swainson: *The Development of Corporate Capitalism in Kenya, 1918-1977*

establish itself in direct competition with foreign firms²⁹. Himbara³⁰ builds this debate further by including the 'subdued' analysis of Kenyan-Indians as indigenous bourgeoisie. The study illustrates the central role Kenyan-Indian capitalists have played and asserts that this class has immensely contributed to the growth of commerce and industry in the country. The dominance of European agro-settler capitalism, combined with the contentions on the presence of indigenous bourgeoisie whether 'auxiliary', 'embryonic' or 'budding' demonstrates the minimal participation of Kenyans in important sectors of the economy during the years after independence.

State-based Capital Formation

The strong desire to gain control of the national economy as constrained by the relative weakness of indigenous bourgeoisie resulted in expansion of State-Owned Enterprises (SOEs) after independence.³¹ At independence Kenya had approximately twenty (20) State-Owned Enterprises, most of them serving in the settler-dominated, large-scale agricultural sector. The number had trebled by 1979 and their operations diversified.³² However, the performance of the SOEs relative to expectations has been a contentious subject. Grosh has presented a detailed account of the performance of SOEs in Kenya by covering most of the important parastatals at the time.³³ Assessment was based on financial rate of return on investment, efficiency, returns to consumers and returns to suppliers. The study concluded that parastatals' financial rate of return and

²⁹ Nicola Swainson: 'The Rise of a National Bourgeoisie in Kenya' *Review of African Political Economy*, 8 (1978) pp 39-55

³⁰ David Himbara: *Kenyan Capitalists*, op cit

³¹ Goran Hyden: '*No Shortcuts to Progress: African Development Management in Perspective*' (London: Heinemann Educational Books Ltd., 1983) pp 96,

³² Republic of Kenya: *Review of Statutory Boards* (Nairobi: Government Printer, 1979) pp 29

³³ Barbara Grosh: '*Public Enterprise in Kenya: What Works, What Doesn't, and Why?*' (Boulder and London: Lynne Rienner Publishers, 1991)

efficiency was adequate and satisfactory respectively whereas in two-thirds of the parastatals, product and consumer prices were found to be competitive.

Goran Hyden on the other hand, points out that the expectation that SOEs were to give way to African-Kenya capitalism implied that local and foreign capital played complementary roles in the Kenyan economy.³⁴ The poor performance of SOEs is attributed to a combination of factors such as the politicization of decisions and the decision making structures, especially in appointments of officials; corruption; shortage of competent staff and weak control.

Rwekaza Mukandala has discussed the role of politics in the formation, expansion, management and disbanding of SOEs highlighting the crises that faced the sector in Kenya, Uganda and Tanzania.³⁵ The study shows that the formation and expansion of SOEs were a function of the nature and composition of the post-independence ruling coalitions, their objectives and subjective interests, ideology and their opposition. The study also points to the challenges of political influence and ministerial involvement in the management of the SOEs and the consequent variation in profitability and efficiency of SOEs from excellent to abysmal with the better performance being recorded in the early years of the post-independence and gradually deteriorating in subsequent years.

Privatization of State-Owned Capital

The question about the future of the SOEs in Kenya as elsewhere in Africa has been discussed from the standpoint of state disengagement from widespread participation in economic enterprise and management. This debate is captured in the context of the

³⁴ Goran Hyden: *'No Shortcuts to Progress:'* op. cit.

³⁵ Rwekaza Symph Mukandala: *'The State and Public Enterprise'* in Walter O. Oyugi (ed) op. cit

SAPs whereby the World Bank and International Monetary Fund (IMF) strongly advocated for among other things the divestiture of SOEs.³⁶ Since the early 1980s, the IMF and World Bank, advocated for liberalization of financial markets and deregulation in order to remedy inadequate resources to finance long-term development and the poor performance record of SOEs. Essentially, countries were required to reverse protectionist positions that impeded the flow of international capital and open up their markets.³⁷ This rekindled the debate on privatization versus increased government control.

In contributing to this debate, Grosh³⁸ compares privately-owned and publicly-owned manufacturing firms and concludes that the performance of SOEs is not generally worse than that of private firms. Therefore, the changes in ownership from public to private would not necessarily solve the existing problems of inefficiency and low profit of SOEs, specifically those in the manufacturing sector. Consequently, Grosh concurs that the SOEs sector is faced with serious challenges that require remedial measures but asserts that neither privatization of SOEs nor strengthening of control mechanisms offers the solution. Instead, broad regulatory and policy reforms, in particular in the sectors where the main problem firms operate could be the more helpful option. Mukandala³⁹ builds the debate further by citing four reasons for the preference of East African states for privatization of SOEs: importance of the SOE sector that necessitated that it performs well for the well being of their economies, criticism arising from the generally low levels of financial performance and poor services provided to the public, the tough economic

³⁶ World Bank: *Accelerated Development in Sub-Saharan Africa: An Agenda for Action* (Washington, D.C: World Bank, 1981) pp 37-40

³⁷ World Bank: *Adjustment in Africa: Reforms, Results, and the Road Ahead* (Washington, D, C: World Bank, 1994)

³⁸ Barbara Grosh: *Public Enterprise in Kenya*, op. cit.

³⁹ Rwekaza Symph Mukandala: 'The State and Public Enterprise' in Walter O. Oyugi (ed) op. cit

conditions that militate against subsidization, the 'conditionalities' imposed by foreign donors in the form of SAPs, before new loans and aid packages are made available to their economies. Thus, privatization which may involve the transfer of public assets to the private sector including foreigners or asset divestiture was a decision that Kenya had already made in principle. Mukandala, contends that privatization originated from and has been dominated by international capital, multi-lateral institutions and elements of the African petty-bourgeoisie. This is the background to the prominent rise of FDI as a source of capital for investment.

The FDI Controversy

The effect of FDI on the national economy of the host country is arguably the most widely discussed theme in the literature on MNC especially in developing countries. The neo-classical proponents of FDI believe that FDI effects the host country economy positively filling resource gaps and improving the quality of the factors of production.⁴⁰ Specifically, FDI brings otherwise unavailable financial resources to the host-country through MNC's own capital and their access to international capital markets;⁴¹ contributes to foreign exchange earnings through exports and saving of foreign exchange by local production of products that would otherwise have been imported;⁴² broadens the tax-base and helps improve the balance of payment;⁴³ introduces technology that would otherwise be out of reach of the host country;⁴⁴ improves the quality of labor by

⁴⁰ Mordechai E Kreinin (4th ed): *International Economics; A Policy Approach* (New York: Harcourt Brace Jovanovich, 1983)

⁴¹ Thomas J Biersteker: *Multinationals, the State and the Nigerian Economy* (New Jersey: Princeton University Press, 1987)

⁴² Gerald M. Meier: *International Economics*: op. cit

⁴³ For an analysis on the effect of FDI on the balance of payment of a country both in the short run and in the long run see for example Bo Sodersten; *International Economics* (London; Macmillan Press, 1970) pp 463.

⁴⁴ L. Alan Winters; *International Economics* op. cit

providing needed managerial skills that improve production, create employment and training of workers and improves welfare through the creation of jobs, provision of new and better products and programs to improve health, housing and education for employees and local communities.⁴⁵

Critics of MNCs essentially from the economic nationalist thought, claim that FDI through MNCs inhibit capital accumulation through profit repatriation, unjustifiably high price for technology in terms of royalties and license fees; and the evasion of higher tax rates through transfer pricing that in turn curtail government ability to redistribute national income.⁴⁶ Furthermore FDI is said to yield less foreign capital than commonly claimed. MNCs preferred local sources of capital thereby giving local entrepreneurs unfair competition. For example, the U.S manufacturing subsidiaries in Latin America are said to have obtained 80 per cent of all their financing locally either through borrowing or subsidiary earnings between 1958 and 1968.⁴⁷ Finally, the critics claim that FDI is exploitative and an extension of foreign economic power to the host-country in that it often involves foreign control over natural resources and public utilities. MNCs, in their attempts to enhance global competitiveness often use home-countries to obtain foreign policies that favor corporate interests.⁴⁸ FDI are therefore a means for political domination and loss of domestic economic autonomy.⁴⁹

⁴⁵ Joan Edelman Spero: *The Politics of International Economic Relations* (4th ed) (New York: St Martin's Press. 1990)

⁴⁶ Gerald M. Meier: *International Economics*: op. cit pp .351 and Mordechai E. Kreinin; 4th ed): *International Economics*, op. cit

⁴⁷ Joan E. Spero: *The Politics of International Economic Relations* op. cit

⁴⁸ The International Telephone and Telegraph Corporation (ITT) interference in Chile's presidential election for fear of nationalization without compensation of its Chilean affiliate serves as an extreme example on political interference by MNCs. See Joan E Spero: Ibid for details and Theodore H Cohn: *Global Political Economy*; op. cit pp345-346.

⁴⁹ Gerald M. Meier; *International Economics*: op. cit.

The governments of host countries are thus biased in favor of FDI inflows; FDI is far from a purely economic phenomenon, but a political issue and one that transcends national borders and blurs the domestic-international affairs dichotomy. The importance of FDI in the development of the host country is therefore a controversial subject in the literature on this matter. The real issues for the host-country governments are how to provide an environment in which FDI can contribute to national goals while minimizing the costs and maximizing the benefits of FDI.⁵⁰ Government policies in host-countries can influence FDI inflows by altering the relative attractiveness of the host-country to foreign investors.⁵¹ That is, the national policy framework preconditions MNC's decision to undertake FDI in a country.

Moderating FDI

The dominant debate on FDI is between the protectionists and liberalists. The protectionist argument articulates the merit of easing state restrictions on FDI while the liberalists thought is in favor of free movement of investment capital across national borders. The protectionist economic policies on FDI create a restrictive environment for entry and operation of FDI through imposition of rules and regulations regarding the entry and operation of FDI that distinguish FDI and domestic investment and are restrictive on FDI. The purpose of these restrictions is to enhance the attainment of national economic goals for which FDI inflows is required.⁵² Restrictions of FDI are

⁵⁰ Kempe Ronald Hope; 'Private Direct Investment and Development Policy in the Caribbean: Nationalism and Nationalization Scared Away Foreign Investors but Reagan Initiative's Luring Them.' *American Journal of Economic and Sociology*, Vol.48, No. 1. (Jan., 1989), pp69-78. pp 72

⁵¹ Steven Globerman; Daniel Shapiro: 'The Impact of Government Policies on Foreign Direct Investment: The Canadian Experience.' *Journal of International Business Studies*, Vol.30, No, 3 (3rd Qtr. 1999) pp.513-532. pp 515.

⁵² This is the conclusion arrived at when FDI inflows were not deterred by the restrictive entry and operation requirements imposed by the Foreign Investment Review Act (FIRA) in Canada. See Steven

achieved through screening of new FDI, sector and equity limitations, local content and export requirement, curtailment of level of profit repatriation and emphasis on state-owned enterprises.⁵³ Screening the entry of new FDI often involves evaluating the investment to determine its contribution on employment, government revenue and access to modern technology. Sector restrictions limit foreign investment in certain economic sectors of the host-country whereas equity restrictions involve amount of shares that foreign investors can hold in local firms. Local equity participation requires that equity capital on an MNC's local establishment must be owned by the host-country citizens. The purpose is to enable the local shareholders to earn dividends. They can also use their voting power to encourage the MNC's local operations to work in the best interests of the host-country. The local content requirement insists that firms utilize certain proportions of the locally available resources as inputs in the local production. This can be in the form that labor accounts for some minimum percentage of the total value of final output.⁵⁴ The export requirements ensure that MNCs produce not only for local consumption but also for external markets. Finally, the emphasis on State-owned enterprises as an alternative to FDI in industries with high barriers to entry significantly restricts FDI inflows because FDI is mostly found in industries dominated by a small number of large firms. Therefore, government involvement in such industries deters FDI. Further, nationalization has taken place as an implication of this national economic

Globerman; Daniel Shapiro: 'The Impact of Government Policies on Foreign Direct Investment: Ibid pp. 532.

⁵³ Sajal Lahiri and Yoshiyasu Ono: 'Foreign Direct Investment, Local Content requirement and Profit Taxation.' *The Economic Journal*, Vol. 108, No. 447 (Mar., 1998), pp 444-457 also see Joan E. Spero; *The Politics of International Economic Relations* op. cit

⁵⁴ Roger Bennett (2nd ed): *International Business* (New Delhi: Rashtriya Printer. 2006)

policy. Nationalization is the State take-over of private firms with or without compensation.

Protectionism calls for increased State-intervention whereas liberalism advocates for a weak or minimal government in the field of FDI. These two perspectives are the extreme ends of opposing dynamics. They assume hard and fast rules as to the policy preference of State with regards to its relationship with MNCs. That is, States either liberalize or restrict their FDI environment. Yet, the specific national policies need not be 'one size fits all' but be adapted to specific host-country characteristics. Therefore, on the one hand, liberal policies on FDI need not call for a weak or minimal government but be of appropriate mix between the market system and State-intervention. On the other hand, protectionist policies need to be matched with appropriate measures to maximize the benefits of the market system while imposing State-control. As such, the national policy framework needs to be adaptive to the changing host-country characteristics. Therefore, in as much as more and more countries are accepting the liberal principles and open their economies to FDI, attempts to regulate FDI with a view of maximizing the benefits and minimize loss of control still exist.

Although FDI is a firm-level decision,⁵⁵ the national policy on FDI preconditions the MNC's decision in undertaking FDI in a particular country.⁵⁶ This implies that the level of FDI inflows to a country is determined by the national policies on FDI.⁵⁷ Hence,

⁵⁵ This is the position of many writers on the reasons for international production. See John H. Dunning: Location and the Multinational Enterprise: A Neglected Factor? *Journal of International Business Studies*, Vol.29, No.1. (1st Qtr., 1998), pp.45-66, Sajal Lahiri and Yoshiyasu Ono, 'Foreign Direct Investment, Local Content requirement, op. cit

⁵⁶ Saskia K. S Wilhelms and Morgan Stanley Dean Witter: Foreign Direct Investment and Its Determinants in Emerging Economies. *African Economic Policy Paper*, Discussion Paper Number 9 (July 1998)

⁵⁷ David N. Abdulai: Attracting Foreign Direct Investment for Growth and Development in sub-Saharan Africa: Policy Options and Strategic Alternatives. *Africa Development*, Vol. XXXII, No.2. 2007, pp.1-23

liberal policies on FDI attract more FDI inflows whereas the protectionist policies deter FDI inflows.

In conclusion, FDI as a source of investment capital is not new. Its rise in prominence in Kenya, as elsewhere in the developing countries, is due to the presence of a relatively weak indigenous bourgeoisie, poor performance of SOEs, international debt burden and the conditionalities imposed by foreign donors. The host-country governments are rarely neutral to FDI. This is because FDI has both benefits and costs. In as much as more and more countries do subscribe to the economic liberalism principles as they open up their economies, these receptive policies are combined with attempts to control and regulate the MNCs activity. That is, they adapt their national policies to their specific country characteristics with a view to maximize benefits from FDI and minimize the loss of control. Thus, the national policy framework is a crucial determinant of FDI inflows and to a greater extent explains the variations of FDI inflows among countries.

Theoretical Framework

This section of the chapter reviews the leading theoretical perspectives on the relationship between the state and the market in international economic transactions. The aim of this undertaking is to specify a suitable analytical framework for the present study. First, this section will clarify the conceptual meaning of FDI. Secondly, this section reviews the underlying tenets, policy implications and the relationship between the host-country and FDI.

Meaning of FDI

FDI concerns firms that invest their capital in a foreign country and retain control over the investment in relation to the host government.⁵⁸ Some scholars include technology and managerial skills as part of FDI, quite besides capital.⁵⁹ FDI is distinct from portfolio investment based on definition and the purpose of undertaking the investment. Portfolio investment involves the purchase of bonds, money market instruments or a small amount of equity securities or stocks of a firm simply to realize financial return.⁶⁰ Portfolio investment does not require management effort by the investor and does not offer any special rights to the investor. Portfolio investment therefore, is passive, mostly done for speculative purposes and over a short time horizon.⁶¹ On the other hand, FDI is carried out by foreign individuals or private firms, that is, multinational corporations (MNCs) who exercise control over the management of the firm.

Nevertheless, a firm's qualification for FDI status is still a contested matter, based mostly on the proportion of initial capital or equity capital ownership.⁶² Initial capital includes the initial investment in plant and equipment. Equity capital is the investor's purchase of shares in the host-country. For instance, if ownership is widely dispersed, then a foreign investor who owns 5 per cent of equity of a foreign firm and exerts a significant degree of influence over the management of the firm is said to be engaged in

⁵⁸ Robert Mudida, *Modern Economics*, (Nairobi: Focus Books, 2003) pp 316 and Francis Cherunilam, *International Economics* (4th ed) (New Delhi: Tata McGraw-Hill, 2006) pp 464. Robert Grosse and Duane Kujawa: *International Business: Theory and Managerial Applications* (2nd ed) (Boston: Irwin, 1992)

⁵⁹ Yash Tandon: NEPAD and Foreign Direct Investment: Symmetries and Contradictions. In Peter Anyang' Nyong'o, Aseghedech Ghirmazion and Davinder Lamba (eds): *New Partnership for Africa's Development NEPAD: A New Path?* (Nairobi: Heinrich Boll Foundation. 2002) pp.119-140.

⁶⁰ Theodore H Cohn: *Global Political Economy: Theory and Practice* (New York; Pearson Education Publishers, 2005) pp 313

⁶¹ Robert Grosse and Duane Kujawa (2nd ed): *International Business*: op. cit

⁶² Charles Kindleberger (5th ed): *International Economics* (Illinois; Richard D Irwin Inc, 1973)

FDI. On the other hand, a foreign investor with 49 per cent of initial capital or equity capital of a foreign firm does not engage in FDI when the other investor holds 51 per cent of initial capital or equity capital and exerts a significant degree of influence over the management of the firm. This has resulted in the need for standardization over when a foreign investment is considered FDI. For practical purposes, most collectors of FDI statistics consider a foreign investment to be FDI when the foreign investor owns 10 per cent or more of the initial capital or equity capital and hence exercises a significant degree of influence on the management of the investment.⁶³ International Organizations such as the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) use the 10 per cent figure for statistical purposes. Consequently, this study adopts this consensus and considers a foreign investor to have undertaken FDI when s/he owns 10 per cent or more of the initial capital or equity capital and exerts a significant degree of influence over the management of the investment.

Economic Liberalism and FDI

The market is a concept at the heart of neo-classical economics. The basic assumption of the classical and neo-classical economists is that firms are rational actors and endeavor to make conscious choices to maximize their interests at lowest possible costs to themselves.⁶⁴ Neo-classical economists are essentially economic liberalists. Economic liberalists assume that markets develop naturally in order to coordinate, with varying degrees of efficiency, the actions of different participants. The market is assumed to be governed by objective laws and universal principles such as the law of demand and

⁶³L. Alan Winters: *International Economics* (4th ed) (London and New York; Routledge, 1991) and Gerald M. Meier: *International Economics: The Theory of Policy* (New York, Oxford University Press, 1980)

⁶⁴ Robert Gilpin: *Global Political Economy; Understanding the International Economic Order* (Princeton & Oxford: Princeton University Press, 2001)

supply and the principle of comparative advantage. As a result, it is believed that the market is self-regulating and self-correcting and at least in the long run, tends toward an equilibrium in which supply matches demand.⁶⁵

Economic liberalists argue further that the behavior of the firm is determined almost entirely by the market signals of demand and supply. Consequently, the market allocates scarce resources efficiently through economic specialization based on the distribution of productive factors. As a result, FDI flows to areas where it is most needed or in shortest supply because of difference in factor endowments.⁶⁶ In this regard, FDI is a mutually rewarding exchange between entrepreneurs and the nationality of a firm and whether they operate nationally or internationally are of slight importance.

Liberalism also use market imperfections to explain why MNCs undertake FDI. The arms-length transaction of intangible assets such as technology and managerial skills is clouded in imperfections on information, knowledge, and uncertainty. A further source of market imperfections internationally is government intervention. The existence of international trade barriers, restrictions on international capital movements or differences in tax rates between countries creates market imperfections. Therefore, these market imperfections create incentives for MNCs to undertake FDI by bypassing them through internalization. Internalization involves the transfer of intangible assets across national boundaries within the organization of the firm rather than their right of use to foreign based enterprises.⁶⁷ Therefore, the economic liberalists argue that countries are in a

⁶⁵ Robert Gilpin: *The Nature of Political Economy*; 'op. cit

⁶⁶ Robert Gilpin: *Global Political Economy; Understanding the International Economic Order* (Princeton & Oxford: Princeton University Press, 2001)

⁶⁷ This discussion is derived from International Business scholars who are essentially liberalists. See for example John H. Dunning: *The Eclectic Paradigm of International Business: A Restatement and Some possible extensions. Journal of International Business Studies. Vol.19, No.1 (Spring, 1998) pp.1-31*

position to benefit more from FDI by providing a favorable FDI environment. That is, markets should be left alone by governments. Governments should neither intervene in the economy nor try to influence market outcomes.

The policy prescription by the economic liberalists is that the host-country should provide a favorable FDI environment. They recommend the removal of government induced distortions such as protectionist policies that deter FDI inflows. These government-induced distortions on FDI inflows can be eliminated through liberalization of the economy, particularly by either deregulation or privatization of State-owned enterprises (SOEs). The governments are advised to be more open to FDI inflows, eliminate restrictions on the entry and operations of MNCs and facilitate FDI through quality administrative, regulatory and legal infrastructure.⁶⁸ Accordingly, the policy preference expressed by economic liberalists is that host-countries should be increasingly receptive to FDI inflows by being more open to FDI inflows and running a privatized economy. This is because, more FDI flows into countries that embrace reversal of protectionist policies on FDI by the adoption of deregulation and privatization of SOEs.⁶⁹

However, the belief by neo-classical economists that the market is autonomous, self-regulating, and governed by its own laws has been problematized. It has been suggested that markets are embedded in larger sociopolitical structures. These sociopolitical structures determine to a considerable extent the role and functioning of markets in social and political affairs. Further, the social, political, and cultural environment significantly influence the purpose of economic activity and determines the

⁶⁸ World Bank: *World Development Report 1991: The Challenge of Development* (Washington; Oxford University Press.1991)

⁶⁹ Joan E Spero: *The Politics of International Economic Relations* op. cit pp 152.

boundaries within which markets necessarily must function.⁷⁰ Indeed, it is extremely difficult to find historical examples of markets that function as most neo-classical economists assume they do.⁷¹ The economic liberalists also assume that the market imperfections are exogenous. That is, the market imperfections are either government-induced or arise from the nature of the product such as technology. Thus, the MNCs do not themselves generate such imperfections. However, MNCs are primarily monopolistic or oligopolistic and function in imperfect markets.⁷² Further, a government sometimes creates market imperfections to encourage MNCs to invest in their economies. For example, governments can erect trade barriers and provide tax breaks to encourage FDI. Without such imperfections a firm might find it more efficient to export its products from its home economy or to license its technology to a foreign firm. This supports the idea that the market mechanism cannot be left alone to generate the desired resources for investment to realize desirable national economic outcomes.⁷³

Economic Nationalism and FDI

State-centric perspectives assume that the international system is anarchic. The state in the absence of higher authority is the principal actor in international affairs.⁷⁴ Also national security is the principal concern for states. Therefore, in an international system where states cannot appeal to a higher authority for succor in times of trouble, states must constantly guard against actual or potential threats to their political and

⁷⁰ Robert Gilpin; *Global Political Economy*; op cit pp.74-75

⁷¹ Geoffrey R D Underhill: Conceptualizing the Changing Global Order in Richard Stubbs and Geoffrey R.D. Underhill (ed) (2nd ed) *Political Economy*, op. cit pp 82-90

⁷² Some liberal economists explain FDI using the monopolistic advantages such as possession of superior technology and managerial skills. See for example Bo Sodersten: *International Economics*, op. cit and Charles Kindleberger: (5th ed): *International Economics* (Illinois; Richard D Irwin Inc, 1973)

⁷³ UNCTAD: *Economic Development in Africa: Rethinking the Role of Foreign Direct Investment* (New York and Geneva, United Nations, 2005) pp 66

⁷⁴ Hans J. Morgenthau Revised by Kenneth W. Thompson (6th ed): *Politics Among Nations: The Struggle for Peace.*(New Delhi; Kalyani Publishers; 2001)

economic independence.⁷⁵ As a result, they insist that the state still retains the ultimate legal claim to effective supremacy over what occurs within their own territories because the territorial boundaries are a necessary basis for national autonomy and political unity.⁷⁶

The economic nationalists posit that MNCs are simply national firms with foreign operations. The MNC's primary market is still its home-market and home-government policies weigh more heavily in the decisions of the firm than do those of the host-government. Home-governments sometimes attempt to monitor, control or even restrain MNCs from undertaking FDI in the interests of the home-economy.⁷⁷ Moreover, MNCs are deeply embedded in their national societies. They also argue that every government in one way or another promotes the interest of its own national firms. Thus, the MNCs are closely attached to and dependent on their home-economies.⁷⁸

The economic nationalists also view FDI as part of corporate strategy of oligopolistic firms and not as a resource flow. That is, MNCs are oligopolistic and create of market imperfections. As a result, FDI is not an efficient response to exogenous market imperfections. The MNCs enjoy considerable discretionary power through access to capital, control of technology, marketing through product differentiation and privileged access to raw material. Therefore, MNCs are not the atomistic firms that respond to market conditions.⁷⁹

⁷⁵ Robert Gilpin: *Global Political Economy; op. cit*

⁷⁶ Robert Gilpin: 'The Nature of Political Economy' *op. cit* pp 11

⁷⁷ Theodore H Cohn: *Global Political Economy; Theory and Practice* (New York; Pearson Education Publishers, 2005) pp 336

⁷⁸ Robert Gilpin: *Global Political Economy; op. cit.*

⁷⁹ Rhys Jenkins. 'Theoretical Perspectives on the Transnational Corporation.' in C. Roe. Goddard, Patrick Cronin & Kishore C. Dash (eds)(2nd ed) *International Political Economy; State-Market Relations in a Changing Global Order*. (New Delhi; Lynne Rienner Publishers, 2005) pp 415-433. pp 419&421

Not all the economic nationalists subscribe to its normative commitment and policy prescription on FDI. Instead, others accept its analytical perspective but subscribe their normative commitment to economic liberalism. Economic nationalism is a normative commitment to the nation-state, state-building and the moral superiority of one's own state over all other states.⁸⁰ Therefore, economic nationalism advocates for state-control on MNC's activity to ensure that the monopoly rents accrue more to the host-country. Thus, their policy prescription to the host-countries include the imposition of performance requirements such as local content requirement, local equity participation, exports requirement; regulations on transfer pricing and restrictive business practices; bargaining with the MNCs; 'unpackaging' constituent FDI elements; offering preferential treatment to local capital and nationalization. This means that economic nationalism is essentially protectionist and aims to increase local participation and control of significant economic enterprises or sectors in an economy.⁸¹ On the other hand, the economic nationalists committed to the economic liberalism's policy prescription assert the importance of a favorable international political environment created by a dominant power whose economic and security interests favor an open and liberal international economy. They argue that the hegemon provides the liberal market economy and a corresponding strong liberal international economic regime at its own cost. For instance, in the 1980s and 1990s, the United States, Western Europe and Japan all had an interest in maintaining and even strengthening international conditions that favored MNCs. Therefore, these writers believe that if the consensus and cooperation of the major capitalist powers were to break down, the predominant role of the MNCs in the world

⁸⁰ Robert Gilpin: 'The Nature of Political Economy' *op. cit* pp 14.

⁸¹ Thomas J. Biersteker: *Multinationals, the State*, *op. cit*

economy would gradually diminish. However, this perspective risks equating FDI as an agent of economic globalization with the spread of Western capitalism and hence arouses nationalist sentiments among the developing and less-developed countries.

State-market relation and FDI

Economic liberalism and economic nationalism appear in the first instance to be in sharp contrast. However, to the extent that they emphasize the separation of the State and the 'market', each with its own laws and dynamics, then they are two sides of the same coin.⁸² These perspectives depict competitive relationship between the state and the market and hence host-countries and FDI. That is, economic liberals believe that MNCs have broken free from their home-economy and have become a powerful force determining both international economics and political affairs. On the other hand, economic nationalism despite its divergent normative commitment maintains that states are not passive victims of MNCs activity but, on the contrary, its primary architects. Therefore economic nationalists reject the economic liberalism's presumption but believe that MNCs remain a creature of its home-country.

FDI is an international transfer of capital, technology and managerial skills to a definite national territory. Thus, FDI is an intermestic affair because it cuts across both international and national affairs. In this regard, the growing FDI flow is associated with a deepening enmeshment of the local and the global affairs such that the boundaries between them get blurred. Therefore, this view requires a reorganization of the national economies such that the national economic space no longer coincides with national territorial boundaries.

⁸² Susan Strange: World Order, Non- State Actors, and Global Casino: The Retreat of the State? In Richard Stubbs and Geoffrey R.D. Underhill (ed) (2nd ed) *Political Economy and the Changing Global Order* (New York: Oxford University Press; 2000) pp 82-90.

The study views the state and the market as part of the same, seamless entity of governance, not as contrasting principles of social organization.⁸³ It also holds that FDI as an agent of economic globalization blurs the distinction between national and international affairs. Thus, even where sovereignty still appears intact, states no longer, if they ever did, retain sole command of what transpires within their own territorial boundaries. This way it rejects the competitive nature of the outcome of the relationship between the host-countries and MNCs. That is, either MNCs are independent actors in international affairs or they remain a creature of the home-economy. Instead it argues that the form and functions of the state are forced to adapt as governments seek coherent strategies of engaging with MNCs in a more interconnected but highly uncertain world. Therefore, this account is dynamic and open-ended with regards to the direction of the relationship between host-countries and MNCs. As a result, it does not make claims of the future path of the relationship between the host-country and MNCs.⁸⁴ Instead; we recognize that the host-country-MNCs relations are full of contradictions and significantly shaped by conjectural factors.

Methodology

This section of the chapter deals with the type of research, research design, sampling procedures, sources of data, tools for collecting data and data analysis. The study sets out to examine the extent to which policy shifts affects FDI inflows to Kenya with reference to the industrial sector. Reference to the industrial sector is primarily informed by the recognition that industrialization diversifies the economy. Thus,

⁸³ Geoffrey R D Underhill: Conceptualizing the Changing Global Order in Richard Stubbs and Geoffrey R D. Underhill (ed) (2nd ed) *Political Economy and the Changing Global Order* (New York: Oxford University Press; 2000) pp 82-90

⁸⁴ David Held, Anthony McGrew, David Goldblatt and Jonathan Perraton: *Global Transformations; Politics, Economics and Culture*.(Stanford, California; Stanford University Press; 1999)pp 7

industrialization contributes to the transformation in Kenya's economy. In this study, the industrial sector is construed to be dominated by the manufacturing division. This focus is not in any way meant to underestimate the contribution of the other divisions of the industrial sector such as mining and construction. Instead it is to acknowledge that the manufacturing division is the most dynamic part of the industrial sector and that it is often given a leading role in the planning strategies.

First, the study reviews the industrial development objectives in Kenya. The study then examines the sources of domestic capital vis-à-vis the industrial development objectives to illustrate the gap between targeted industrial development objectives and domestic capital that FDI can fill. This is followed by an analysis on the rationale for FDI and the efforts made to promote FDI inflows particularly in the industrial sector. Finally, the study reviews the pattern of FDI inflows and examines the factors that influence FDI inflows to Kenya. This way the study describes the extent to which policy affects FDI inflows to Kenya. Hence, the research is descriptive in nature.⁸⁵

There are numerous national policies that have an impact on FDI inflows either directly or indirectly. This study purposively samples those policies that primarily and explicitly alter the environment for FDI in Kenya or, if part of a broader policy agenda, contains prominent and explicit provisions dealing with FDI. In addition, the dependent variable of this research is FDI inflows. That is, FDI inflows vary as a function of the national policy. This implies that the trends of FDI inflows in Kenya are explained by the national policy. Therefore, this research holds all other factors that determine FDI inflows

⁸⁵ Olive M. Mugenda and Abel G Mugenda; *Research Methods; Quantitative and Qualitative Approaches* (Nairobi; Acts Press, 1999)

constant and examines the extent to which the national policy affects FDI inflows in Kenya.

The sources of data for this research are both primary and secondary. The research relies on primary documentary source. These are government policy papers and statements, national development plans, Acts of Parliament, Statistical Abstracts Economic Surveys and publications of the relevant government institutions that handle FDI- particularly the Kenya Investment Authority (KenInvest).

The secondary sources of data complement the primary sources in this study. The secondary sources that have been used in this research are the United Nations Conference on Trade and Development (UNCTAD) annual publication- the World Investment Report (WIR) and authored books on the subject. The UNCTAD's WIR provides data on the levels and trends of FDI inflows in Kenya to complement those obtained from the primary sources. The review of authored books on the subject enables us to assertively infer from the information and data collected.

The main data collection tool is content analysis. This is because the study uses both primary and secondary documentary sources. Therefore, the study extensively deduces and infers its findings from the content in these sources.

Therefore, this type of research, research design, sampling procedure, sources of data, the tools for collecting data and data analysis procedure explain to a high degree, the extent to which national policy affects FDI inflows to Kenya.

Organization of the Study

Chapter one of the study consists of the Problem Statement; Objectives of the Study; Literature Review; Theoretical Framework; Methodology of the Research, Scope and Limitations of the Research and Organization of the Study.

The second chapter aims to assess Kenya's industrial development goals vis-à-vis the capital requirements to meet these goals. Towards this end, the chapter will review the industrial development objectives, assess the capital required to meet these objectives and illustrate the variations between objectives and capital resource requirements. This gap will point towards the inadequacy of capital that could be overcome through FDI.

Chapter three will show the importance that the government of Kenya has assigned to FDI in the effort to meet the capital shortfall for industrialization. Specifically the chapter will show Kenya's policy regarding FDI paying special attention to industrial sector. That is, it will show; the rationale for FDI inflows; the measures that have been taken to promote FDI and the measures that have been taken to attract FDI in the industrial sector.

Chapter four analyses the patterns of FDI flows in Kenya in relation to the factors that influence the flows. To do this, the chapter will describe the changing pattern of FDI flows since independence; explain the factors that encourage the flow of FDI with particular reference to the industrial sector; explain the factors that inhibit the flow of FDI with reference to the industrial sector.

Chapter five will conclude the study by first revisiting the problem statement; revisiting the objectives and condensing the findings under each objective.

Chapter Two

Development Capital Requirements in Kenya

Introduction

This chapter will assess Kenya's industrial development objectives in relation to the capital requirements to meet these objectives since independence. Specifically, the chapter will present the country's industrial development objectives, assess the capital required to meet these objectives and illustrate the variations between the set objectives and the capital resource requirements. Finally, the chapter will assess the inadequacy of domestic capital that Foreign Direct Investment (FDI) flows could overcome.

Industrialization in Kenya

The industrial sector is accorded priority in transforming Kenya's economic structure. The structure of Kenya's economy is characterized by the dominance of the agricultural sector over the other sectors.¹ This is by virtue of the contribution of agriculture to the national product specifically in terms of employment, foreign exchange earnings and food security. The agricultural sector accounts for 18 per cent of total formal employment and more than one-third of Kenya's agricultural produce is exported accounting for 65 per cent of Kenya's total exports.² However, the Kenya Government considers industrial development alongside agriculture in its growth projections. For instance, the industrial sector was projected to grow rapidly than the expected 6.3 per cent economic growth in the period 1979-1983.³ Compared to the agricultural sector, the

¹ Republic of Kenya: *Development Plan for the Period 1965/66 to 1969/1970* pp 124 and Republic of Kenya: *National Development Plan 2002-2008; Effective Management for Sustainable Economic Growth and Poverty Reduction* pp 23.

² Republic of Kenya: *Kenya Vision 2030: A Globally Competitive and Prosperous Kenya* (Nairobi: Government Printer, 2007) pp 39

³ Republic of Kenya: *Development Plan 1979-1983* pp (iii) and pp 325/6.

growth in the industrial sector was projected at an average of 1.2 percentages more in the period 1984 to 1988.⁴ In line with the aspirations of Vision 2030, the industrial sector, specifically the manufacturing division is expected to play a critical role in propelling the economy to a 10 per cent growth rate with a projected growth rate of 3 percentages more in the period 2008 to 2012.⁵ This serves to show the expectation that an increased share of the industrial sector to the overall economy will restructure Kenya's economy. That is, industrialization is expected to expand and diversify Kenya's economy. The existence of the symbiotic relationship between the agricultural sector and the industrial sector plays a vital role in this process. This is mainly because industrialization increases the degree of processing of agricultural raw materials into processed products and also provides supplies required to support development in the agricultural sector. As a result, the agricultural sector induces industrial development which in turn expands and diversifies the economy and hence transforms the economic structure.

The thrust for the position that industrialization will transform the economy is the recognition by the Kenya Government that industrial development is 'an essential ingredient of rapid and sustained economic growth'.⁶ Towards this end, agriculture provides the base for the overall economic growth but the industrial sector is the main engine for faster economic growth. Industrial development has been envisioned to and indeed plays a crucial role in terms of foreign exchange earnings, provision of employment, training opportunities and income, supply of consumer goods and services, provision of the means by which natural raw materials can be processed into finished goods for domestic and foreign markets and the development of a diversified

⁴ Republic of Kenya: *Development Plan for the Period 1984-1988* pp 177 and 200.

⁵ Republic of Kenya: *Kenya Vision 2030*: op. cit pp 44 and 60

⁶ Republic of Kenya: *Development Plan for the Period 1965/1966* op. cit pp 235.

technological base.⁷ The industrial sector, specifically the manufacturing division, has contributed an average of 12.3 per cent to the Gross Domestic Product (GDP) from 1964-2000.⁸ Clearly, this analysis excludes the other divisions in the industrial sector. Yet, the contribution of the industrial sector is nearly a half that of agriculture whose average was at 30.0 per cent in the same period. This indicates the significance that the Kenya Government has attached to industrial development.

Therefore, the Kenya Government has pursued industrial development with a wide range of objectives. The principal ones are: the growth of the industrial sector, employment and Kenyanization, export production and diversification. The following sub-sections outline the major strategies used to realize each of these objectives.

Growth of the Industrial Sector

The growth of the industrial sector has been necessitated by the increasing demand for manufactured items coupled with the desire to earn foreign exchange through exports of manufactured items. The growth in domestic demand for manufactured items was estimated at 13.7 per cent in the period 1967-1970 and continued to grow ever since.⁹ This demand can be supplied by either domestic production or imports. The Kenya Government prefers domestic production over the importation of manufactured items. The government of Kenya aptly argues that imports impose foreign exchange constraints.¹⁰ Therefore the growth of the industrial sector is expected to enable the government to meet the increasing domestic demand for manufactured items. This must

⁷ Ibid pp 235, Republic of Kenya: *Development Plan for the Period 1974 to 1978* pp 278-279. Republic of Kenya: *Development Plan for the Period 1984-* op. cit pp 196.

⁸ Republic of Kenya: *National Development Plan 2002-2008*; op. cit pp 2.

⁹ Republic of Kenya: *Development Plan for the Period 1974* op. cit pp 278.

¹⁰ Ibid pp 278

be done at prices competitive with the international prices and the profitability of the enterprise.

To promote rapid growth in the industrial sector, the government of Kenya, first, employed the Import Substitution Strategies (ISI) in the 1960s up to late 1970s as stated thus industrial ranking 'will influence Government decisions on support, protection and preferential status.'¹¹ Therefore, an Industrial Protection Committee was formed to advice on the appropriate treatment to be accorded to the various industries. At this time, the government of Kenya used the protective incentive system that entailed elements such as 'licensing that limited or prohibited the importation of goods competing with domestic manufactures; high duties on competing imports; and relatively low duties on industrial inputs.'¹² These measures were intended to make it worthwhile to produce manufactured items in Kenya than to import them.

In addition, the government of Kenya provided active financial support or participated in joint ventures through the Development Finance Company of Kenya (DFCK) and Industrial and Commercial Development Corporation (ICDC) to promote industrial growth.¹³ This was intended to attract private capital and management in strategic industries whose benefits could not be 'given full weight in commercial considerations.'¹⁴ In this case, some of these industries were considered fundamental to the industrial development in that they would establish the base through which other industries would be built. Thus, Governmental financial participation was used as a

¹¹ Republic of Kenya: *Sessional Paper No. 10 of 1965 on African Socialism and its Application to Planning in Kenya* pp 43

¹² Republic of Kenya: *Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth* (Nairobi: Government Printer, 1986) pp 95

¹³ Republic of Kenya: *Development Plan 1965/66* op. cit pp 239-240

¹⁴ Republic of Kenya: *Sessional Paper No. 10 of 1965* op. cit pp 43

straightforward method of showing approval and encouragement particularly to foreign firms who might hesitate to invest in large industrial projects that were desirable from a public point of view and profitable to the private investor. Thus, the protection, preferential treatment and governmental financial participation significantly created an incentive environment for the growth of the industrial sector and broadened the industrial base. As such the rate of growth in the manufacturing sector division was almost 10.5 per cent between 1972 and 1977 twice the overall economic growth.

The ISI strategies ran into serious challenges. The ISI placed considerable emphasis on consumer goods substitution and there were no commensurate incentives for the development of intermediate and capital goods. For instance, high tariffs on competing import goods and duty concessions on imported intermediate inputs offered to 'infant' industries protected local manufacturers from international competition.¹⁵ This led to greater demand for foreign exchange resources in disproportion to other sectors as aptly stated that 'the manufacturing sector is a net consumer of foreign exchange...and concerted efforts will be made to reduce the foreign content of goods manufactured in Kenya.'¹⁶ There were also no backward linkages. This is clearly so when the government states that it intends to guide the existing enterprises 'to develop projects to achieve backward linkages where economically feasible.'¹⁷ Further, the industrial sector became inward oriented as many domestic firms were able to earn high profits in the domestic market at low capacity utilization.¹⁸ As such, the industrial sector became a major drain

¹⁵ Republic of Kenya: *Development Plan 1979-1983 Part 1* (Nairobi: Government Printer, 1979) pp336

¹⁶ Republic of Kenya: *Development Plan 1979*, *ibid* pp 329

¹⁷ Republic of Kenya: *Development Plan 1984-1988* (Nairobi; Government Printer, 1984) pp 197

¹⁸ Republic of Kenya: *Sessional Paper No. 1 of 1986* op. cit pp 17

on foreign exchange resources since no firm saw the need to take the risks inherent in the external export market.

In tackling these challenges, the government of Kenya proposed to reverse its protective incentive system to the market-based incentive system in the early 1980s onwards.¹⁹ The government of Kenya began to progressively implement 'the structural adjustment strategy... which was essentially a move away from direct Government involvement in manufacturing and other sectors where the private sector can operate effectively.'²⁰ Therefore the policy shifted towards reducing 'the emphasis of highly protected, import-substituting industries in favor of those capable of exporting.'²¹ This was to be achieved through realistic exchange rates, moderate protection, reduced taxes on industrial inputs, and special export incentives. This approach was not necessarily a shift from import-substituting industries as a strategy for continuing industrial growth but subjected import-substituting industries to a different set of qualifiers; that is they compete with imports at moderate rates of protection and without quantitative restrictions. This was intended to make it viable for the private sector to invest in areas of highest productivity.

There is evidence that the growth in the industrial sector has not been steady and sustainable²² but the above measures demonstrate the government interventions that have been undertaken to promote industrial growth.

¹⁹ Ibid pp 24-25

²⁰ Ibid pp 92

²¹ Ibid pp 94

²² Central Bureau of Statistics: *Economic Survey 1984* pp 6, Central Bureau of Statistics: *Economic Survey 1990* pp 7 and Central Bureau of Statistics: *Economic Survey 1993* pp 7

Creation of Employment Opportunities and Kenyanization

The government of Kenya links the growth in the industrial sector with increased employment opportunities. The government holds that as a result of the 5.9 per cent growth in real output in the manufacturing sector a 2.8 per cent growth in employment in the manufacturing sector was recorded in 1989.²³ That is, 182,282 persons were employed in 1989 from the level of 177,354 persons employed in 1988. Further, the government of Kenya asserts that as a result of the poor performance of the domestic manufacturing sector in the year 1992, employment in manufacturing was 189,596 persons only 0.4 per cent above the 1991 employment level.²⁴ This linkage informs the government of Kenya's position of encouraging 'enterprises to explore all possibilities of adapting more labor intensive techniques.'²⁵ The key strategy to bring about this is by promoting enterprises that use labor intensive technologies, promoting small scale rural and informal sector enterprises and differential investment allowances based on employment generated by each manufacturing unit. The government is also committed to train and educate its work force in order to upgrade the existing skills by utilizing public and private institutions.²⁶

The government of Kenya takes cognizance of its shortage of capital and lack of trained, educated and experienced manpower²⁷ that constitute serious barriers to increased African participation in industry. Through a program called Kenyanization,²⁸ the government intended to make capital available to Africans and to provide education,

²³ Central Bureau of Statistics: *Economic Survey* 1990 pp 7

²⁴ Central Bureau of Statistics: *Economic Survey* 1993 pp 7

²⁵ Republic of Kenya: *National Development Plan 1974* op. cit pp278

²⁶ Republic of Kenya: *Development Plan 1965/6* op. cit pp 271 and 311-312

²⁷ Republic of Kenya: *Sessional Paper No. 10 of 1965* op. cit pp 19

²⁸ Republic of Kenya: *Development Plan 1979-1983 Part 1* pp 331

training and experience through extension services in order to empower them to own new industrial enterprises. In addition, foreign firms were asked to take on as apprentices Africans who showed aptitude and willingness to enter into industrial career. They were also asked to ensure the participation of their staff in training courses.²⁹ Foreign firms were also required to employ Kenyans at managerial and technical levels as soon as there are qualified people. As expected, Kenyanization has to a great extent been achieved by employing Kenyans in the industrial sector.³⁰ However, Kenyanization through ownership of industries still faces some challenges. For example, Kenyans have been sidelined to the ownership of medium and small scale industrial enterprises as stated 'small scale industrial development programs will promote Kenyan entrepreneurs.'³¹ Further, the government of Kenya participation in large industrial enterprises through the Development Finance Institutions (DFIs) such as the DFCK and ICDC is put to question by the presence of foreign capital in the financial composition of these institutions.³² The DFIs such as the DFCK are funded by external loans as discussed later in this chapter.

Export Orientation and Diversification

As already indicated above, one of the most serious problems faced by the industrial sector is its inward orientation. The industrial sector further drains much of the needed foreign exchange resources³³ mostly generated from the agricultural sector. Therefore the government of Kenya aimed to 'increase the degree of processing raw material produced in the country and to gradually export processed products rather than

²⁹ Republic of Kenya: *Development Plan 1965/6* op. cit pp 271

³⁰ Republic of Kenya: *Sessional Paper No. 10 of 1965* op. cit pp 27

³¹ Republic of Kenya: *Development Plan 1974* op. cit pp 278-279

³² Central Bureau of Statistics: *Economic Survey 1981* pg 160.

³³ Republic of Kenya: *Development Plan For the Period 1974-1978 Part I* pp 280

raw materials.³⁴ The strategies to achieve this are phasing out of protectionist measures by for example, rationalizing the tariffs structure, modifying the remission and refund of duty on intermediate and capital goods, as well as import licensing. The duty-drawback system not only discouraged domestic intermediate and capital goods industries but also was biased against export industries based on local materials.³⁵ Therefore, reforming this system was a principal element for sustained industrialization based on the ability to compete with other countries for exports. It was envisioned that hinging industrial growth on the rapid expansion of production for export would contribute towards the stabilization of the balance of payments position. As a result, the government of Kenya holds that the efficient local production of manufactured goods particularly for exports, leads to 'better utilization of domestic resources, creation of employment opportunities, and saving or earning of foreign exchange.'³⁶

The government of Kenya also spells export promotion programs aimed at increasing foreign exchange earnings, employment opportunities, income per capita and trade surplus.³⁷ These programs are based on the production of non-traditional export products and increase in value addition to primary products through packaging, styling and design and new product development alongside international competitiveness in quality, prices and timely delivery of products. The government of Kenya employs three principal incentives schemes: duty/VAT remission; export processing zones (EPZ); and manufacturing under bond (MUB). It also provides necessary support services by working closely with the private sector through the Export Promotion Council (EPC) to

³⁴ Republic of Kenya: *Development Plan For the Period 1970-1974* pp 304

³⁵ Republic of Kenya: *Development Plan 1974* op. cit pp 281

³⁶ Republic of Kenya: *Development Plan For the Period 1979-1983* pp 329

³⁷ Republic of Kenya: *Sessional Paper No. 2 of 1996 on Industrial Transformation to the Year 2020* (Nairobi: Government Printer, November 1996) pp 63

identify export opportunities. The EPC undertakes market surveys and investigations, trade fairs, exhibitions and trade missions to expand Kenyan market presence in traditional and new markets.

The promotion of export production in the industrial sector effectively diversifies Kenya's export base which has been predominantly agricultural. Furthermore, the industrial sector is expected to help in the processing of agricultural commodities before exportation so as to increase the level of value added retained within the economy. This diversification significantly transforms Kenya's economic structure, increases foreign exchange earnings, and results in favorable terms of trade which in turn reduces the challenges in the management of the balance of payments. This is well captured in statements such as; 'only a diversified industrial sector can maximize the benefits of industrialization.'³⁸ This is because, 'such a sector would produce a wide range of products at all stages of output: whole manufacturing plant, machinery, equipment, intermediate goods, and consumer goods.'³⁹

Capital for Industrial Development

The principal industrial development objectives outlined above require among other things, capital for them to be achieved. Many planned industrial projects would not be initiated without capital. In Kenya, the provision of industrial capital has mostly been the responsibility of the DFI such as the Industrial and Commercial Development Corporation (ICDC), Development Finance Company of Kenya (DFCK), Kenya

³⁸ Republic of Kenya: *Development Plan For the Period 1974* op. cit pp 279

³⁹ Ibid pp 279

Industrial Estates (KIE) and the Industrial Development Bank (IDB).⁴⁰ The following sub-sections review the roles and sources of finance for each of these institutions.

Industrial and Commercial Development Corporation (ICDC)

ICDC is the pioneer Development Finance Institution (DFI) in Kenya. It was established through an Act of Parliament in 1954 to facilitate industrial growth in the country. ICDC is fully owned by the government of Kenya. It was assigned the role of not only providing financial assistance but also extension services by technical and commercial experts.⁴¹ The objective was to make marginal industrial projects economic and to assist and promote those projects which would form a spearhead for Kenyanization of the industrial sector.⁴²

Therefore, where possible, ICDC provided loans so that ownership of the enterprise would rest with those who manage them. Most ICDC's investments are in small and medium scale firms. Thus, Kenyan owner/managers command very limited funds. Hence, ICDC as an investment arm of the government and participates in the equity of those enterprises which are accorded high priority in the planned government projects.⁴³ Nevertheless, ICDC has an option where entrepreneurs can buy up its share as their firms progress and they accumulate their own savings. ICDC also helps entrepreneurs to get bank loans and supplier credits but will expect the entrepreneurs to put up some risk capital.⁴⁴

⁴⁰ Republic of Kenya: *Development Plan 1965/6* op. cit pp 241

⁴¹ Republic of Kenya: *Development Plan For the Period from 1st July, 1964, to 30th June, 1970* pp 81-82

⁴² Republic of Kenya: *Development Plan 1965/6* op. cit pp 242

⁴³ Republic of Kenya: *Development Plan 1979* op. cit pp 347

⁴⁴ Republic of Kenya: *Development Plan 1965/6* op. cit pp 242

Development Finance Company of Kenya (DFCK)

The DFCK was formed in 1963 with an initial capital of £ 1.5 millions.⁴⁵ This capital was equally subscribed by the Commonwealth Development Corporation, the (West) Germany Development Company and the ICDC. Therefore, DFCK's sources of finance include equity subscription from its shareholders, both local and foreign, as well as internally generated funds.⁴⁶ The activities of the DFCK mainly focus on the development of medium and large scale industrial enterprises to which it provides both equity and loan capital.

Kenya Industrial Estates (KIE)

KIE was established in 1967 as a subsidiary of the ICDC to facilitate development and incubation of micro, small and medium enterprises (MSMEs). This is the government's main agency for promoting small-scale and rural industries through establishing of industrial estates, providing loans and business development services (BDS) to entrepreneurs. An industrial estate is not just an industrial area, but an organization that builds up an integrated structure of individual enterprises which share common services, transport arrangements, and commercial and technical assistance in the form of extension services.⁴⁷

KIE provides loans at relatively lower interest rates and negotiable repayment terms. The KIE is funded by both the exchequer and foreign bilateral and multilateral institutions.

⁴⁵ Ibid pp 241

⁴⁶ Republic of Kenya: *Development Plan 1979* op. cit pp 348

⁴⁷ Republic of Kenya: *Development Plan 1965/6* op. cit pp 243

Industrial Development Bank (IDB)

The IDB is a DFI that was formed in 1973 to assist medium and large scale industries mainly through loans and equity participation.⁴⁸ IDB was re-launched as IDB Capital Limited in 2006 to further the establishment, expansion and modernization of medium and large scale industrial enterprises through the provision of medium and long-term loans, direct equity investment, provision of guarantees for loans from other sources and underwriting of securities. It also offers management and consultancy services.

The sources of funds for the IDB are funds generated by its own operations and external loans from the World Bank and other financial institutions.⁴⁹ IDB Capital Limited also partners with the ICDC, Kenya Reinsurance Corporation, Kenya National Assurance, National Bank of Kenya and the Government of Kenya.

It is therefore clear that the main functions of DFIs is the provision of loans, equity participation and extension services for the expansion of capacity in existing industrial enterprises and the erection of enterprises planned for new lines of production. Thus, the industrial development objectives can be achieved in the backdrop of the planned industrial projects whose initiation and operation is significantly determined not only by the financial but the technical and commercial assistance that is provided by the DFIs.

Industrialization and Capital

The main channel for both public and private financing for industrial development in Kenya has been the DFIs.⁵⁰ This is evidenced, for instance, by the fact that the

⁴⁸ Republic of Kenya: *Development Plan For the Period 1974* op. cit pp 292

⁴⁹ Ibid pp 292

⁵⁰ Central Bureau of Statistics: *Economic Survey 1990* pg 143.

expansion of new manufacturing capacity in the medium and large scale industries was mainly financed by the ICDC, DFCK and IDB in 1976.⁵¹ As it has been indicated above, the source of finance for the DFIs range from the domestic savings, external loans and funds generated internally. Thus, effective mobilization of both domestic savings and external loans is a pre-requisite for industrial development. That is, when the government of Kenya is able to generate a high savings ratio that can be complemented by external loans so will it be able to invest more in industrial development projects. This means that savings is a key performance indicator for industrial investment.

Since independence, the government of Kenya has been able to save and invest a substantial percentage of Gross National Product (GNP). For example, an average of 25 per cent of GNP has been invested from 1970-1989.⁵² In this period, there was also an increase in the level of investment financed by households, domestic corporations and Government. In addition, the level of investment funded through foreign savings particularly external loans has been on the decline since the mid 1970s.⁵³ This indicates that the main source of investment finance to the DFIs is domestic savings. That is, savings arising from both the private and public sector constitute a huge fraction of the DFIs financial composition.

The level of domestic savings is substantially dependent on economic performance. As a result, countries with high consumption share and low domestic savings run the dual risk of under investing and excessive reliance on foreign saving to fund their investment. In as much as the government of Kenya is wary of such a scenario,

⁵¹ Central Bureau of Statistics: *Economic Survey 1977* pg 123.

⁵² Republic of Kenya: *Development Plan 1989-1993* pp 10.

⁵³ Republic of Kenya: *Sessional Paper No. 1 of 1994 on Recovery and Sustainable Development to the Year 2010* (Nairobi; Government Printer, 1994) pp 36

it is evident that Kenya's domestic savings have continued to decline. For example, the level of Kenya's domestic savings declined from an annual average of 17.2 per cent in 1964-1973 period to 11.8 per cent in 1996-2000 period.⁵⁴ The Gross Domestic Investment (GDI) as a per cent of GDP has fluctuated between 19.7 per cent in 1964-1973 to 17.6 per cent over the 1996-2000 period.⁵⁵ This indicates that there has been a significant reduction in industrial credit available to the DFIs. This in turn constrains the DFIs from approving industrial projects. A case in point is the reduction of the number of projects approved by the KIE to 69 projects worth Ksh.20.7 millions out of a total of 170 projects worth Ksh.55.8 millions in 2006/7 compared to 83 projects worth Ksh.33.5 millions in the previous period. The activities of the DFIs have been further subdued when donors withdraw funding to them. In this case, the African Development Bank withdrew funding to the KIE limiting funding to the corporation to internally generated funds only.

The government of Kenya recognizes the shortage of domestic capital to attain the high levels of investment required to bring about the planned industrial transformation.⁵⁶ That is, the capital required to finance the industrial sector to achieve the desired industrial development objectives far outweigh the domestic capital. The government of Kenya considers this shortage of domestic capital to be cyclic. This is because, the fundamental cause of the shortage of domestic capital is the low per capita incomes out of which people must finance a living before they can save and pay taxes.⁵⁷ To increase the per capita income then Kenya's economy must grow. In order for the Kenya's

⁵⁴ Republic of Kenya: *National Development Plan 2002-2008. Effective Management for Sustainable Economic Growth and Poverty Reduction* (Nairobi: Government Printer, 2002) pp 2

⁵⁵ Ibid pp 2

⁵⁶ Republic of Kenya: *Sessional Paper No. 10 of 1965* pp 19

⁵⁷ Ibid pp 19

economy to grow then more must be saved and invested. To save and invest more, Kenya's economy must grow faster. Thus, the government of Kenya recognizes that to solely rely on domestic savings to grow is a futile exercise.⁵⁸ To move out of this cycle not only does the government of Kenya intend to substantially increase its domestic savings but seeks alternative sources of finance to compensate for the shortfall in domestic capital in order to achieve the desired levels of investment. As a result, Kenya has to 'borrow from foreign governments and international institutions and stimulate the inflow of private capital from abroad.'⁵⁹ Accordingly, the Kenya Government places considerable emphasis on attracting FDI in the manufacturing sector.⁶⁰

Conclusion

Industrialization plays a crucial role in Kenya's economy in transforming Kenya's economy through its contribution to the national economy in terms of employment creation, foreign exchange earnings and diversification of Kenya's export base. Over the years, the government of Kenya has, with a sizeable degree of variation, pursued three principal industrial objectives: industrial growth, creation of employment opportunities and Kenyanization, and export orientation and diversification. Major strategic interventions such as the ISI strategies and Structural Adjustment Strategy were implemented with the aim of transforming Kenya to a newly industrializing economy. Further, DFIs were used as the main channels of investment finance for industrial development. The sources of finance for the DFI are mainly domestic savings, external loans and internally generated funds. It was established that the levels of domestic

⁵⁸ Republic of Kenya: *National Development Plan for the Period 1997-2001* (Nairobi: Government Printer, 1997) pp 44

⁵⁹ Ibid pp 19

⁶⁰ Republic of Kenya: *Kenya Vision 2030* op. cit pp 60

savings are inadequate to finance investment required to attain the desired industrial development. However, considering the risks associated with external loans and the diminished relative availability of aid and concessionary loans, it is clear that Kenya must depend on its own resources while attracting increased volumes of foreign, non-debt, private capital; that is FDI.

Chapter Three

Development through Foreign Direct Investment (FDI) in Kenya

Introduction

This chapter aims to show the importance that the government of Kenya has assigned to Foreign Direct Investment (FDI) in the effort to meet the capital shortfall for industrial development. Specifically, the chapter will show Kenya's policy regarding FDI with particular reference to industrial development. Towards this end, the chapter will first, analyze the rationale for FDI inflows; then the measures that have been taken to promote FDI. Finally, the chapter will examine the measures that have been taken to attract FDI in the industrial sector.

Rationale for FDI Inflows

FDI is crucial to the Kenyan economy. FDI contributes foreign capital that helps close the resource gap between targeted investment and locally mobilized savings.¹ For instance, it is stated that 'most, if not all countries which now enjoy high living standards have, at some point in their development, imported capital to supplement their domestic savings.'² This statement belies the belief that development is untenable without supplementing domestic capital with foreign capital such as FDI. Indeed, Kenya faces the challenge of shortage of domestic capital for investment and trained and experienced manpower.³ For instance, Kenya's Gross Domestic Investment (GDI) was 13.1 per cent of Gross Domestic Product (GDP) while Gross Domestic Savings was 10.4 per cent of

¹ Republic of Kenya: *Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth*. (Nairobi, Government Printer, 1988) pp 15-16

² Republic of Kenya: *Sessional Paper No. 1 of 1994 on Recovery and Sustainable Development to the year 2010*. (Nairobi, Government Printer, 1994) pp 35-36

³ Republic of Kenya: *Sessional Paper No. 10 of 1965 on African Socialism and its Application to Planning*, (Nairobi, Government Printer, 1965) pp 19

Gross Domestic Product in 2002.⁴ Thus, as an extra source of capital and investment, FDI helps to close this gap. FDI inflows to the industrial sector, specifically the manufacturing division have led to the creation of employment, technological advancement and diversification of output and exports.⁵ For instance, the manufacturing division employed 254, 000 people which represents 13 per cent of total employment in 2007.⁶ Further, the increased FDI inflows in the labor intensive Export Processing Zone (EPZ) have employed over 35 000 people with around 12 000 jobs indirectly created as a result of sub-contracting. Horticulture and floriculture had around 135 000 employees as of 2003 whereas Brooke Bond Kenya which operates in the agricultural sector employed 21 191 persons as of 2003. Kenya has also been able to diversify output and exports in horticulture and floriculture.⁷ All these point to the contribution of FDI to the national economy in terms of investment capital, employment creation, foreign exchange earnings, and diversification of the economy.

In light of the risks associated with commercial external borrowing and that high levels of grants and concessionary loans are not forthcoming, 'Kenya can gain access to foreign private capital without borrowing'⁸ through FDI. Thus, FDI, which is 'foreign, non-debt, private capital'⁹ relieves the government from the pangs of external debt. An additional advantage, cited by the government of Kenya, is that the risks inherent in business undertaken by foreign investors are borne partly or wholly by these foreign

⁴ UNCTAD: *Investment Policy Review: Kenya*. (New York and Geneva: United Nations, 2005)

⁵ Ibid

⁶ Republic of Kenya: *Kenya Vision 2030: A Globally Competitive and Prosperous Kenya* (Nairobi: Government Printer, 2007) pp 60.

⁷ UNCTAD: *Investment Policy Review: Kenya* op. cit

⁸ Republic of Kenya: *Sessional Paper No.1 of 1994* pp 37

⁹ Ibid pp 37

investors.¹⁰ This is because FDI involves ownership and control of a firm in a foreign country hence confers the rights to a company's profits or otherwise to the foreign owners. Therefore, FDI absolves the government from the inherent risks in undertaking an investment. Further, the government of Kenya argues that 'foreign entrepreneurs can contribute knowledge of, and access to, foreign markets and technology that is in very short supply in Kenya.'¹¹ Therefore, the government of Kenya believes that FDI comes with the much needed foreign market knowledge and access. It also contributes to technological advancement that can improve efficiency of production and increase national output. The government of Kenya further builds the argument for FDI by asserting that FDI 'creates opportunities for local entrepreneurs in joint ventures and in backward linkage industries to provide intermediate products and services to foreign firms.'¹² It is the opinion of the government of Kenya that FDI is a mutually rewarding exchange between entrepreneurs since FDI creates opportunities for local entrepreneurs to form joint ventures and to establish backward linkages industries to provide intermediate products and services to the foreign firms.

It is, therefore, evident that the government of Kenya intends to supplement its limited domestic capital with FDI. As a result, the government of Kenya's policy towards FDI is basically positive and non-restrictive characterized by encouragement and support where needed. This implies that, the Kenya government has welcomed and encouraged FDI in order to supplement its domestic capital, acquire superior technology, skills and techniques as well as experience and knowledge in the design and marketing of exports.

¹⁰ Ibid pp 37

¹¹ Ibid pp 37

¹² Ibid pp 38

Thus, the government of Kenya seeks to stimulate the flows of FDI without necessarily relaxing its effort to promote domestic savings.

Promotion of FDI Inflows in Kenya

Encouraging FDI has been a key economic objective of the government of Kenya since independence.¹³ Much as it is stated that ‘the government will encourage foreign investment on the same terms as domestic investment’¹⁴ specific measures have been undertaken that directly promote FDI inflows. Therefore, the government of Kenya policy is aimed at extending facilitating measures in favor of FDI. These measures are grouped into four broad categories: investment incentives, investment approvals, moderated nationalization and privatized economy. The sections below examine in detail the measures and instruments in each of these categories.

Investment Incentives

Investment incentives are offered as an inducement to foreign direct investors’ preference and choice of the location to undertake FDI. Kenya was faced with capital disinvestment on a large scale at independence. The government’s preoccupation was to halt this outflow and restore confidence among foreign investors. To redress this challenge, the government of Kenya adopted protection of foreign investment. As a result, a major instrument, the Foreign Investment Protection Act (FIPA) of 1964 was passed. Under FIPA, foreign investors were issued with a Certificate of Approved Enterprise (CAE).¹⁵ The holders of the CAE were guaranteed the right to repatriate

¹³ See for example the National Development Plan 2002-2008: *Effective Management for Sustainable Economic Growth and Poverty Reduction*. pp 44.

¹⁴ Republic of Kenya: *Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth*. (Nairobi, Government Printer, 1986) pp 98

¹⁵ See The Foreign Investments Protection Act, No.35 of 12 December 1964; effective on 15 December 1964. Sec.3 (1) Source: <http://www.kenyalaw.com/theForeignInvestmentsProtectionAct.htm>

profits, loans, interest on loans and the approved proportion of the net proceeds of sale of all or any part of the approved foreign enterprise. The holders of the CAE were also assured that no approved enterprise would be compulsorily acquired except under the provisions of the Kenya Constitution.¹⁶ These guarantees on the right to repatriate profits, remittance of capital and property rights protection provide an incentive environment to retain the foreign firms already established in Kenya. Indeed, FIPA was used as one incentive to persuade foreign investors to undertake FDI in Kenya¹⁷ as has been aptly asserted that 'Kenya's steady record for facilitating profit remittances makes her an attractive country for foreign investment.'¹⁸

The government of Kenya holds that 'imports cost foreign exchange'¹⁹ and that it is essential to develop local production of manufactures in particular. This statement encourages the setting up of an industry whose products would otherwise be imported; that is import-substituting industry. The aim of import-substituting was to facilitate Kenya's transformation from a predominantly agricultural to a modern industrial economy. It was expected to generate opportunities for employment, raise the levels of productivity and raise the standards of living of the majority of Kenyans. On the external sector, import-substituting was expected to diversify exports from the predominantly primary sector in which exports from the industrial sector would play a significant role. In addition, import-substitution was expected to address the concerns on the balance of

¹⁶ The Constitution of Kenya requires justification in terms of the public interest, the right of appeal to the Supreme Court and full and prompt payment of compensation. See the Constitution of Kenya Section 75(1) a, b, and c. See also FIPA (1964) Sec 7 and 8.

¹⁷ Steven Langdon: *The Multinational Corporation in the Kenya Political Economy*. In Raphael Kaplinsky (ed): *Readings on the Multinational Corporations in Kenya* (Nairobi, Oxford University Press. 1978) pp 134-200. pp 163

¹⁸ Republic of Kenya, *Sessional Paper No. 1 of 1986* op. cit 99

¹⁹ Republic of Kenya: *Development Plan For the Period 1974-1978* pp 278

payments associated with deteriorating terms of trade and independence of the economy through substitution of imported goods by domestic production.

In Kenya, import-substitution took place behind the wall of relatively heavy protection against foreign competition.²⁰ The government used relatively over-valued exchange rate to keep imported capital goods and intermediate inputs relatively cheap. Interest rates were subsidized to make domestic investment attractive. There was also direct government participation in industry interventions in the form of the provision of direct loans and equity capital and access to foreign exchange for imported inputs and remittances at subsidized official rates. These protective measures were a significant incentive to foreign investors. The foreign investors sought these protective incentives through the Industrial Protection Committee which made decisions on tariff protection and remissions or refunds.²¹ Much as there has been a shift in emphasis in the use of some instruments for protection such as restrictive import licensing to rationalized import tariffs the local-industry is still accorded a significant degree of protection. For instance, the slow exposure of the domestic industry to competition from imports significantly protects these firms to 'produce profitably within this protective structure.'²²

Import-substitution strains the foreign exchange earnings required in sustaining the importation of capital and intermediate inputs. Further, industrial investment and operations are not necessarily associated with strong linkages with the rest of the economy.²³ However, the government of Kenya 'believes that the country has not yet

²⁰ Republic of Kenya: *Sessional Paper No.1 of 1986* op. cit pp 95

²¹ Republic of Kenya: *Development Plan 1974* op. cit 280-281

²² Ibid pp 95

²³ See for example Samuel M. Wangwe and Haji H. Semboja: Impact of Structural Adjustment on Industrialization and Technology in Africa in Thandika Mkandawire and Charles C. Soludo (eds) *African Voices on Structural Adjustment* (Dakar: Africa World Press, 2003) pp 161-187.

exhausted all the opportunities of import-substitution industries.²⁴ This is due to the recognition that there are increasing opportunities for producing both capital and consumer goods locally which presently imported. It is further emphasized that 'Kenya's strategy also encompasses import substitution as a continuing avenue for industrial growth.'²⁵ Thus, with the shift from the protective incentives structure to the market-based incentives structure, import-substituting industries are expected to compete with imports at moderate rates of protection and without import quotas. Import-substitution under the market-based incentives therefore, becomes efficient. The market-based incentives structure entail the dismantling of quantitative restrictions on imports, rationalization and lowering import tariffs, abolition of exchange controls, including controls on the capital account, liberalization of the interest rates to reflect market conditions in the money market and privatization of non-strategic State-owned enterprises (SOE).²⁶ This shift establishes a market friendly set of incentives that to some extent encourages the flow of FDI into Kenya.

The shift to market-based incentives also encourages export-oriented manufacturing.²⁷ The government of Kenya extends a number of incentives to the export-oriented industries. Key among them is the flexible management of the exchange rate. The management of a flexible exchange rate enables export-oriented industries to maintain profitable margins of export earnings over the domestic costs of production by making export products affordable and hence increase their demand. The additional

²⁴ Republic of Kenya: *Development Plan 1974* pp 304-305

²⁵ Republic of Kenya: *Sessional Paper No. 1 of 1986* op. cit pp 94

²⁶ Ibid pp 24-25. See also Haris Mule: *Lesson on Regulatory Reform; Kenya's Experience in* Laura Wallace (ed): *Africa; Adjusting to the Challenges of Globalization* (IMF. Ministry of Finance of Japan, 1992) pp 27-32.

²⁷ Republic of Kenya: *Sessional Paper No. 1 of 1986* op. cit pp 94

incentives include export compensation and Export Processing Zones (EPZ). The purpose of export compensation is to pay exporting firms for the cost of production that are higher because of tariffs on their imported inputs or because their protected domestic suppliers produce at high cost. On the other hand, the Export Processing Zones (EPZ) offers a set of incentives. The EPZ offers considerable advantages such as a ten-year tax holiday followed by a 25 per cent tax rate for the next ten years, exemption from all withholding taxes on dividends and other payments to non-residents during the first ten years, exemption from import duties on machinery, raw material and intermediate inputs and no restriction on management or technical arrangements. The other advantages are exemption from stamp duty, exemption from VAT and that EPZ can operate under one license only.²⁸

Therefore, it is evident that the government of Kenya has made deliberate effort to create an incentives environment by providing for a large degree of protection from competition-international and sometimes domestic-of foreign enterprises established in Kenya. The measures that were used include high import tariffs, import quotas and exemption from duties on imported machinery and inputs. The Kenya Government also provided for the deregulation and removal of government-induced distortions and privatization of non-strategic State-Owned enterprises (SOE). The measures used are rationalizing and reducing import tariffs, managed floating exchange rate system and liberalizing the interest rates to reflect real scarcity. In addition, incentive devices that are of uncertain benefit in attracting FDI such as tax holidays, special depreciation rules, customs duty and sales tax remission have been reservedly employed.

²⁸ Export Processing Zones Act of 1990.

Investment Approvals

The formal FDI approval process has evolved from being muddled, often *ad hoc* with a lot of discretionary powers²⁹ to being institutionalized. This evolution underlies the government of Kenya's intention to attract new FDI inflows by offering relatively liberal and simplified FDI approval environment.

The rules and regulations that governed the entry of new FDI in Kenya were first spelt under the Foreign Investment Protection Act (FIPA) of 1964. FIPA formed the benchmark for the approval of new FDI. Foreign direct investors were required to obtain an approval certificate before undertaking FDI in Kenya.³⁰ The rules and regulation on FDI entry requires the issuance of an investment certificate to an investment that 'would further the economic development of, or is of benefit to, Kenya.'³¹ In determining that FDI is beneficial to Kenya, consideration is given to the extent to which FDI contributes to 'the creation of employment, acquisition of new skills or technology, contribution to taxes or other government revenue, the transfer of technology, an increase in foreign exchange, either through exports or import substitution, utilization of domestic raw materials, supplies and services, adoption of value addition in the processing of local, natural and agricultural resources and the utilization, promotion, development and implementation of information and communication technology'.³²

²⁹ See for example David Gachuki and Peter Coughlin: Structure and Safeguards fro Negotiations with Foreign Investors: Lessons from Kenya in Peter Coughlin and Gerishon K Ikiara: *Industrialization in Kenya; In Search of a Strategy* (Nairobi; Heinemann Kenya Ltd. 1988) pp 91-111

³⁰ This requirement is provided for under the Foreign Investment Protection Act of 1964, Investment Promotion Centre Act of 1986 and the Investment Promotion Act of 2004.

³¹ See the Foreign Investment Protection Act of 1964. sec. 3(1)

³² See the Investment Promotion Act of 2004 Sec 4(2) a,b,c,d,e,f,g,and h.

The approval of FDI was done on a case by case basis in Kenya. The process was markedly *ad hoc* and discretionary in nature.³³ An inter-ministerial committee, the New Projects Committee (NPC) was established to regulate the flow of FDI by evaluating industrial projects in terms of benefit to Kenya. NPC was *ad hoc*, had no clear mandate or legislated responsibilities to enforce or implement and never had core permanent staff. The NPC had no decision-making powers due to political interference and that the ultimate decision about an investment was vested with the Minister.

The government of Kenya was committed to simplify, co-ordinate and shorten the process of FDI approvals.³⁴ The investment approval procedure was simplified, made coordinative and shortened through the Investment Promotion Act (IPA) 2004 which created the Kenya Investment Authority (KenInvest) formerly the Investment Promotion Center (IPC).³⁵ The Investment Promotion Center (IPC) as established under the Investment Promotion Center Act of 1986³⁶ resulted from the need for a 'one-stop shop' for investment. The IPC provided information on various incentives to investors including, the procedure for obtaining such information and how incentives are implemented. However, the IPC lacked proper authority to implement many incentives and procedures. Consequently, the IPC was reconstituted to become the Kenya Investment Authority (KenInvest).³⁷ KenInvest issues an Investment Certificate to new

³³ See David Gachuki and Peter Coughlin: Structure and Safeguards for Negotiations with Foreign Investors: Lessons from Kenya. In Peter Coughlin and Gerishon K Ikiara Op cit.

³⁴ Republic of Kenya, *Economic Recovery Strategy for Wealth and Employment Creation 2003-2007*. (Government of Kenya, June 2003) pp 35 and also *Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth*

³⁵ The Investment Promotion Center (IPC) was established under the Investment Promotion Center Act. IPC was a 'one-stop' bureau for inward investors. The Investment Promotion Act 2004 led to the creation of the Kenya Investment Authority (Kenvest). See also the Investment Promotion Act 2004.

³⁶ *Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth* pp 99, and *Sessional Paper No. 1 of 1994 on Recovery and Sustainable Development to the Year 2010* pp 40.

³⁷ See Investment Promotion Act 2004 Sec 14(1)

foreign investors who have fulfilled the required conditions. These are a mandatory threshold of US\$ 0.5 million and that the investment is of benefit to Kenya. The benefit is in terms of employment, new skills and technology and contribution to tax revenue or other government revenue.³⁸ The holders of the Investment Certificate are then entitled to all operational licenses including work permits for foreign management expatriates. This is aimed at minimizing the unnecessary delays that foreign investors had been previously experiencing as they sought the various approvals.³⁹ Thus, KenInvest is legally charged with the responsibility of promoting and facilitating foreign investment in Kenya. KenInvest evaluates FDI in terms of its benefit to Kenya and facilitates the issuance of an investment certificate and assists in obtaining the necessary licenses and permits. KenInvest also has core permanent staff.⁴⁰ Therefore, KenInvest offers relative simplified procedures for FDI approval.

Moderated Nationalization

The government of Kenya considers nationalization to be 'a useful tool that has already been used and will be used again when circumstances require.'⁴¹ The reservation on the use of nationalization of private assets is as a result of the 'pertinent questions' on the cost, purpose and timing of nationalization. With regard to cost, the government of Kenya is wary of buying out foreign enterprises to increase her control of the economy. The government reasoned that buying foreign owned enterprises using existing domestic capital adds no value in terms of employment and output but only transfers ownership;

³⁸ See the Investment Promotion Act 2004.

³⁹ This is spelt in the *Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth* pp 99. The Investment Promotion Center Act was passed in this spirit.

⁴⁰ The Investment Promotion Act 2004 Sec 24 (1) allows KenInvest to appoint such other staff as it considers advisable.

⁴¹ Republic of Kenya: *Sessional Paper No. 10 of 1965* op. cit pp 26

*'The nation has no more productive assets than before-only their ownership has changed. What may be lost are the new resources that could have been purchased instead ... and the new employment opportunities and the added output that these new developments would create.'*⁴²

This cost of nationalization arises from the government of Kenya's commitment to prompt payment of full compensation whenever nationalization is used. These clearly defined stipulations within which compulsory acquisition can occur earns the foreign investor's confidence on investing in Kenya. The other cost implication of nationalization arises from the clarity with which the government of Kenya asserts that nationalized industries had to be efficiently operated so as to cover their costs and earn a profit at least equivalent to the taxes paid when operated privately. Otherwise, nationalization would be of little gain when taxes are used every year to subsidize the operations of nationalized industries.⁴³ Thus, the opportunity cost of nationalization placed considerable restraint the government of Kenya which in turn encouraged foreign investor to undertake FDI in Kenya.

Apart from the cost of nationalization that is evidently high, there are circumstances that the government considers nationalization to be necessary. Specifically, the government of Kenya has considered nationalization for strategic purposes such as national security, health, protection of the environment and the provision of essential services to the public regardless of the cost implication.⁴⁴ For instance, the government purchased control in oil-refining, banking and power by

⁴² Ibid pp 26

⁴³ Ibid pp 27

⁴⁴ Ibid pp 27

obtaining a 60 per cent interest in East African Oil Refineries, 50 per cent in the Standard Bank of Kenya and 50 per cent in Barclays and 59 per cent in East African Power and Lighting.⁴⁵ Thus, the government of Kenya considers nationalization only when the need is urgent, other less costly controls are ineffective and when the nationalized industries will not be operated at a loss.

The question as when to nationalize is dealt by the government concern, at the time when nationalization was prominent in many developing countries, that 'the money paid for nationalized resources and the people who managed them before nationalization would most likely leave the country increasing our foreign exchange and skilled manpower problems.'⁴⁶ Further, the government of Kenya concludes that 'there is a firm likelihood that nationalization would discourage additional private investment,'⁴⁷ an indication that private investment, foreign or local is desirable and encouraged.

Therefore, the government of Kenya clearly demonstrated that nationalization would not be used indiscriminately. Instead, the government of Kenya spelt the circumstances within which nationalization may occur. The government of Kenya also went further to address the remedial measures that to be pursued by the foreign investor including prompt and full compensation whenever nationalization was used. Nationalization in Kenya was therefore moderate. This brimmed confidence on the foreign investors already established in Kenya as well as prospecting foreign investors to undertake FDI.

⁴⁵ Colin Leys: *Underdevelopment in Kenya; The Political Economy of Neo-Colonialism*. (Nairobi, East African Educational Publishers 1975) pp132

⁴⁶ Republic of Kenya: *Sessional Paper No. 10 of 1965* op. cit pp 26

⁴⁷ Ibid pp 26

Privatized Economy

Kenya has encouraged the operations of a mixed economy with well defined roles for both the government and the private sector.⁴⁸ This has been achieved through the government's respect of the right to private ownership and encouraging private enterprise to undertake those developments to which it is best suited.⁴⁹ Therefore, the government of Kenya 'expects the private sector to play a role in development, subject to firm guidance, and explicit control where necessary.'⁵⁰ It is expected that encouraging the private sector will significantly 'permit Kenya to attract private capital and management which could not otherwise be obtained for development.'⁵¹ Further the government of Kenya fully recognizes the factors that can impede private-sector co-operation and participation in investments. To earn this co-operation and to make the private sector effective, the government of Kenya makes a concerted effort to fully inform private sector investors on the objectives of the Government and of the priorities it places on alternative development. The main tools for the dissemination of this information include the broad outlines through Government pronouncements and policy statements and speeches. Equally important to the private sector investors is the assurance that the investment environment will be reliable and stable over a long period of time. The government of Kenya has always recognized and assured the private investors by, for instance, stating that the 'Government recognizes the importance of keeping the incentive system in place for many years and plans to do so.'⁵² Therefore, the economy of Kenya is

⁴⁸ Republic of Kenya: *Sessional Paper No. 1 of 1986* op. cit pp3

⁴⁹ Republic of Kenya: *Development Plan 1965/66* op. cit pp 59

⁵⁰ Republic of Kenya: *Sessional Paper No. 10 of 1965* op. cit pp 42.

⁵¹ *Ibid* pp 42-43

⁵² Republic of Kenya: *Sessional Paper No 1 of 1986*, op. cit pp 94

considerably privatized. This significantly promotes private investment and by extension FDI.

In the period following independence, there was a scarcity of private domestic savings, management talent and entrepreneurial experience. As a result, the government directly participated in commercial and industrial activities. The main instrument was the State-Owned Enterprises (SOEs). The intended purpose was to induce development, promote regional balance, attract private investors and also act as essential step towards Kenyanization of the economy.⁵³ This clearly demonstrates that even with government participation in investment, the underlying purpose was to promote private investment.

However, over the years it became increasingly apparent that government participation in the economy had grown beyond the government's original intentions. Furthermore, a large debt exposure among the SOEs was increasingly draining the resources in the Treasury. Thus, it was paramount to restructure the SOEs. To this end, privatization was viewed as a strategy to limit the role of the government in commercial activities, raise revenue for government, improve corporate governance and provide the basis for competitive industry.⁵⁴ Privatization is the transfer of a function, activity, organization or an investment holding from the public to the private sector. Privatization is aimed at enhancing the role of the private sector in the economy by shifting more responsibility for investment from the government to the private sector. There are a number of alternative ways of effecting privatization among them is new FDI.

In Kenya, there were 204 commercially oriented SOEs with direct or indirect government ownership. Of these 33 were designated as 'strategic' SOEs and the

⁵³ Republic of Kenya: *Sessional Paper No. 1 of 1994* op. cit pp91

⁵⁴ OVP/MOF Kenya: *Policy Paper on Public Enterprise Reform and Privatization*. July 1, 1992.

government intended to retain control and its ownership and active board participation. Of the remaining, 45 were selected for the first phase of privatization while 162 are to be processed in subsequent privatization.⁵⁵ The privatization of Kenya Airways, a strategic SOE, completed in 1996 was a notable success. KLM became a strategic investor in Kenya Airways. KLM purchased 26 per cent of the shares of Kenya Airways and agreed not to sell its stake for at least five years. This shareholding gave KLM a significant control over the management of Kenya Airways. As a result, the privatization of Kenya Airways involved new FDI. Therefore, the process of privatization is not an end in itself. It is an integral and visible element of the government's overall SOE reform program⁵⁶ and a progressive effort to promote productive efficiency, to strengthen competitive forces in the economy, and to support entrepreneurial development. It is in the process of reducing the role of the government in commercial activities, particularly in strategic SOEs, through the privatization program that promotes FDI inflows.

Promotion of FDI in the Industrial Sector

The government of Kenya has undertaken various measures to promote the flow of FDI to the industrial sector. These measures include industrial protection, government financial participation, transfer of technology, export promotion.

Industrial Protection

The government of Kenya offers temporary protection to both new and existing industries.⁵⁷ Protectionism stimulates industrial investment.⁵⁸ Industrial protection is afforded through import tariffs, import licensing and quantitative restrictions and by

⁵⁵ Republic of Kenya: *Sessional Paper No. 1 of 1994* op. cit pp 97-99

⁵⁶ Ibid pp 97

⁵⁷ Republic of Kenya: *Development Plan 1974* op. cit pp 280

⁵⁸ World Bank: *Sub-Saharan Africa: From Crisis to Sustainable Growth, A Long-Term Perspective Study* (Washington, D, C: World Bank, 1989) pp 109

drawbacks of duty on imported raw materials.⁵⁹ The government of Kenya also offers additional tax incentives to the foreign investors in the form of tax holidays, accelerated depreciation, investment allowances, and gradual reduction of corporate tax rates.⁶⁰ The effectiveness of these tax incentives in attracting FDI for industrial investment was however minimized by factors such as 'dwindling domestic markets, increases in cost of capital and production and the widespread controls and bureaucratic red tape.'⁶¹ Nevertheless, the government of Kenya commits to continue with these tax incentives while ensuring that 'bureaucratic controls do not act as a constraint.'⁶² Therefore, the moderate protection accorded to both new and existing foreign firms is expected to significantly promote FDI inflows to the industrial sector.

Government Financial Participation

The government of Kenya encouraged FDI in the industrial sector by promoting joint ventures with foreign investors.⁶³ The government of Kenya opines that such ventures are not only beneficial in terms of capital inflow but more valuable is technology, skills and techniques as well as experience and knowledge in the design and marketing of exports.⁶⁴ Financial assistance to the industrial sector was mainly offered by the parastatal Development Finance Institutions (DFIs) such as the Development Finance Company of Kenya (DFCK) and the Industrial and Commercial Development Corporation (ICDC).⁶⁵ The government participated in joint ventures when foreign investors were particularly hesitant to undertake investment in industrial projects that

⁵⁹ Republic of Kenya: *Development Plan 1970-1974* op. cit pp 320

⁶⁰ Republic of Kenya: *National Development Plan for the Period 1997-2001* pp 195.

⁶¹ Republic of Kenya: *Sessional Paper No. 2 of 1996* op. cit pp 58-59

⁶² Ibid pp 59

⁶³ Republic of Kenya: *Development Plan 1974* op. cit pp 284

⁶⁴ Ibid pp 284

⁶⁵ Republic of Kenya: *Development Plan 1965/6* op. cit pp 240

were desirable in the public view and also profitable to them unless they know that the Government supports their activities.⁶⁶ Therefore, government financial participation exuded government's confidence in an industrial project and considerably promoted FDI.

Technology Transfer

FDI 'has been the most prominent source of technology acquisition and is expected to remain so.'⁶⁷ Therefore, the government of Kenya gives greater attention to the nature and conditionalities surrounding the importation of technology and to promote a greater diffusion of such technology. Appropriate technology in Kenya is labor-intensive. This is mainly due to the nature of Kenya's workforce. FDI incorporates technology transfer; therefore promoting FDI inflows to the industrial sector is a prerequisite for technological advancement.

Export Promotion

The promotion of investments in industries with an export potential significantly attract FDI inflows.⁶⁸ This is mainly because Kenya's production of non-traditional export products and increase in value addition to primary products remains largely unexploited.⁶⁹ This is in addition to the incentives scheme of duty/VAT remission; Export Processing Zones (EPZ) and Manufacturing Under Bond (MUB) offered to promote export-production.

Conclusion

Attracting FDI is a key economic objective of the government of Kenya. This is mainly because economic development is untenable without supplementing domestic

⁶⁶ Ibid pp 240

⁶⁷ Republic of Kenya: *Sessional Paper No. 2 of 1996* op. cit pp 62

⁶⁸ Republic of Kenya: *Development Plan 1974* op. cit pp 284

⁶⁹ Republic of Kenya: *Sessional Paper No. 2 of 1996* op. cit pp 63-64

capital with international capital flows such as FDI. Further, the government of Kenya compares FDI with other sources of international capital and aptly concludes that FDI is non-debt foreign capital; confers the risks of investment on the foreign investors and helps in the transfer of knowledge and sophisticated technology. As a result, the government of Kenya intends to promote FDI inflows to Kenya by extending facilitating measures towards FDI. These measures are investment incentives, investment approvals, nationalization and privatized economy. There are also measures that are aimed at promoting FDI particularly in the industrial sector; industrial protection, government financial participation, technology transfer and export promotion. With these measures aimed at promoting FDI inflows, it is therefore expected that the levels of FDI inflows to Kenya are not only high but steady.

Chapter Four

Foreign Direct Investment (FDI) Trends

Introduction

This chapter analyses the patterns of Foreign Direct Investment (FDI) inflows to Kenya in relation to the factors that influence the inflows. The pattern of FDI inflows to Kenya is to an extent a derivative of the government action or inaction towards the factors that influence FDI. The sections below will present an analysis of the changing pattern of FDI inflows to Kenya since independence, examine the factors that encourage and inhibit the inflow of FDI to Kenya with particular reference to the industrial sector.

Pattern of FDI Inflows

There was substantial volume of new capital belonging to foreign firms not previously established in Kenya between 1964 and 1970. These were foreign firms such as Union Carbide, Firestone, United Steel, Del Monte, Mitsui, Nomura, Schweppes, Inchcape and Lonhro.¹ Table 4.1 shows that between 1963 and 1965 the number of foreign companies operating in Kenya was 116 whereas those that had liquidated their assets was 73.² This reflects the political and economic uncertainty resulting from the attainment of political independence that made foreign investors and prospecting investors relocate their capital elsewhere. This divestiture resulted in extensive capital flight and stagnation of investment. The government of Kenya moved in to enhance guarantees on property rights particularly through the promulgation of the Foreign Investment Protection Act (FIPA) in December, 1964. This move by government of Kenya paid off as the number of foreign firms that were removed from register has not

¹ Colin Leys: *Underdevelopment in Kenya: The Political Economy of Neo-Colonialism 1964-1971* (Nairobi; East African Educational Publishers, 1975) pp.118.

² Republic of Kenya: *Statistical Abstract 1966* pp 76.

exceeded the 1964 levels since then. In addition the numbers of foreign companies registered have recently hit a high of 127 in the year 2007. This demonstrates the effort the government of Kenya was making to retain as well as attract new foreign investors.

The levels of FDI flows to Kenya have varied from year to year hitting a low of US \$ 0.39 million and a high of US \$ 729 million in 1988 and 2007 respectively (Table 4.2). The highest level of FDI inflows of US \$ 729 million received in 2007 was mainly due to massive investment by France Telecom following the privatization of Telkom Kenya. FDI inflows to Kenya grew steadily fluctuating from the absolute value of US \$ 10 million a year in the 1970s before attaining a peak of US \$ 84 million in 1979. This period is distinct for the high tariff protection that encouraged the development of the industrial sector. In this period 359 foreign companies were registered whereas only 77 companies were removed from register (Table 4.1). This is indicative of the stability gained by the government of Kenya that had the effect of building confidence among the foreign investors. Kenya's absolute annual average FDI inflows were US \$ 28 million in the period 1981-1990. The number of new foreign companies in Kenya was at 58 in 1981 but plummeted to 40, 12 and 10 in the years 1982, 1983, and 1984 respectively. This was clearly the period when Kenya started to progressively implement the structural adjustment program. The attempts at macroeconomic and structural reforms in the 1980s and 1990s were markedly incomplete and non-sustained. They never succeeded in putting Kenya on a sustained high-growth path but only provided temporary relief based on the evolution of the world economic environment. Kenya received its lowest ever FDI flow of US \$ 0.39 million in 1988 before it rose to US \$ 62.19 million in 1989 when the number of foreign companies that were registered had risen to 43 and 73 respectively.

This indicates that the number of foreign companies that operate in Kenya do not necessarily reflect the amount of capital they have invested in Kenya but sufficiently provides for the building confidence amongst foreign investors particularly in the late 1980s when Kenya's policy shift was articulated through the *Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth*.

However, it was until the year 2000 that Kenya exceeded the 1979 FDI inflows by receiving US \$ 127 million. This was mainly due to the sale of mobile phone licenses to Kenyan-foreign joint ventures where Vodafone invested US \$ 20 million to gain control and management rights of mobile telephony in Kenya. In addition, there was accelerated offshore borrowing by private companies to finance electricity generation activities due to the prevailing drought in 2000. This was not sustainable as it lowered to US \$ 5.31 million in 2001 before rising to 81.75 million in 2003 due to textiles investments in the Export Processing Zones (EPZs). Table 4.3 shows that there were 39 foreign owned firms operating in EPZ as of 2002. The ownership of these firms was dispersed and included United States of America (USA), United Kingdom (UK) India, Pakistan, Hong Kong, Taiwan, Sri Lanka, China, Netherlands, South Africa, Denmark and Belgium. Most of these foreign firms were dealing in garments.³ Also notable is the entry of Chinese firms in the recent past.

Data are not available on the sector allocation of the FDI flows to Kenya but particularly striking is the significant contribution of largest affiliates of foreign multinational corporations (MNCs) in the industrial sector specifically in terms of employment. Table 4.4 shows that Brooke Bond Kenya had 21 191 employees the largest number in 2004. The government of Kenya aims to promote foreign firms that are labor

³ Export Processing Zone Authority, 2002

intensive. This is mainly because labor intensive foreign firms use the available capital to employ a large number of persons. Table 4.4, also shows that the industrial sector employed approximately 63 per cent of the total work force amongst the largest affiliates of foreign MNCs in 2004. Therefore, in line with the government of Kenya intention to create more employment opportunities per unit of capital it is evident that more FDI flows to the industrial sector. Another distinctive feature is the dominance of foreign firms whose home country is the United Kingdom in all sectors of the economy. It is also evident that 71 percent of the largest affiliates of foreign MNCs in the industrial sector originate from the United Kingdom.

Therefore, the year to year variations of FDI inflows indicate that there exist factors that encourage and others that inhibit the flows of FDI to Kenya. It is for these reasons that FDI inflows fluctuates. The next sections set out to examine these factors.

Factors That Encourage the Flow of FDI

This section examines the measures that the government of Kenya has put in place that in the view of foreign investors encourage FDI. Foreign investors consider, private property rights' protection, conditions for entry of new investors and its exit, access to financial capital and investment incentives.

Protection of Private Property Rights

The government of Kenya attaches great importance on the protection of private property rights. The rights of private property ownership are enshrined in the Constitution. The Kenya Constitution provides that no property shall be compulsorily acquired for public purposes except on prompt payment of full compensation.⁴ There is also a provision in the Kenya Constitution that in case of expropriation then the foreign

⁴ Republic of Kenya: *The Constitution of Kenya* (Nairobi: Government Printer, 2001) Chapter V Section 75

investor has a right of direct access to the Supreme Court for the determination of the amount of any compensation to which the foreign investor is entitled.⁵ The guarantee on property rights' protection which is enshrined in Kenya's Supreme Law, effectively shields foreign investors from political risks especially regime change that may lead to expropriation, resulting into loss of assets, termination of operations or cancellation of agreements with the government. Foreign investors take into account uncertainty over the future rewards from the investment hence the government of Kenya's guarantee on private property rights' protection significantly encourages foreign investors to undertake FDI.

Entry and Exit Conditions for New FDI

Initially, the government of Kenya required that proposed foreign investment that is significantly beneficial to the economy will get a Certificate of Approved Enterprise (CAE).⁶ The legislation that laid down the procedure for obtaining the CAE is the Foreign Investment Protection Act (F.I.P.A) of 1964. The process of investment approval presented the foreign investors with an opportunity to negotiate for any concessions and industrial protection. In addition, FIPA provided for the liquidation of an approved enterprise and the transfer, out of Kenya, of the benefits thereof.⁷

The regulations for the entry of new investment were reviewed over the years with the aim of simplifying the investment approval procedures to eliminate unnecessary delays that were a strong deterrent to investors.⁸ As a result the Investment Promotion Centre (IPC) the predecessor to the Kenya Investment Authority (KenInvest) was

⁵ Republic of Kenya: *National Development Plan 1965/6* op. cit pp 238

⁶ Republic of Kenya: *National Development Plan 1965/6* op. cit pp 238

⁷ Republic of Kenya: *Development Plan For the Period 1970-1974* pp 321

⁸ Republic of Kenya: *Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth* (Nairobi: Government Printer, 1986) pp 99

established. Now KenInvest offers a 'one-stop shop' for foreign investors. Foreign investors whose investment is beneficial to Kenya are issued with an investment certificate. The investment certificate entitles them to acquire all operational licenses. This has had the effect of minimizing the unnecessary delays for seeking various approvals by coordinating, shortening and simplifying the investment approval procedure.⁹

Evidently, the government of Kenya has shown determination to improve the conditions for entry of new investment by reducing the time wasted in pre-operational activities and the liquidation of an investment. Therefore, this has a significant effect on encouraging foreign investors to undertake FDI in Kenya.

Access to Financial Capital

The Kenya government recognizes that financial participation in industrial investment through joint ventures encourages FDI inflows to Kenya.¹⁰ Parastatal Development Finance Institutions (DFIs) such as the Industrial and Commercial Development Corporation (I.C.D.C) play a significant role in financing industrial development. The rationale for government participation in joint ventures particularly with foreign firms is to offer encouragement and to reduce the risk in case of profitable but risky investment.¹¹ Foreign investors might hesitate to undertake FDI in industrial projects that are desirable from a public point of view and profitable to them unless they know that the government supports their activities. They may also be willing to risk their money only when the Government too is willing to take some financial risk.

⁹ Republic of Kenya: *Economic Recovery Strategy for Wealth and Employment Creation: 2003-2007* (Nairobi: Government Printer, June 2003) pp 35

¹⁰ Republic of Kenya: *Sessional Paper No. 10 of 1965 on African Socialism and its Application to Planning in Kenya* (Nairobi: Government Printer, 1965) pp 43

¹¹ Republic of Kenya: *National Development Plan 1965/6* op. cit pp 240

The government of Kenya also eased the restriction of access to domestic credit markets to firms with foreign ownership. As a result, foreign firms can borrow from local financial institutions up to the amounts required to pay customs duty on imported capital equipment in addition to borrowing amounts proportional to the share of equity owned by Kenya citizens.¹²

Therefore, the Kenya government's financial participation and the relaxation of access to domestic credit markets set in motion profitable foreign enterprises which would otherwise never come about. In addition, the government benefits in the share of the profits of such enterprises, quite apart from the tax revenues that will be generated.

Investment Incentives

The Kenya government offers various incentives to foreign investors who wish to invest. These incentives are in the form of tax holidays, accelerated depreciation, investment allowances, low duties on intermediate capital goods and gradual reduction of corporate tax rates. The rationale for the tax incentives is that FDI is highly sensitive to taxation of the income they generate. As a result, FDI inflows decline with increased taxation. The Kenya government deducts 37.5 per cent of a company's income as tax a rate the government considers to be relatively lower than rates charged in other countries.¹³ The government also offers an investment allowance of 20 per cent of the costs of new industrial buildings, machinery and fixed equipment to both new and existing foreign investors. It further offers depreciation allowances and refunds customs duties to companies utilizing imported raw materials in the manufacturing process. The duty refunds are normally granted when the duty on imported raw materials hinders

¹² Republic of Kenya: *Sessional Paper No. 1 of 1986* pp 99

¹³ Republic of Kenya: *National Development Plan 1965/6* op. cit pp 239

competition with comparable imported manufactured products, where raw materials are imported for manufacture prior to re-export as part of finished product or where an anomaly in the tariff rates has unforeseen and unintended adverse effects on a local industry. The duty refunds are granted for a limited period according to a sliding scale. They are particularly useful to new FDI that requires some years of operations before they can reduce their costs to the level permitted by normal tariff protection.¹⁴ However, the Kenya government recognized that these tax incentives were not as effective as expected. Therefore, the special tax incentives were reservedly employed and limited to for instance the ten years tax holidays granted to those in Export Processing Zones (EPZ).

The other form of incentives offered by the Kenya government is in the form of locational incentives. This is given to both foreign and domestic firms that are located in rural areas and the smaller cities of Kenya. This was intended to achieve geographical dispersion of the benefits of industrialization. Localization factors such as markets for industrial goods, developed infrastructure and administrative as well as commercial centers concentrated industries in Nairobi and Mombasa. The government's intention to locate industries outside Nairobi and Mombasa required that a selection of a number of major urban growth centers such as Eldoret, Embu, Kakamega, Kisumu, Nakuru, Nyeri, and Thika be developed to industrial centers. As such, the government not only developed the infrastructure and essential services of these centers but also offered concessions individually tailored to the needs of particular firms.¹⁵ Thus, the government confined the offer of investment allowance to enterprises located in the semi-urban and rural areas of the country.

¹⁴ Ibid pp 239

¹⁵ Republic of Kenya: *National Development Plan 1979-1983* pp 333

The government also offered industrial protection as an incentive to both new and existing foreign firms in Kenya.¹⁶ The main strategy for industrial protection was import tariffs on goods. The instruments were import licensing and quantitative restrictions, and by drawbacks of duty on imported industrial raw materials. Industrial protection was offered temporarily to industries with high initial costs since those that needed permanent protection would be a drain on the economy in the long run.

Factors That Inhibit the Flow of FDI

The factors that inhibit FDI inflows to Kenya are mainly encompassed in the measures ostensibly aimed to leverage undertakings from foreign investors that would be significantly beneficial to the nation. The government of Kenya has provided for the review of new FDI undertakings through legislation; the Foreign Investment Protection Act (FIRA) of 1964, the Investment Promotion Centre Act (IPCA) of 1986 and the Investment Promotion Act (IPA) of 2004. Through these legislations, the government of Kenya approves FDI that 'would further the economic development of, or is of benefit to, Kenya.'¹⁷ In determining that FDI is beneficial to Kenya, consideration is given to the extent to which FDI contributes to 'the creation of employment, acquisition of new skills or technology, contribution to taxes or other government revenue, the transfer of technology, an increase in foreign exchange, either through exports or import substitution, utilization of domestic raw materials, supplies and services, adoption of value addition in the processing of local, natural and agricultural resources and the utilization, promotion, development and implementation of information and

¹⁶Republic of Kenya: *National Development Plan 1970* op. cit 320

¹⁷ Foreign Investment Protection Act of 1964 Section 3(1)

communication technology'.¹⁸ Foreign investors are particularly responsive to these requirements since they affect their decisions on employment, technology use and profit margins. The sub-sections below examine in detail the measures that the government of Kenya has used to ensure that FDI is beneficial to the nation. These are sector restrictions, local equity participation, local resource utilization, the technology to be employed and licensing of operations.

Sector Restrictions

The government of Kenya is restrictive on the sectors on which foreign investors can invest. The Kenya government reserves the small and medium scale industrial enterprises to its citizens.¹⁹ Thus, the government of Kenya encourages domestic investment in manufacturing by availing credit facilities through commercial banks. In addition, loans are provided through the Industrial and Commercial Development Corporation (ICDC) to small and medium-scale domestic investors.²⁰ Through these strategies, the government of Kenya restricts the access of foreign investors to these small and medium-scale industrial enterprises and effectively leaving them to domestic entrepreneurs. Therefore, sectoral restrictions prevent small and medium-scale foreign investors from undertaking FDI and hence considerably inhibit the flows of FDI to Kenya.

Local Equity Participation

The Kenya government encourages local equity participation in industrial projects.²¹ The main purpose of local equity participation is to enable the local shareholders to earn dividends. They can also use their voting power to encourage the foreign enterprises'

¹⁸ Investment Promotion Act of 2004. Section 4(2) a, b, c, d, e, f, g, and h

¹⁹ Republic of Kenya: *National Development Plan 1974* op. cit pp 285

²⁰ National Development Plan 1974-1978 pg 284

²¹ Republic of Kenya: *Sessional Paper No. 10 of 1965* op. cit pp 13

local operations to work in the best interests of the country. In the case of government financial participation through ICDC the government benefits in the share of the profits of these enterprises and the tax revenues generated. FDI not only involves equity participation but management too. Foreign investors are deterred from undertaking FDI when equity participation is not matched with management competence to operate the firm. Therefore, the requirement that local equity constitutes part of the investment capital inhibits FDI inflows to Kenya.

Local Resource Utilization

Local resource utilization is part of the conditions that foreign investors must fulfill before undertaking FDI in Kenya. Foreign investors that propose to undertake FDI while utilizing local resources to produce for either local consumption or export are encouraged. It is reasoned that the use of local resources enhances capacity utilization and leads to a reduction of costs of production. This in turn helps to make local products competitive in the internal as well as external markets. The use of local resources also creates backward linkages. The producers of the local resources such as trees required in the pulp and paper mill immensely benefited from the pulp mill established at Broderick Fall. Therefore, the requirement that local resources constitute part of the final product is noble. However, this can be a great hindrance to FDI inflows in industrial projects whose raw material cannot be locally sourced such as happened in the local manufacture fertilizers.

Use of Technology

The government of Kenya favors labor-intensive industrial projects. It is stated that 'the pursuit of technology that is efficient but creates little or no employment is not

appropriate.’²² This is because, labor-intensive industrial projects provide maximum employment opportunities with limited capital. The effect on FDI is to block capital-intensive industrial projects. In addition, the country fails to benefit from superior technology that is not necessarily labor-intensive but cuts on the costs of production which are transferable to the consumers through reduced commodity prices.

Operational Licenses

The delay in gaining Government approval to undertake FDI is ‘a strong deterrent to investors.’²³ As many as thirty (30) specific approvals existed ranging from the purchase of land to work permits for expatriates and the importation of goods. There is overwhelming bureaucracy and corruption that frustrates foreign investors and unduly increases the cost of undertaking FDI in Kenya.²⁴ ‘The absence of adequate commercial courts to adjudicate speedily business disputes also add to the difficulties’²⁵ of the foreign investors. Much as these challenges are acknowledged by the government and targeted for review, they significantly inhibit the decision by foreign investors to undertake FDI in Kenya.

Conclusion

The pattern of FDI inflows indicates that Kenya is as a highly unsteady destination. This trend is mainly attributable to the prevailing mix of policy objectives that influence FDI inflows to Kenya. However, presuming that this pattern demonstrates that the Kenya’s policy towards FDI is widely uncertain and highly unpredictable is an overstatement of facts. The findings of this chapter reject this to the extent that the

²² Republic of Kenya: *Sessional Paper No.2 of 1996 on Industrial Transformation To The Year 2020* (Nairobi: Government Printer, November, 1996) pp 61

²³ Republic of Kenya: *Sessional Paper No.1 of 1986* op. cit pp 99

²⁴ Republic of Kenya: *Sessional Paper No. 2 of 1996* op. cit pp 21

²⁵ *Ibid* pp 21

government of Kenya clearly articulates the policy objectives that foreign investors consider before undertaking FDI. It is prudent, therefore, to conclude that the pattern of FDI inflows to is to a large degree a reflection of the expected benefits to Kenya. This means that the government of Kenya selects the FDI undertakings that it considers is of benefit to the nation. In this process, there is no specific criterion that is considered ideal for all FDI projects and at all times. Instead, each FDI project is profiled on its own merits and demerits in line with the fundamental policy objectives as articulated in the policy objectives. This does not amount to policy uncertainty.

Chapter Five

Foreign Direct Investment (FDI) in the National Economy

Introduction

This study sought to investigate availability of investment capital particularly Foreign Direct Investment (FDI) for Kenya's development. FDI is a bundle of resources consisting of capital, technology and managerial skills that supplements domestic capital. The trends of FDI flows to Kenya indicate a substantial year to year variation. The aim of this study is to explain this fluctuation from the national policy orientation regarding the contribution of FDI to national development point of view. Therefore, the chapter weaves together the study by revisiting the problem and condensing the findings under each objective.

Shortage of Domestic Capital

The economy of Kenya is dominated by the agricultural sector in terms of its contribution to the Gross National Product (GNP), foreign exchange, employment creation and provision of raw materials to the agro-based industries. This was the result of the influence of external forces especially international trade and bilateral loans that made Kenya a net exporter of primary agricultural produce to industrialized countries of Europe. Kenya's reliance on the export of primary agricultural produce faced numerous challenges. The main one has been dwindling foreign exchange earnings due to unpredictable crop yields, unfavourable terms of trade and unfavourable balance of payments. This led to the shift in emphasis from the export of primary agricultural produce to export of processed agricultural produce through industrialization. The main

constraint to industrialization is availability of domestic capital to finance targeted industrial projects.

The government supplements domestic capital with multilateral and bilateral loans and FDI. However, the creeping in of the debt burden, the contentious Structural Adjustment Programs (SAPs) and other conditionalities have led to the prominence of FDI. FDI inflows to Kenya have been unstable. This fluctuation has been attributed to unfavourable business environment, loss of competitiveness in attracting FDI especially to Tanzania and Uganda and the relatively negative perception on Kenya on factors that affect FDI inflows especially corruption, crime, theft and inadequate infrastructure supply. This study explains this fluctuation from the standpoint of national policy orientation regarding the contribution of FDI in national development.

FDI for Development

The investigation of the industrial development objectives in relation to capital requirements to meet these objectives has established that the government of Kenya cannot rely on its own resources but to attract increased volumes of FDI for development. The government of Kenya recognises industrial development alongside agriculture in its growth projections. Industrialization complements agriculture as an essential ingredient of rapid and sustained economic growth. Agriculture provides the base for the overall economic growth but the industrial sector is the main engine for faster economic growth. Industrial development plays a crucial role in terms of its contribution to foreign exchange earnings, provision of employment, training opportunities, income, supply of consumer goods and services and provision of the means by which agricultural raw

materials are processed into finished goods for domestic and foreign markets and diversification of the technological base.

The government of Kenya has employed Import Substitution Industrialization (ISI) strategies to promote rapid industrial growth. The main elements of this strategy were tariff and non tariff barriers such as high duties on competing imports and relatively low duties on industrial inputs, import quotas and licensing that limited or prohibited the importation of goods competing with domestic manufactures. The implementation of the Structural Adjustment Strategy did not lead to a substantial shift from promoting import substituting industries but subjected them to a new set of qualifiers such as flexible exchange rates, rationalized import tariffs and the removal of import quotas.

The government of Kenya has also provided active financial support and participated in joint ventures particularly through the Industrial Commercial and Development Corporation (ICDC) to attract private capital and management to the strategic industries. This was a simple way to exhibit government support in large industrial projects that were desirable from a public point of view and risky but profitable to the private investor.

In the view of the government, industrial growth creates employment opportunities. Therefore, it is the governments' position to encourage enterprises that employ labour intensive techniques, offers training and employs Kenyans at managerial and technical levels. Further, the government believes that industrial growth helps generate foreign exchange particularly through increasing the degree of processing raw material produced in the country for exports. The government offers special export

incentives such as duty/VAT (value added tax) remission, Export Processing Zones (EPZ) and Manufacturing Under Bond (MUB) to encourage export production.

Industrial capital is mostly provided by Development Finance Institutions (DFIs) such as the ICDC, Development Finance Corporation of Kenya (DFCK), Kenya Industrial Estates (KIE) and Industrial Development Bank (IDB). These institutions provide loans and extension services for the expansion of industrial enterprises and erection of planned new lines of industrial production. The main sources of finance for these DFIs are domestic savings, external loans and funds generated from their own operations. The activities of these DFI are constrained by their reliance on the limited domestic capital and donor withdrawal. Thus, promotion of FDI inflows helps supplement this shortfall.

Promotion of FDI

The study has established that it is the policy of the government of Kenya to promote FDI inflows. It has been shown that the government believes that FDI closes the resource gap between targeted investment and locally mobilized savings, creates employment opportunities, leads to technological advancement and diversifies output and exports. The government has displayed four main policy objectives to promote FDI. These are investment incentives, liberal investment approval, moderated nationalization and privatized economy.

The study found that the government of Kenya created a protective incentive environment using relatively over-valued exchange rates, subsidized interest rates, import quotas and licensing. These measures shielded foreign investors from international competition. It is also evident that the government of Kenya has continually improved the

investment environment. This was achieved by shifting from the protective incentive system to the market based incentive system. The market based incentive system subject import-substituting industries to reduced import quotas, rationalized tariffs, flexible exchange rates and liberalized interest rates.

The study has shown that the government of Kenya envisaged institutionalizing the FDI entry regime. Until recently, the FDI approving committee was constituted on a case-by-case basis. Successive institutions such as the New Projects Committee, Investment Promotion Centre (IPC) and Kenya Investment Authority (KenInvest) have constantly attempted to institutionalize the FDI approval process.

The study reveals that the government of Kenya has been hesitant to nationalizing private enterprises. The government believes that the cost of nationalization is high especially when money paid to nationalize resources and the people who managed them before nationalization leave the country that way increasing the foreign exchange and manpower problems. Therefore, the government of Kenya used nationalization moderately for strategic purposes such as national security, health, protection of the environment and provision of essential services to the public. This built confidence on foreign investors to undertake FDI.

The study has demonstrated the attempt by the government of Kenya to operate a privatized economy. This was mainly achieved through the respect of private ownership, encouraging private enterprises to undertake development they are best suited and privatizing the strategic and non-strategic State Owned Enterprises (SOEs). These measures significantly permit Kenya to attract FDI that could not otherwise be obtained for development.

Determinants of FDI

The study has presented a substantial variation in the year to year flows of FDI to Kenya. This has been attributed to the effect of the policy orientation on FDI. In particular, the policy measures put in place to promote FDI inflows in the context of overall development policy significantly influence FDI inflows. The study established that protection of property rights, institutionalized FDI approval process, access to financial capital and investment incentives significantly promote FDI inflows to Kenya. The government of Kenya effectively shields foreign investors from expropriation by enshrining in the constitution the protection of property rights. It has also been shown that KenInvest has successfully institutionalized the FDI approval process. Further, it has been established that government financial participation in industrial investment particularly in joint ventures through the ICDC plays a significant role in encouraging FDI. In addition, the government of Kenya offers numerous investment incentives in the form of tax holidays, investment allowances and low duties on imported intermediate capital goods.

On the other hand, the study found out that sector reservations, requirements on local equity participation and local resource utilization, restrictions on the type of technology used and the bottlenecks in obtaining operational licenses significantly inhibit FDI inflows. It has been shown that the government of Kenya reserves some sectors of the economy to its citizens, requires that local equity constitutes part of the investment capital, requires that foreign investors utilize local resources as input to the final product,

that it favours labour-intensive industrial projects and that there are bottlenecks in obtaining operational licenses. These factors, singularly and cumulatively, inhibit the flow of FDI to Kenya.

Conclusion

The study has demonstrated that Kenya's policy orientation on FDI significantly explains the trends of FDI inflows. It is the policy of the government of Kenya to promote FDI inflows. The government believes that FDI bridges the resource gap between targeted investment and locally mobilized savings, brings in sophisticated technology, builds local expertise, creates employment and generates foreign revenue. FDI is a crucial source of capital for development. It is how FDI undertaking fits in the context of overall development policy that significantly determines how much FDI is allowed in the national economy. Foreign investors are subjected to a set of policy measures that signify the attempt by the government of Kenya to ensure FDI undertakings are beneficial to the country. Therefore, the year to year variations of FDI flows are a result of the contribution of FDI undertakings in the national economy as articulated by the policy orientation and implemented under the specific policy measures.

Appendix

**Table 4.1: Number of Foreign Companies Registered and Removed from Register:
1963-2008**

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
Foreign Companies													
Registered	42	36	38	42	39	39	42	26	32	31	42	40	31
Removed from register	28	24	21	19	23	23	20	12	12	11	11	15	2

1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	
Foreign Companies												
Registered	37	33	50	37	55	58	40	12	10	63	43	
Removed from Register	14									1		

1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	
Foreign Companies												
Registered	43	73	51	53	35	56	82	44	60	69	57	44
Removed from Register	2	1			3	3	10	0	8		7	15

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Foreign Companies									
Registered	82	67	52	80	73	86	105	128	102
Removed from Register		9	3	4	8	9	5		

Source: Republic of Kenya: *Statistical Abstracts (Various Issues)*

Table 4.2: Net FDI inflows to Kenya from 1970-2009 (US \$ million)

Year	Net FDI Inflows (US \$ million)
1970	13.80
1971	7.40
1972	6.30
1973	17.26
1974	23.42
1975	17.16
1976	46.37
1977	56.55
1978	34.41
1979	84.01
1980	78.97
1981	14.15
1982	13.00
1983	23.74
1984	10.75
1985	28.85
1986	32.73
1987	39.38
1988	0.39
1989	62.19

1990	57.10
1991	18.80
1992	6.00
1993	2.00
1994	4.30
1995	33.00
1996	10.55
1997	52.52
1998	11.41
1999	13.82
2000	110.90
2001	5.31
2002	27.63
2003	81.75
2004	46
2005	21
2006	51
2007	729
2008	96
2009	141

Source: UNCTAD: FDI *database*

Table 4.3: Foreign Firms Operating In EPZs, 2002

Company	Ownership	Activity	Date of operation
Birch Investments	Hong-Kong	Garments	Mar 93
Indigo Garments	India	Garments	Sep 99
Jar Kenya	USA	Garments	Jul 97
Kenap		Garments	Sep 99
Upan Wasana	Sri Lanka	Garments	Sep 01
Kapric Apparels	Hong Kong	Garments	Jan 01
Kentex Apparels	India	Garments	Jan 01
California Link EPZ (K) Ltd.	Sri Lanka	Garments	Mar 01
Union Apparels	Sri Lanka	Garments	Jul 01
MRC Nairobi	Sri Lanka	Garments	Oct 01
Sino Link	China	Garments	Aug 01
Sin Lane K	Taiwan	Garments	Dec 01
Protex K	Taiwan	Garments	Nov 01
Mirage Fashion Wear	India	Garments	Mar 02
Kenya Knit Garments	Taiwan	Garments	Mar 02
Wild Life Works	USA	Garments	Mar 02
Global Apparels (K)	India	Garments	Mar 02
Rolex Garments	India	Garments	Mar 02
Mega Garments Industries	Sri Lanka	Garments	Aug 02
Rising Sun	Sri Lanka	Garments	Oct 02
Ashton Apparels	India	Garments	Aug 01
Orange Styles	India	Garments	Dec 02
Senior Best Garments	Taiwan	Garments	Nov 02
Ancheneyar	Sri Lanka	Garments	Dec 02
Lihua Garments	China	Garments	Dec 02
Premium Machinery Distribution	India	Sewing machines	
TJM Apparel Solutions	India	Sewing machines	Nov 02
De La Rue Currency and Security Printing EPZ Ltd.	UK	Security printing	Mar 93
Golden Light	China	Torch bulbs	Oct 99
Indu Farm	Netherlands	Fruits & vegetables	Oct 00
Insight Digital Graphics EPZ	UK	Digital printing	Feb 00
Ivee Aqua.	India	Pharmaceuticals	Sep 95
Logistic Container Centre	Denmark	Container repair	Dec 97
Nodor Kenya.	UK	Dart boards	Sep 99
Norbrook Africa	UK	Pharmaceuticals	Apr 96
Oil Tanking	South Africa	Bitumen	Jan 93
Rayven EPZ Ltd.	UK/Kenya	Electronics	Oct 92
Rosavie	Belgium	Preserves	Mar 98
Plastic Compounders	UK	PVC compound	Jul 01
Transfleet	Pakistan	Godowns	Jan 95
Match Point	USA	Buying office	Oct 02

Source: The table is adapted from Francis Mwega and Rose Ngugi: *Foreign Direct Investment in Kenya*. A paper presented during AERC, Special Workshop on SSA (2005)

Table 4.4: Largest affiliates of foreign MNCs in Kenya, 2004

Company	Home Economy	Industry	Number of Employees
A. Industrial			
British American Tobacco	United Kingdom	Tobacco	780
Brooke Bond Kenya	United Kingdom	Agriculture	21 191
Raymond Woolen Mills	India	Textiles and clothing	2 072
East African Industries	United Kingdom	Chemicals and chemical products	1 920
The Standard Newspapers Group	United Kingdom	Publishing, printing	546
Limuru Tea Co Limited	United Kingdom	Agriculture	544
Eatec Limited	United Kingdom	Wood and wood products	300
Cadbury Kenya Ltd	United Kingdom	Food products, beverages and tobacco	230
Glaxo Smithkline Ltd	United Kingdom	Chemicals and chemical products	220
Reckitt Benckisser East Africa Ltd	United Kingdom	Chemicals and chemical products	200
De La Rue Currency Limited	United Kingdom	Publishing, printing	155
Greif Kenya Limited	United States	Machinery and equipment	120
Nestle Foods Kenya Limited	Switzerland	Food products, beverages and tobacco	120
Henkel Polymer Co	Germany	Chemicals and chemical products	111
B. Tertiary			
Basf East Africa	Germany	Wholesale trade	400
Total Kenya	France	Wholesale trade	228
Kenya Shell	United Kingdom	Wholesale trade	200
Express Kenya	Switzerland	Transport and storage	345
Amiran Kenya	United Kingdom	Wholesale trade	102
Tibbett & Britten Kenya	United Kingdom	Transport and storage	530
Cetco	Germany	Wholesale trade	25
Hoescht East Africa	France	Wholesale trade	300
Kodak (Kenya)	United States	Wholesale trade	50
The Crown Cork Company	United States	Other business services	50
Blackwood Hodge (Kenya)	United Kingdom	Wholesale trade	50
Amiran Kenya Limited	United Kingdom	Wholesale trade	130
Holman Brothers	United Kingdom	Wholesale trade	45
Colas (East Africa)	France	Other business services	80
Securicor Security Services	Germany	Other business activities	9 105
Kapchorua Tea Company	United Kingdom	Wholesale trade	1 622
C. Finance and Insurance			
Barclays Bank of Kenya	United Kingdom	Finance	1 741
Stanbic Bank Kenya	South Africa	Finance	68
Middle East Bank Kenya	Belgium	Finance	59
Dubai Bank Kenya Limited	United Arab Emirates	Finance	..
UAP Provincial Assurance Society	United Kingdom	Insurance	172
Standard Chartered Bank	United Kingdom	Finance	1 269
American Life Insurance Comany	United States	Insurance	209
British American Insurance	Mauritius	Insurance	148
Phoenix Of East Africa Assurance	Tanzania	Insurance	90
Royal Insurance Company of East Africa	United Kingdom	Insurance	35
Independent Adjusters Kenya	Netherlands	Insurance	6

Source: The table is adapted from UNCTAD WID Country Profile: Kenya (2006):http://www.unctad.org/sections/dite_fdostat/docs/wid_cp_ke_en.pdf. last posted on November, 2006

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