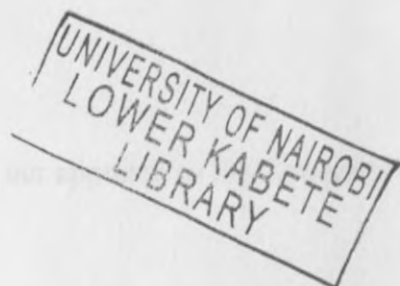# BUSINESS ENVIRONMENTS OF INTERNATIONAL

FINANCIAL CENTRES; LESSONS FOR NAIROBI

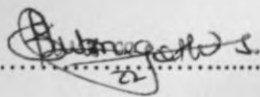**By:** Tutu Stephen Kariithi

(X50/75271/2009)

A research paper submitted to the School of Economics in partial fulfilment of the requirements for the award of the Masters of Arts degree in Economics of the University of Nairobi.
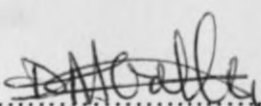
November 2011

DECLARATION

This research paper is my original work and has not been presented for a degree in any other university or institution.

Signed: .... Date: .... 23 November 2011 ....

Tutu Stephen Kariithi

This research paper has been submitted for examination with our approval as the University supervisors.

Signed: .... Date: ... 22|11|2011 ....

DR. D.O. Abala

Signed: .... Date: ....

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There are a number of people who invested in the development of this project who deserve to be acknowledged. Without them I would not have been able to meet the stringent demands of my life and still build into the quality of the content herein.

I express my sincere appreciation to my supervisor, Dr. D.O. Abala, who tirelessly laboured to enhance this project with their insights and creativity.

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Finally, I am deeply indebted to my friends and family for their love, support, encouragement and concern.

DEDICATION

This study is dedicated to my friends, family and my immediate community who inculcated a deep sense of mission in me and devoted their limited resources to invest in my education. All I am and ever will be is in triumph and indeed a declaration of victory to this society that brought me up. Their immense dedication, sacrifice and faith in me continue to serve as the unwavering foundation on which I am build as both an economic agent and analyst.

ABSTRACT

Kenya lacks natural resources like minerals and oil. As a result, the population continues to suffer from unemployment and in general low GDP per capita. To remedy this situation, this study proposes creation of financial resources by developing Nairobi to an international financial centre (IFC) through attracting foreign financial assets to trade in the Nairobi Securities Exchange.

Ordinary least squares method is used to show the relationship between IFCs and the business environment of a city. To quantify the dependent variable (stature of Nairobi as an IFC), market capitalisation is used as a proxy whereas to quantify the independent variables (business environment of Nairobi), several factors were used. These factors include level of business disclosure required, availability of credit information, cost of dismissing employees to the employer, use of Information and Communication Technology (ICT) – number of cell phone users was used as an indicator, political stability, strength of the legal system, tax burden on businesses, level of urbanisation and adult literacy levels.

The results indicate that most of these business environment proxies are statistically significant determinants of market capitalisation. The results also show that Nairobi's business environment is underdeveloped.

The study proposes that to attract financial resources to trade in the Nairobi Securities Exchange, the policy makers need to develop Nairobi's business environment by improving on the factors identified.

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LIST OF ACRONYMS

IFC/ OFC	International Financial Centres/ Offshore Financial centres
GDP	Gross Domestic Product
IT/ ICT	Information Technology/ Information and Communications Technology
DR	Democratic Republic of Congo
OECD	Organisation for Economic Cooperation and Development
G20	Great Twenty
KIPPRA	Kenya Institute of Public Policy Research and Analysis
VAT	Value Added Tax
NSE	Nairobi Securities Exchange
FDI	Foreign Direct Investments
DFI	Development Finance Institutions
CFO	Chief Finance Officer
VP	Vice President
WDI	World Development Indicators
GDF	Global Development Fund
DRS	Development Reporting System
CIA	Central Intelligence Agency
BPM	Best Markets Practise
SMEs	Small and Medium Sized Enterprises
EBRD	European Bank for Reconstruction Development
OTC	Over The Counter
PEV	Post Election Violence
CSI	Corporate Social Investment
TSS	Total Sum of Squares

LIST OF ACRONYMS (Continued)

SIX	Swiss Exchange
PT	Put Through
USD	United States Dollar
JPY	Japanese Yen
ETP	Electronic Trading Platform
ETS	Electronic Trading System
IMF	International Monetary Fund
MIT	Massachusetts Institute of Technology
REITs	Real Estate Investment Trusts
OLS	Ordinary Least Squares
WHT	Withholding Tax
SET	Stock Exchange of Thailand

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DEFINITION OF TERMS

International financial centre/ hub – The term refers to a city that is a major participant in the international financial markets for the trading of cross-border assets.

Offshore financial centre (OFC) – An OFC is a low-tax jurisdiction specialising in providing corporate and commercial services to non-residents in the form of offshore companies and the investment of offshore funds.

Tax havens – A tax haven is a low tax jurisdiction. Although the terms are not synonymous, many leading offshore finance centres are regarded as "tax havens". A tax haven is more specific on the low taxation as the centre of attraction for financial institutions into a jurisdiction.

Business environment - refers to the macro economic factors that either facilitate or impede the ability of firms to profitably conduct their businesses with ease in a jurisdiction.

CHAPTER ONE

1.0.   INTRODUCTION

1.1.   Background of the study

International financial centres (IFCs) play a major role in enhancing globalisation. The IFCs facilitate ease of access to capital by firms and also they provide avenues for investments by holders of capital. They have however been hit by the challenges of urbanisation. Technology, some predicted, would end clustering of people in city centres. Armed information and technological tools, it was envisaged that people could work from anywhere. Yet the cities still have their compensations. So rather than dying out, financial centres are proliferating.

Today's developed financial centres not only include long-established places such as London, New York and Hong Kong, but also a growing number of newer financial hubs in Asia, the Middle East, Caribbean Islands and Africa.

The development of financial centres in the underdeveloped world particularly Africa has enabled creation of more jobs are good for social and economic stability, so countries that used to rely for capital on banks, the rich or the state are allowing new capital providers into their markets. Money that used to be routed through the world's biggest hubs now often goes through non-traditional capital markets, or directly between emerging markets.

Governments are paying more attention than ever to wooing and keeping financial firms because of the benefits they bring with them, such as highly paid jobs, large tax revenues and international connections.

Aside from the political and economic gains to the host countries, economists and investment bankers point to two wider benefits from having a range of financial centres around the world. One is the increase in overall liquidity as new countries and regions become integrated into the global financial system. The second is increased efficiency as competition between centres drives down the cost of trading and other financial transactions. New and developing financial centres are knocking down protectionist barriers and emulating the regulatory practices of the more established hubs.

The term "international financial centre" is usually meant to designate a city as a major participant in international financial markets for the trading of cross-border assets. An international financial centre will usually have at least one major stock market as well as presence of international banks and financial services companies.

It must be distinguished from an offshore financial centre (OFC). An offshore financial centre, is usually a small, low-tax jurisdiction specialising in providing the corporate and commercial services to non-residents in the form of offshore companies and the investment of offshore funds. Although the terms are not synonymous, many leading offshore finance centres are regarded as "tax havens", and the lack of precise definitions often leads to confusion between the concepts. According to Tolley (2003), an offshore financial centre is indeed a tax haven but the use of the term offshore financial centre makes the important point

that a jurisdiction may provide specific facilities for offshore investors without being in any general sense a tax haven.

In 2009 the International Financial Centres Forum (IFC Forum) was established by a group of professional service firms and businesses with offices in the leading offshore centres. The IFC Forum aims to provide authoritative and balanced information about the role of the small international financial centres in the global economy.

An international financial centre index has been established and it summarises the availability of a skilled workforce, the flexibility of the labour market, the quality of the business education and the skill set of the workforce. The business environment index aggregates and values the regulation, tax rates, levels of corruption and economic freedom and how difficult in general it is to do business. The market access index looks at the various equities and bonds available. The volume and value of trading and also the cluster effect of the number of different financial service companies at the location influence the index. The infrastructure index has also been developed and makes use of road networks, prices of real estate, ICT infrastructure and railway network at the location. Other factors such as public transport have a minor impact. General competitiveness relies on more traditional economic factors as price level, quality of life and economic sentiment.

The qualitative attributes of an IFC such as level of corruption, economic freedom and ease of doing business are estimated based on the opinions of investors towards specified financial centres. The World Bank has developed questionnaires that collect the opinion of the sampled investors and uses the collected primary data to rate the financial centres in a scale of one to ten.

London, New York, Hongkong, Singapore, Japan, Toronto and others are the leading global financial centres. However, they have been experiencing challenges due to the following factors:

- The credit crunch of 2008 followed by the Europe debt crisis of 2010/ 2011. The financial crisis led to collapse of key companies resulting to loss of confidence in financial centres.

- The intensifying competition from other financial centres in Europe and elsewhere, some of which are aggressively targeting sub-sectors of the financial services industry.

- The risk of reactionary new regulation decreasing their competitiveness.

Most of the poor will only be able to work their way out of poverty if they can start and grow their own businesses - or find employment in another, growing business. In many developing countries like Kenya, these businesses face enormous regulatory and other barriers which impede their ability to profitably conduct business.

Business environment refers to the macro economic factors that either facilitate or hamper the ability of firms to profitably conduct their businesses. Such factors should enhance the following:

- Dispute resolution mechanisms, Legal institutions for a market economy and personal and property rights, corporate governance and a competition policy.

- Tax and policy administration

- Infrastructure services for private sector development

- Financial and private sector development

- Export development and competitiveness

- Trade facilitation and market access

1.2. Statement of the Problem

Unlike her neighbours like Uganda and South Sudan, Kenya is lacking in natural resources like oil, gas and other minerals as well as agricultural resources such as fertile soil and adequate rainfall. Kenya's land mass is majorly arid or semi arid. The aridity of Kenyan land means rain fed agriculture is not sufficient to feed the entire population. Irrigated farming is capital intensive and out of reach for the ordinary Kenyans to undertake. This lack of natural resources is exacerbated by a huge population of over 38.5 million people which cannot be sustained by the existent natural resources. As a result, situations of food shortages and abject poverty have continued to haunt the country.

Unless the country is able to create other forms of resources such as financial resources to remedy the lack of natural resources the country will continue to suffer from poverty and hunger.

1.3. Objectives

1.3.1. General objective

The general objective of this study is to establish optimal conditions that a city must have in order to convert itself to a financial centre and thereby attract capital inflows from abroad.

1.3.2. Specific objectives

a) To identify the business environment factors that are significant determinants of a city's attractiveness as an international financial centre.

b) To establish the functional relationship between the business environment factors identified in (a) above and the stature of a city as an international financial centre.

c) Using the functional relationship identified in (b) above, make policy recommendations on how Nairobi can improve its business environment factors so as to attract foreign securities to trade in the Nairobi Securities Exchange and thereby develop itself as the preferred International Financial Centre in the region.

CHAPTER 2

2.0.   LITERATURE REVIEW

2.1.   Introduction

There are a number of researchers who have explored this subject before. To ensure that this study builds on the contributions already made, a number of academic materials have been reviewed. The literature reviewed which are relevant to this study assess the importance of International Financial Centres in development of an economy. The literature also helps in identifying the features of the business environments of the various IFCs.

2.2.   Theoretical Literature

In analysing the importance of IFCs, Jason Sharman (2009) tested how International Financial Centres (IFCs) provide support for economic growth and poverty alleviation among developing countries. He argued that IFCs offer a natural complementarity for developing countries seeking better government support for the growth of their businesses which their local governments may not offer due to corruption or simply lack of finances to build infrastructure. Sharman further elaborated that Small- and medium sized enterprises from developing countries may be able to access capital much more efficiently in or through IFCs than domestically. For foreign investors, IFCs ease the path of entry into developing countries. He observed that the positive role played by IFCs in enhancing economic growth and poverty alleviation in developing countries may also help to explain the Chinese government's supportive attitude towards IFCs.

One of the features of IFCs includes low taxation in their jurisdictions. This is explained by Mihir Desai (2005) who studied if multinational firms divert activity from non tax havens

when they expand their operations in tax havens. His study sought to establish if business activity in a tax haven has externalities in neighbouring non tax havens which the tax haven trades with. The evidence from this study suggested that tax haven activity enhances activity in nearby non-havens. The evidence also indicated that use of tax havens indirectly stimulates the growth of operations in non-haven countries in the same region. A one percent greater likelihood of establishing a tax haven affiliate is associated with 0.5 to 0.7 percent greater sales and investment growth by non-haven affiliates, implying a complementary relationship between haven and non haven activity. He concluded that a country will stand to benefit by converting itself into a tax haven and at the same time benefit its neighbours.

According to George Mendes (2007), little research has been conducted into understanding the role of tax havens in an increasingly globalised environment. He analysed the economy of an Offshore Financial Centres (OFCs) through the use of the Bahamas as a case study. He chose the Bahamas because it offered the opportunity to investigate a specific OFC whilst also being representative of the condition of many offshore jurisdictions, and the challenges they face in light of the OECD led impetus for tax reforms. The results of his analysis suggested that tax competition provides exceptional benefits in assisting undeveloped countries that have limited options to grow their domestic production.

Other than low tax jurisdiction, the other important feature of an IFC is political stability. Mark Roe and Jordan Siegel (2011) brought forward strong evidence that political instability impedes financial development and that it needs to be added to the short list of major determinants of financial development. They conducted a survey on managerial perceptions of nation-by-nation political stabilities among 2,000 CEOs of leading multinational companies worldwide. Their results indicated that 64% of the business leaders consider

inequality and political instability in their targeted investment destination countries as a major threat to their potential investment. The significance of their findings demonstrates the importance of political economy explanations for financial development.

2.3.   Empirical literature

Other than taxation and political stability, another important feature of an ideal IFC is infrastructure. In KIPPRA's policy brief of 2006, Justus Nyamunga explored ways of increasing foreign direct investments in Nairobi. He pointed out that a key element of attracting foreign direct investments is reducing the cost of doing business in the city. He notes that this can be accomplished through infrastructural development. He argued that good infrastructure will enable businesses to reduce transport costs.

For a city to attract foreign investors, it also needs a strong legal environment to protect property rights and enhance resolution of disputes. Rose W. Ngugi and Owen Nyang'oro (2005) looked at the relationship between Foreign Direct Investment (FDI) flows and various institutional factors. They analysed the strength of institutions for developing countries using the number of days it takes to resolve disputes in courts. Their results from this study show that Kenya ranks poorly in terms of the strength of its institutions particularly the judicial mechanism. They concluded that the government should undertake reforms on its judicial and law enforcement mechanisms to restore law and order and reduce corruption in order to gain substantially in investment growth.

Urbanisation poses serious challenges to cities due to the huge levels of investment needed in order to provide basic amenities like electricity, water and transport to the urban dwellers. It however plays an important role in development according to John P. Mason (2007). Using

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cross sectional data, he studied the role of urbanisation in development by establishing the relationship between the levels of urbanisation and the GDP for 164 countries in the world. His results indicated a significant positive correlation between urbanisation and GDP. He also observed despite this relationship, many governments in developing countries still pursue policies that discourage urbanisation. Although urbanization is not occurring along the same lines in the developing countries as it has in Western countries, the writer demonstrated that it contributes effectively to overall national economic growth and development.

The tax system in Kenya and its role towards the growth of Nairobi as an IFC has also been studied. Stephen Karingi and Bernadette Wanjala, (2005) studied the tax reform experience in Kenya. They observed that Kenya's tax reforms have mainly been aimed at achieving greater simplicity and ensuring uniform tax burden across individuals with equal income, but do not consider distribution of tax burdens across the income categories. As a result, they observed that there still are sectors of the economy especially in the informal sector which the government does not collect taxes even as it heavily taxes the formal sector. They observed that the heavy taxation of the formal sector is making the country unattractive to foreign investors. They recommended a wider tax burden distribution accompanied by a lower tax rate. According to their study, a wider tax administration system accompanied by a lower tax rate will reduce the costs of administering the taxes as well as reduce evasion and avoidance. It will also attract foreign investors and as a result the economy will grow at a faster rate.

Other than a poor business environment, the structure of Nairobi Securities Exchange also contributes to the low standing of Nairobi as an international financial centre due to lack of a variety of products for trade. Rose Ngugi and Roline Njiru (2005) studied factors influencing growth of the market using a sample of twenty (20) firms that had made public offers since

1980. They observed that the number of listed firms in the Nairobi Securities Exchange in 2005 is less than that at independence (1963). They explained that this is caused by the stringent requirements of listing in the Nairobi Securities Exchange which many local firms are not able to meet. To remedy this short coming, they proposed the establishment of a secondary market in which firms that do not meet the requirements of listing in the main market can list.

Separately, Martin Mbewa (2007) analysed the Kenyan experience of the development of bonds market in terms of development of money market, wider participation and protection of investors, reduced information asymmetry and an efficient trading system. He observed that the length of treasury bonds market is shorter than that of developed bonds markets, the trading system is not harmonized with intermediaries using different pricing models and the regulatory framework does not accommodate diversification of corporate bonds. Also, growth of corporate bonds is yet to pick momentum, and the debt market is thin, with the type of securities that have negative implications on the competitiveness of the market. He concluded that for the Nairobi Securities Exchange to meet the financing needs of member firms, the bonds market requires huge investment in institutional building.

2.4. Overview of the literature

From the literature reviewed, there is a general appreciation that IFCs are important for the growth of developing economies. The literature so far reviewed also point out two broad elements that a city must achieve to attain the status of a developed IFC.

a) A developed market

b) Ideal business environment to attract foreign investors

Development of the market

The market needs to attract foreign investors to make the city an IFC. To achieve this, it needs to have an array of products ranging from equities, bonds, commodities, futures, swaps and other derivatives. The market will also need to have several sections to cater for the big investors and the SMEs. Moreover, the market must operate a fully integrated exchange, offering the complete range of exchange-related services including trading, clearing, settlement and depository services.

Ideal business environment

The studies reviewed also show that for a city to attract foreign investors, it needs to have a good business environment that will minimise the costs of doing business for potential investors. Such an environment must entail the following features:

- Low taxation – the tax rates must be low enough to attract foreign investors who would want to make tax savings by investing outside their existent jurisdictions.

- Good infrastructure – broadly defined as good road network, good railway system, good ICT development and adequate housing, good infrastructure also attracts foreign investors.

- Political stability – political stability creates comfort on the investors that their property will be secure from vandalism and that there businesses will not be interrupted by political upheavals.

- Urbanised population – Urbanised population offers labour and market for the foreign investors.

- Strong legal environment – this will enable the investors enforce property rights and contracts as well as settle disputes speedily at a low cost.

This study seeks to build on the knowledge obtained from the literature reviewed. Whereas an appreciation of the benefits the factors pointed out by the literature in elevating Nairobi to an IFC has been inculcated in this study, knowledge gaps identified in previous studies are addressed as follows:

- The literature reviewed so far does not demonstrate how a government of a big country in terms of its area can cut its taxes and still achieve the same level of public expenditure it had before the tax cuts. The studies so far analysed restrict tax havens to small countries and islands which need little public expenditure in infrastructure due to their small sizes. This study demonstrates that is possible for a country with a large area to reform and convert some of her cities to IFCs.

- Unlike the preceding studies, this paper quantifies how each business environment factor should be developed to transform a city to an international financial centre.

- In any planning initiative, prioritisation is critical. The studies so far do not prioritise how a government should approach the reforms of the business environment factors given the budgetary constraints that many developing economies face. Based on their levels of significance, this study shall prioritise these business environment factor reforms.

CHAPTER THREE

3.0. METHODOLOGY

3.1. Introduction

This study establishes a functional relationship between an ideal business environment based on the business environment factors identified and the stature of a city as an international financial centre. Based on the comparability of their economic structures with Nairobi's, a number of cities which have developed financial centres are then selected. These cities have been referred to as Best Practice Markets (BPMs). Nairobi is then benchmarked to these best practise markets (BPMs) and lessons which Nairobi can draw from them are analysed. Using the average business environment on the select BPMs and the functional relationship obtained between the stature of cities as international financial centres and their business environments, the level of Nairobi as a developed IFC is predicted if it develops its business environment to the level of the BPMs.

To arrive at the functional between a cities stature as an IFC and its business environment factors, it is imperative that units being used to measure the respective variables be understood clearly.

Market capitalisation as a percentage of the GDP shall be used as a proxy for international financial centres. Whereas the measurement of the market capitalisation per GDP shall be used per country, the results will reflect the ability of an economy to make its cities international financial centres because the cities operate within the environment created by the country.

The business environment factors that affect a city's attractiveness as an international financial centre include business extent of disclosure, credit depth of information, ease of doing business, employee dismissal/ firing costs (weeks of wages), ICT infrastructure, political stability, strength of legal rights, levels of skilled labor, the tax rate and levels of urbanization.

These are generally policy variables which can be used to make policies that will help an economy convert some of her cities to internationally recognised financial centres. Whereas a claim cannot be placed that these are all the factors that a city needs to develop into a financial centre, their statistical significance is established to illustrate how altering them in specific direction and magnitude moves cities closer to attainment of financial centre status.

3.2.   Theoretical framework

To transform a city to an international financial centre, no one factor can be sufficient. Policy makers need to work on several factors that are important to potential investors as they look for ideal places to invest. The business environment factors to be considered are both qualitative and quantitative. They include the following.

Taxation

In theory, a country that eliminates taxation completely will attract maximum foreign direct investments since businesses all over the world shall seek to invest in this economy and enjoy higher profits. In the corporate world today, companies are employing tax planning structures which include investing in tax havens to ensure they are able to avoid a heavy tax burden. However, as data will illustrate, this principle should be applied cautiously because, companies would rather invest in a high tax jurisdictions that provides an ideal business

environment than in a low tax regime where they will still incur additional costs to mitigate hardships in doing business.

ICT Infrastructure

Businesses also consider the infrastructure in terms of roads and ICT such that the costs they are able to reduce by the reduced taxes are not wiped out by increased costs of travelling or the delay in passing information. Infrastructure encompasses availability of internet, mobile phones network coverage, telephone connectivity, good roads, railways and a port. Good infrastructure enables the businesses to offer quality services to their clients.

Human resources

Availability of skilled workforce enables businesses to conduct their operations efficiently. In 2006, an online survey of Chief Financial Officers (CFOs) conducted by 'CFO On-line' showed that 43% of the CFOs consider skilled workforce as the most important factor in their business. 48% described it as one of the top two or three factors that facilitate the running of their businesses and only 7% said it was important, but not one of the top most important factors.

In theory, a city with more skilled workforce attracts more foreign investments compared to a city with less skilled work force. Potential investors not only consider availability of skilled labour but also employee dismissal / firing costs.

Business extent of disclosure

Depicted by the business extent of disclosure index, this is a key variable in companies that consider investing abroad. Theoretically, businesses are quite keen in keeping their business

secrets but a regulatory environment that requires them to disclose more are preferred because businesses want to use these financial centers to obtain the competitive edge against their competitors and to safeguard their assets from loses emanating from underground deals. If anything, businesses learn about investment opportunities from the disclosures of their peers.

Credit depth of information

Credit depth of information index measures rules affecting the scope, accessibility and quality of credit information available through public or private credit registries. Higher values indicate the availability of more credit information, from either a public registry or a private bureau, to facilitate lending decisions. In this study, the theory states that offshore investors prefer to invest in an economy with a higher credit information rating.

Strength of the legal environment

A country with a strong legal environment is better placed to protect property rights and as a result attracts more investors than a regime that does not guarantee proprietors a footing on their wealth. For instance, during the era of land grabbing in Zimbabwe where the government forcefully took over foreign owned land, investor largely lost confidence in that economy leading to mass withdrawal of foreign investments and an almost collapse of the economy.

Urban population (% of over 15s)

That there is a close positive relationship between urbanization and economic development is evident from experience in most countries that have undergone development although it may not be the only factor. In recent history, as communications have been revolutionized,

economic development has come to consist more of applying ideas, no matter where they originate. Still however, urbanization helps investors obtain cheap and readily available labour as well as domestic market for their products.

Political stability

Political instability impedes financial development and is a primary determinant of differences in financial development around the world. This is because investors want to avoid political risk as they venture into a new market given the other risks they have to contend with such as liquidity risk, market risk, credit risk and currency risk. In theory therefore, a country with lower political risk is preferred as an investment destination to a country with a higher political risk.

Based on the theoretical framework, Nairobi can build a service based international financial hub to support the global industry and thereby remedy the lack of natural resources in the country that would otherwise have supported trade in the city's financial markets. To realise this however, the city needs to make deliberate and agile steps to reform its business environment by:

a) Reducing its tax rate to levels that can attract foreign investors.

b) Improving its ICT infrastructure.

c) Improving the skills of its human capital.

d) Increasing disclosure requirements for body corporate and more stringent corporate management guidelines.

e) Improving the depth of credit information as managed by the credit reference bureaus.

f) Improving the strength of its legal environment.

g) Improving urban living conditions to attract its citizenry to urban areas.

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h) Reducing its political risk by improving on public governance and accountability as well as managing the democratic space.

Though the direction of the impact on these business environment factors have already been predicted in the theoretical framework, data analysis ascertains that the theoretical framework is consistent with results obtained from data analysis. The study also establishes the magnitude which an economy must strive to improve the factors in order to attain the financial hub status.

3.3.   Model specification

The aim of this study is to explore ways which the business environment of a country can be improved to improve a country's cities standing as international financial centres. For modelling purposes market capitalisation of the stocks market in these centres will be used as a proxy to measure how well a country fares as an IFC. The ideal business environment that would make the country attractive to foreigners is captured by the independent variables.

The model is therefore specified as follows:

The model

$$MKT.CAP = \beta_0 + \beta_1 BUS.DISC + \beta_2 CRD.INFO - \beta_3 EMP.FIRE + \beta_4 CEL.SETS + \beta_5 LGL.STR - \beta_6 TAX.CORP + \beta_7 URB.POP + \beta_8 ADT.LIT + \beta_9 POL.STAB + U_t$$

3.4.   Definition of variables and units of measurement

The data codes used in the model are explained in the table below

Table 1: Definition of variables

Data code	Data description
MKT.CAP	Market capitalization of listed companies (% of GDP). This has been used as a proxy to represent a global financial centre. Choice of this variable is based on a factual observation that developed financial centers have higher market capitalization. For comparability among economies of various sizes, the data has been presented as a percentage of the GDP.
BUS.DISC	Business extent of disclosure index (0= no disclosure to 1=full disclosure). Choice of this variable is meant to capture the role of corporate governance as enforced by the government in an economy.
CRD.INFO	Credit depth of information index (0=low to 1=high). This independent variable captures the ease of access to credit and role of lower interest rates.
EMP.FIRE	Firing cost (weeks of wages). This captures the role of high labour costs in attracting foreign investors.
CEL.SETS	Mobile cellular subscriptions (per 100 people). This independent variable has been used as a proxy to capture the role of ICT in development.
ADT.LIT	Adult literacy as a percentage of ages 15 and above. This independent variable has been used to capture the role of skilled labour in attracting foreign capital.
LGL.STR	Strength of legal environment (0 = weak, 1 = strong). A strong legal regime certainly attracts more investors than a weak legal regime.
TAX.CORP	Total tax rate (% of commercial profits). Corporate taxes acts as a fiscal tool which governments continue to use in attracting foreign investors.
URB.POP	Urban population (% of over 15s). Urbanization leads to availability of a financial literate society, labour and local market thus attracts international capital.
POL.STAB	Political stability (-1 = unstable to 1 = stable). Political stability is key in giving investors a sense of financial security.
B_1 to β_9	Coefficients of the independent variables
Ut	Is the error term

3.5. Type of data

The research study relies on secondary cross sectional data from the selected countries. The data has been analysed for the year 2010. However, in cases where data for the year 2010 is not available, recent data e.g. 2009 or 2008, has been used to project the 2010 values as appropriate.

3.6. Data refinement

For purposes of comparability, data obtained from the World Bank have been refined by converting all data across all countries for a particular variable to a common scale of $0<d<1$, where d is the data. This makes it easier for users to make quick inference on the result as to what the various values of the coefficients mean.

To ensure the function developed captures Nairobi's scenario as closely as possible, elimination of the bigger economies like the United States of America and the much smaller or collapsed economies from the data in Appendix II has been done. Further, major oil producing nations or countries with the rich natural resources have also been eliminated. This leaves about 90 countries whose economic structures closely match that of Kenya.

3.7. Data sources

Our sole source of data was the World Bank data available on http://data.worldbank.org/data-catalog. World Development Indicators (WDI) is the primary World Bank database for development data from officially-recognized international sources. Global Development Finance (GDF) provides external debt and financial flows statistics for countries that report public and publicly-guaranteed debt under the World Bank's Debtor Reporting System.

Notably however, the World Bank itself does not necessarily collect all the data. It relies on other sources including the following:

1 Governments of the respective countries,

2 International Monetary fund,

3 United Nations,

4 CIA World Fact book and

5 Eurostat – a statistical data base maintained by the European Commission.

3.8. Limitations

There are no major statistical challenges or otherwise in the data analysis of this study. This is because the possible statistical challenges are addressed as follows:

Endogeneity –To mitigate this challenge, the probable causes of endogeneity have been addressed as follows:

- **Omitted-variable bias** - In this case, the endogeneity comes from an uncontrolled confounding variable i.e. a variable is both correlated with an independent variable in the model and with the error term. To mitigate this risk, only one variable per sector has been included. For example, in the ICT sector, only number of mobile phone users per 100 people has been used in the data.

- **Measurement Error** – This can occur if there is no perfect measure for one of the independent variables. To mitigate this, data to measure all the independent variable have been attained.

- **Dynamic Models** - The endogeneity problem is particularly relevant in the context of time series analysis of causal processes. It is common for some factors within a causal system to be dependent for their value in period t on the values of other factors in the causal system in period t-1. This challenge has not been experienced in the model of this study which is not a time series model.

- **Simultaneity** – To mitigate this risk, no two or more variables are codetermined in the model.

Comparability –To avert this risk, the data across all the countries under study have been refined to a common scale between 0 and 1. This concept has already been elaborated in section 3.6.

CHAPTER FOUR

4.0. EMPIRICAL RESULTS AND DISCUSSION

4.1. Results

From an analysis of data provided in appendix 2 using simple OLS method, the following preferred function is obtained.

The OLS regression function

$$MKT.CAP = -0.756 + 0.71\ BUS.DISC + 0.47\ CRD.INFO - 0.48\ EMP.FIRE + 0.39$$
$$CEL.SETS + 0.17\ POL.STAB + 0.21\ LGL.STR - 0.57\ TAX.CORP + 0.16\ URB.POP + 0.65$$
$$ADT.LIT + 0.37 U_t$$

From the OLS regression function above, it is possible to establish that market capitalisation, which has been used as a proxy to represent an IFC, is directly related to all the factors stated except corporate taxation and employee firing costs. This is because all the co-efficient are positive except the co-efficient of employee firing costs and that of taxation.

The means and standard deviation of the data is provided in Appendix A.1.1. The mean shows the average of all the countries for each variable. Standard deviation indicates the dispersion of the data from the mean. A low standard deviation indicates that the data points tend to be very close to the mean, whereas high standard deviation indicates that the data points are spread out over a large range of values. Appendix A.1.1 shows that market

capitalization and legal strengths are widely dispersed from the mean. This is expected because of the differences in the market structures and the legal systems across the countries.

Appendix A.1.2 shows the correlation co-efficient among the variables which measures the linear dependence between two variables Y, giving a value between +1 and −1 inclusive. It is a measure of the strength of linear dependence between two variables. For most of the pair of variables, the correlation co-efficient is less than 0.5 which indicates weak association between variables and gives comfort on the absence of autocorrelation. However, for cases where the correlation co-efficient exceeds 0.5, it does not show auto-correlation because the data under study is not time series data. This is confirmed by the Durbin Watson test in Appendix A.1.3.

Appendix A.1.3 gives the model summary showing an adjusted R^2 of 64.4 %. This means that 64% of the dependent variable is explained by the independent variables. The residual term is 36.7% which means that 36% of the change in market capitalisation is affected by other factors. Appendix A.1.3 also gives the Durbin Watson test value. Since d is approximately equal to $2(1 - r)$, where r is the sample autocorrelation of the residuals, $d = 2$ indicates no autocorrelation. The value of d always lies between 0 and 4. If the Durbin–Watson statistic is substantially less than 2, there is evidence of positive serial correlation. As a rough rule of thumb, if Durbin–Watson is less than 1.0, there may be cause for alarm. In this case, d = 1.779 indicating no autocorrelation between the independent variables.

The ANOVA table that resulted from this model is given by Appendix A.1.4. It shows the total sum of squares (TSS) is 11.695 and the residual sum of squares (RSS) is 4.586. This leaves an Explained Sum of Squares of 11.695. Analysis of Variance (ANOVA) is a statistical test used to determine if more than two population means are equal. The test uses the F-distribution (probability distribution) function and information about the variances of each population (within) and grouping of populations (between) to help decide if variability between and within each populations are significantly different. The test statistic is the F value of 9.635. Using an α of 0.05, we have that $F_{.05;\ 4,831}$= 5.63. Since the test statistic is much larger than the critical value, we reject the null hypothesis of equal population means and conclude that there is a (statistically) significant difference among the population means. The *p*-value for 9.635 is .0001, so the test statistic is significant at that confidence level of 5%.

The table below summarises the results given in the various appendices.

Table 2: Summary results

Variable	Coefficient	Mean	Std. Deviation	Standard error	t statistic
MKT.CAP		0.7148	0.61533		
Constant	-0.756			0.295	-2.567
BUS.DISC	0.711	0.5359	0.24588	0.295	3.415
CRD.INFO	0.474	0.5952	0.29611	0.241	2.964
EMP.FIRE	-0.476	0.3582	0.23244	0.297	-2.604
CEL.SETS	0.389	1.2798	0.37652	0.229	2.696
POL.STAB	0.166	0.8402	0.5015	0.192	1.863
LGL.STR	0.205	0.715	0.51502	0.2	2.027
TAX.CORP	-0.571	0.3141	0.13314	0.485	-2.176
URB.POP	0.157	0.5155	0.26283	0.441	2.129
ADT.LIT	0.652	0.5225	0.24326	0.408	2.598

From the table above [Table 2], the autonomous term in the results is – 0.756. It means therefore that given no presence of any of the independent variable in a city, the economy will experience a disinvestment of 7% of its market capitalisation.

The coefficients of the various variables given by the partial derivatives each one of them, $\delta MKT.CAP/\delta IND$, where IND represents each of the independent variables separately can be summarised as follows:

Table 3: Interpretation of partial derivatives and t-statistics

Partial Derivative	Value	Interpretation
$\delta MKT.CAP/\delta BUS.DISC$	0.711	Business disclosure index was ranked between 0 and 1. This results show that a unitary increase in business disclosure will improve market capitalization by 0.711. For example, if a city improves it business disclosure requirements and its index grows by 0.1, then market capitalization as a percentage of the GDP will grow from 0% to 7.11% assuming it was initially at 0%, all factors held constant. t-statistic is greater than 2 so the variable is statistically significant at 99% confidence level.
$\delta MKT.CAP/\delta CRD.INFO$	0.474	Credit information index was ranked between 0 and 1. This results show that a unitary increase in credit information will improve market capitalization by 0.474. For example if a city improves it credit information availability index from 0 to 0.1, the market capitalization as a percentage of the GDP will grow from 0% to 4.74% assuming it was initially at 0, all factors held constant. t-statistic is greater than 2 so the variable is statistically significant at 99% confidence level.

Partial Derivative	Value	Interpretation
$\delta MKT.CAP / \delta$ EMP.FIRE	-0.476	Employees firing costs index was ranked between 0 and 1. This results show that a unitary decrease in Employees firing costs will improve market capitalization by 0.476. For example if a city reduces costs associated with dismissing employees from 1 to 0.9, the market capitalization as a percentage of the GDP will grow from 0% to 4.76% assuming it was initially at 0, all factors held constant. t-statistic is greater than 2 so the variable is statistically significant at 99% confidence level.
$\delta MKT.CAP / \delta$ CEL.SETS	0.389	Cell phone set per 100 users was converted to a scale of 0 - 1. This results show that a unitary increase in the number of cell phones per person will improve market capitalization by 0.389, all factors held constant. t-statistic is greater than 2 so the variable is statistically significant at 99% confidence level.
$\delta MKT.CAP / \delta$ POL.STAB	0.166	Political stability index was ranked between 0 and 1. This results show that a unitary increase in political stability will improve market capitalization by 0.166. For example if a city improves it political stability and its index grows from 0 to 0.1, the market capitalization as a percentage of the GDP will grow from 0% to 1.66%, all other factors held constant. However, t-statistic is less than 2 so this variable is not statistically significant at 90% confidence level.
$\delta MKT.CAP / \delta$ LGL.STR	0.205	Legal strength index was ranked between 0 and 1. This results show that a unitary increase in the legal strength will improve market capitalization by 0.205. For example if a city improves it legal environment and its index grows from 0 to 0.1, the market capitalization as a percentage of the GDP will grow from 0% to 2.05%, all factors held constant. t-statistic is greater than 2 so the variable is statistically significant at 99% confidence level.
$\delta MKT.CAP / \delta$ TAX.CORP	-0.571	Taxation was converted to a 0 – 1 scale. The data used was total business earnings that are taxed. If the government reduces taxation by 10% or 0.1 in our scale, market capitalization will increase by 0.571 and vice versa, all other factors held constant. t-statistic is greater than 2 so the variable is statistically significant at 99% confidence level.

Partial Derivative	Value	Interpretation
$\delta MKT.CAP / \delta\ URB.POP$	0.157	The urban population as a percentage of the total population was converted to an index between 0 and 1. If in a country 10% of the population migrates to urban centers, then the market capitalization grows by 0.157, all factors held constant. t-statistic is greater than 2 so the variable is statistically significant at 99% confidence level.
$\delta MKT.CAP / \delta\ ADT.LIT$	0.652	Adult literacy was obtained by taking the total literate individuals as a percentage of the population. If this levels increase by a unit, in this case 10% which also equals to 0.1, then market capitalization will improve by 0.652. If it was at 0, it will grow to 0.562, all factors held constant. t-statistic is greater than 2 so the variable is statistically significant at 99% confidence level.

4.2. Conclusion on the results

From an analysis of the results in Appendix A.1.5, all the factors have a statistically significant influence on the attractiveness of a city as an international financial centre at 99% confidence level except political stability which is statistically significant at 90% confidence level. Moreover, all the variables have a direct relationship with the dependent variable except employee firing costs and taxation.

R^2 is 64.4 % which means that 64.4% of the market capitalisation is explained by the factors above. This is a significant percentage because, as it should be appreciated, market capitalisation measures the volume of trade in the securities market of a particular city. It need not be dependent on any of the factors above but these factors encourage the growth of the stock exchange. The standard Error is thus 36% which will capture other factors that affect market capitalisation not analysed in this study.

CHAPTER 5

5.0. POLICY IMPLICATIONS

5.1. Market restructuring

Nairobi Securities exchange needs to be restructured to accommodate the complex needs of potential investors. This is because it currently has very limited number of products traded in it which includes government bonds and shares only. To achieve greater diversity, it is important that the city should attain a multi-tier market. A multi-tier financial market comprises of the following:

a) *Multi-location*

This implies that like South Africa, the USA and China, a city needs to have other exchanges near it to compliment it activities. In Kenya, the lucrative ones would be Mombasa that would naturally have many companies involved in shipping and transport. Nakuru would also be ideal for trade of stocks of agricultural companies.

b) *Multi-product*

Such a diversification would entail creating markets that trade in a variety of products such as commodities, corporate shares, corporate bonds, government bonds, local government bonds, derivatives such as corporate and government swaps, futures, options, mortgage derivatives and foreign exchange trade. Such a diversified market will attract more traders because it gives them opportunities to diversify their portfolio and consequently hedge their investments against a particular sector collapse.

To convert Nairobi to an IFC, the government needs to envision creation of such multi-tier market across the country as well as improve the business environment such that offshore companies and individuals can trade locally.

Using the function as developed in Chapter 5, it is possible to establish the extent which the government needs to develop some of its components of the business environments to attract global financial operations and trade.

From the data in Appendix II, it is apparent that some cities have better performances in terms of market capitalisation and their economic structures can be compared to that of Nairobi. These cities have been selected as Best Practise Markets (BPMs) and have been used as benchmarks which Nairobi can learn lessons on how it can restructure its securities exchange. The table below looks at their market capitalisations

Table 4: Market capitalisations of select Best Practice Markets (BPMs)

Country Name	MKT.CAP
Switzerland	2.35
Luxembourg	1.84
Malaysia	1.73
Chile	1.68
Singapore	1.66
South Korea	1.07
Papua New Guinea	1.03
Israel	1.00
Montenegro	0.90
Qatar	0.89
Thailand	0.87

Features of the select Best Practice Markets (BPMs) and lessons for Nairobi

It is important that the above exchanges be analysed in depth to help us understand their basic

features, why they have thrived and lessons Nairobi can draw from them. Most of them have

diverse products which cater for varying needs of international investors.

Switzerland for instance has been selected as a BPM because the country has the Switzerland

Exchange (SIX) which is the main exchange and the Berne Exchange that creates a second

tier market which is mainly aimed at Swiss small and medium enterprises (SMEs) that

consider a listing at SIX too expensive.

Luxembourg Stock Exchange is another exemplary market because of its products diversity

and international trade. It specialises primarily in the issue of international bonds, with

approximately 60% of all cross-border securities in Europe being listed in Luxembourg. Fifty

countries list at least some of their sovereign debt in Luxembourg, whilst Luxembourg is also

a market for debt from the EBRD, European Commission, European Investment Bank and

the World Bank. It also has equities of international firms listed. Similarly, Bursa Malaysia or

Kula Lumpar Stock Exchange operates a fully integrated exchange, offering the complete

range of exchange-related services including trading, clearing, settlement and depository

services. Others that have been selected to their product diversities and advanced market

structures include Santiago Stock Exchange, NASDAQ OMX located in Stockholm Sweden,

Korean Stock Exchange, The Tel Aviv Stock Exchange Montenegro Stock Exchange and the

Kuwait Stock Exchange.

Singapore has also been selected as a BPM because it was at the same level as Kenya was in the 1970s but rapidly developed to a leading IFC and left Nairobi at almost the same level hitherto.

Finally, The Stock Exchange of Thailand (SET) has been selected because it allows Put Through (PT) Trading i.e. brokers advertise their buy or sell interests by announcing bid or offer prices. The market has also floor and ceiling limits where stock prices are allowed to fluctuate within a range 30 per cent of the previous closing price on the main board. Finally, the market has a circuit breaker. The circuit breaker operates in two stages. Firstly, if the SET index falls by 10% from the previous day's close, all trading in listed securities will be halted for 30 minutes. Secondly, if the SET index falls by 20% from the previous day's close (i.e. another 10%), trading in all listed securities will be halted for one hour. If the circuit breaker is in effect at the closing time of a session, trading resumes in the next session. This market is also extremely important in our study in terms of implementing controls to increase market stability and by extension boost investor confidence.

Lessons from the Best Practice Markets (BPMs)

In summary, based on our study of the best practices, for Nairobi to realize the status of an IFC, restructuring of the market (the NSE) would a good starting point. To achieve this, the following measures are recommended.

1. Introduction of a market specifically for SMEs that will allow firms that deem listing in the NSE expensive and beyond their reach to seek capital from these alternative markets.

2. Big trade of international bonds should be encouraged. Instead of the Kenyan government borrowing domestically, it can start by floating an international bond such as the Euro bond to jam start diversity in the market.

3. Each and every market should have sub components such as exhibited in Malaysia, to facilitate trade in Islamic products, information dissemination, futures market and other features.

4. Policy makers can also develop Nairobi by introduction of the commodities exchange and mercantile exchange as demonstrated by Singapore.

5. Diversity will further be enhanced by introduction of other products such as investment funds, stock options, futures, gold and silver, FOREX futures, Index futures, Index options, REITs and Corporate bonds among other securities.

6. Policy makers should consider linking Nairobi to a bigger IFC exchange such as the Switzerland Stock Exchange (SIX). Such a linkage will be a symbiotic relationship where Nairobi benefits from exposure and increased interest from the traders in SIX and SIX benefits from the diversity created by the NSE.

7. Embracing open market policies by making it easier for foreign entities to list locally.

8. Hedging the market from bearish shocks by introducing circuit breakers.

5.2. Business environment restructuring

Having developed the market features, policy holders should then shift their attention to the overall macroeconomic environment as depicted by the model in chapter three. Using table 2, it is perceptible that the average market capitalization as a percentage of the GDP that Kenya should target is 1.365 i.e. market capitalisation should be 136.5% of the GDP. Obviously, by the fact that our expectation exceeds 100%, it implies that there is a high level of international trade in the local markets. To achieve this, feed the average of the features of

our select market into function 1 and establish the gap between the ideal business conditions and the Kenyan situation. The table below illustrates the various factors in comparison with Kenya's.

Table 5: Comparison of business environments of BPMs and Kenya

COUNTRY NAME	MKT.CAP	BUS.DISC	CRD.INFO	EMP.FIRE	CEL.SETS	POL.STAB	LGL.STR	TAX.CORP	URB.POP	ADT.LIT
Switzerland	2.35	-	0.83	0.89	1.20	1.21	1.65	0.30	0.74	0.50
Luxembourg	1.84	0.60	-	0.39	1.44	1.44	1.69	0.21	0.82	0.50
Malaysia	1.73	1.00	1.00	0.22	1.09	0.14	0.58	0.34	0.72	0.92
Chile	1.68	0.80	0.83	0.40	0.97	0.61	1.44	0.25	0.89	0.99
Singapore	1.66	1.00	0.67	0.94	1.33	1.12	1.80	0.25	1.00	0.95
South Korea	1.07	0.70	1.00	0.12	0.98	0.10	0.91	0.30	0.82	0.50
Papua New Guinea	1.03	0.50	0.50	0.48	0.13	(0.85)	(0.54)	0.42	0.13	0.60
Israel	1.00	0.70	0.83	0.13	1.21	(1.49)	1.22	0.32	0.92	
Montenegro	0.90	0.50	0.33	0.66	1.19	0.50	(0.06)	0.27	0.60	0.50
Qatar	0.89	0.50	0.33	0.22	1.55	1.06	0.54	0.11	0.96	0.95
Thailand	0.87	1.00	0.83	0.37	1.21	(1.22)	0.19	0.37	0.34	0.94
Average	1.37	0.73	0.72	0.44	1.12	0.24	0.86	0.29	0.72	0.74
Kenya	0.46	0.30	0.67	0.43	0.63	(1.20)	(0.13)	0.50	0.22	0.87

Comparing the average values versus the Kenyan values above is extremely important for policy makers. Looking carefully at the various components, it should be noted that Kenya is faring well in terms of depth of credit information with an index of 0.67 against an average of 0.72 among the BPMs. It means that Kenya has well developed credit information and firms are fairly able to access credit should they decide to domicile their company's securities in the Kenyan financial market.
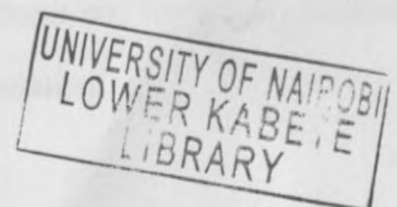
Secondly, literacy levels in the Kenya are relatively good. With an index of 0.87 compared to a BPMs average index of 0.74, Kenya stands above the requirement ideal for attracting foreign investments. This is as a direct product of the country's free primary education policy and subsidised secondary education policy.

Under the employee firing costs index of zero to ten, $0 \leq EMP.FIRE \leq 1$, Kenya has an index of 0.43. This is less than the best practice average index of 0.44. Employee firing costs is closely linked to the adult literacy and is generally set to measure the level of efficiency of employees and the ease which businesses can access their services as well as terminate the same when circumstances are unfavourable. It is apparent that Kenya is at par with the BPMs. This variable therefore does not need to be given priority during the business environment reforms.

This leaves six factors that Kenya ranks below the market best practice average and need to be hoisted to improve Kenya's profile as a designated international financial centre of choice for multinationals. The table below summarises these factors.

Table 6: Comparison of summarised business environments of BPMs and Kenya

COUNTRY NAME	MKT.CAP	BUS.DISC	CEL.SETS	POL.STAB	LGL.STR	TAX.CORP	URB.POP
Average	1.37	0.73	1.12	0.24	0.86	0.29	0.72
Kenya	0.46	0.30	0.63	(1.20)	(0.13)	0.50	0.22

From the above analysis, it is apparent that Kenya has to improve on the level of businesses disclosures required by the government, number of cell phones per 100 people, political stability, strength of the legal environment, taxation and urbanisation.

Business disclosures

Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide stakeholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information. To achieve this, policy makers must require of companies to make disclosures about their shareholders, management team, CSI as well as accurate and full information on all the account balances and transactions to enable users and the public understand exactly how the entity is being managed.

In business disclosures, Kenya ranks poorly with an index of 0.3 compared to the best practice markets level of 0.73, where the scale falls between 0 and 1. This demonstrates that the country has little requirements for disclosures by businesses. This scares off international investors because they lack basic information that would guide their decisions to invest in Kenya.

Ideally, just like in banks, insurance companies and public entities, the government must create regulatory bodies for each industry e.g. Agricultural regulatory Authority, Horticultural Regulatory Authority, Livestock Regulatory Authority, Fisheries Regulatory Authority, Manufacturers Regulatory Authority, among others, to monitor all the business disclosures made by the private players in these respective industries and ensure the global IFRS and local disclosure requirements are strictly met.

ICT infrastructure

Data on cell phone sets per 100 people has been used to capture the level of ICT development in Kenya. Kenya has a scale of 0.63 compared to best practice average of 1.12. It means therefore that for every 10 people, six have access to mobile phones compared to developed markets where each individual has one or more phones.

Mobile connectivity is a key variable in our study because many people access the internet via the mobile phones. Internet is indeed an avenue for marketing and trade. International venture capitalists would therefore prefer an economy with good ICT infrastructure, not only for their internal operations, but also for interactions with the clients via customer interface applications.

The Kenyan government has been working hard on this and this is depicted by the arrival of three submarine cables in Mombasa. Providers are now introducing direct to home services to ensure internet connectivity in all homes.

Internet is still out of reach for many Kenyans due to high poverty levels. Towards this end, the government needs to provide ISPs with incentives for developing their infrastructure in rural areas. This should also be reinforced by promoting sale of gadgets that have internet capabilities such as all mobile phones with internet features can be sold tax free to ensure more Kenyans have access to the internet.

Political stability

The data in Appendix 2 shows that Kenya's political stability index of ranks below the BPM index of 0.24. However, Kenya has enjoyed relative calm since independence in 1963 and is

one of the more stable governments compared to her regional competitors. However, cyclic PEV and political squabbling continue to send the wrong message to investors abroad, hence the low perception by foreign business managers about Kenya's political stability.

To make up for this short coming, policy makers need to improve the level of transparency of the government by introduction of an online system that records all government transactions and operations. This way, international investors will get a more precise picture of the political stability of the country. This will enable the government improve international perception of Kenya's political climate.

Implementation of the new constitution which sets the tone for public governance is also important in improving Kenya's political stability. The new constitution has set up better terms for public governance, improved security, improved human rights and generally a more open society to the outer world, through its provisions.

Strength of the legal environment

Closely related to political stability is the strength of the legal environment in Kenya. The country ranks poorly at -0.13 compared to BPM index of 0.86. This means that the country legal structure is weak that affects investors ability to among other things enforce contracts, seek speedy redress when deals go sour, protect their property from pilferage and vandalism, legally register a business within a short period of time, enforce intellectual property rights, access development land lease from the government and legally employ and dismiss workers based on their performance.

To remedy this weakness, judicial reforms as stipulated by the new constitution is necessary. The government must not only reform the judiciary, it must be seen to be undertaking these reforms by the outside world so as to attract foreign investors into the country.

Taxation

About 50% of corporate profits are remitted to the government through taxation. This is because of 30% corporate taxes, 16% of VAT, 10% of withholding tax (WHT) and for a firm that relies on imports of raw import, more than 70% is paid to the exchequer as customs duty. Compared to a BPM average of 29%, indeed, Kenyan corporate sector is shouldering heavier burden of an inefficient, ineffective, bloated government and civil service in general. The corporate sector further bears the burden of poverty since the government is actively involved in attempting to create equity.

This approach is defective in the sense that whereas it is the moral duty of the government to ensure the gap between the rich and poor is narrowed, in a capitalist community, it is not the responsibility of the rich to support the poor, but more of a duty of the poor to support themselves. The government is responsible to come in and empower the poor to support themselves by ensuring they have equal access to opportunities and resources to exploit these opportunities.

For Nairobi to make a mark in the global financial markets, the country needs to reduce its tax rate especially direct taxation. Managers generally believe direct taxation is actual taxation and indirect taxation a mere part of the cost of the good or service being purchased. To exploit this mentality, any government that seriously wants to attract foreign investors into

its market needs to eliminate direct taxation and marginally compensate the resultant loss in income by increasing indirect taxation.

Increased activity in a market increases the levels of employment due to the growth of banks, insurers, fund's managers, ICT support and other services. This will help fill the gap between the rich and the poor which is the natural objective of the government in the first place hence avert the need to use fiscal tools, particularly taxation in an attempt to achieve the same objective.

Urbanisation

22% of Kenyans live in urban areas compared to 72% in our select BPMs. This illustrates how ineffective the country will be in attempting to attract foreign investments and trade into its market. Trade in securities and stocks, otherwise referred to as trade in soft assets, is a basic feature of urbanised societies as opposed to rural societies. This is because urbanised societies in their very nature prefer liquidity to assets security. It is of vital importance to point out that for any market to develop foreigners watch the behaviour of the market as traded by the locals, then come in to supplement such trade. It is therefore of profound importance, that Kenyans themselves prop up their stocks markets if policy makers expect inflow of capital from foreign ventures.

To achieve this, policy makers should concentrate on making urban areas conducive for human habitation via developed infrastructure and housing. The government should particularly take keen interest on housing since the private sector tends to target the high end market. The urbanised society shall provide the required labour and trading volumes required to support a market with advanced features.

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5.3.   Conclusions

Subsequent to restructuring its market as well as enhancing it business environment, using the equation in table 3 and assuming the country uses the higher of existent or average indices of our select BPMs, the expected resultant market capitalisation is as below.

Table 7: Predicted results

Variable	Co-efficient	BPM Average
Constant	(0.76)	
BUS.DISC	0.71	0.73
CRD.INFO	0.47	0.72
EMP.FIRE	0.48	0.44
CEL.SETS	0.39	1.12
POL.STAB	0.17	0.24
LGL.STR	0.21	0.86
TAX.CORP	(0.57)	0.29
URB.POP	0.16	0.72
ADT.LIT	0.65	0.74
Expected market capitalization		**1.40**

From the predicted results, it is indicated that country shall have a market capitalisation of 1.40. With this market capitalisation, the country shall rank the same as other developed IFCs such as Switzerland, Luxembourg, Malaysia, Chile, Singapore, South Korea, Papua New Guinea, Israel, Montenegro, Qatar, Thailand, USA, Dubai, among others. Such high market capitalisation Nairobi will be the regional's preferred international financial centre.

A developed financial market in Nairobi will have positive externalities to Kenyans and the region as well. Such externalities will include higher levels of employment, increased access to capital for investors, increased government earnings due to a bigger GDP will help in infrastructural development and provision of social amenities.

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APPENDICES

Appendix 1: Regression results

A.1.1. Descriptive Statistics

	Mean	Std. Deviation
MKT.CAP	.7148	.61533
BUS.DISC	.5359	.24588
CRD.INFO	.5952	.29611
EMP.FIRE	.3582	.23244
CEL.SETS	1.2798	.37652
POL.STAB	.8402	.50150
LGL.STR	.7150	.51502
TAX.CORP	.3141	.13314
URB.POP	.5155	.26283
ADT.LIT	.5225	.24326

A.1.2. Correlations

		MKT.CAP	BUS.DISC	CRD.INFO	EMP.FIRE	CEL.SETS	POL.STAB	LGL.STR	TAX.CORP	URB.POP	ADT.LIT
Pearson Correlation	MKT.CAP	1.000	.566	.544	-.512	.633	.362	.510	-.078	.701	.618
	BUS.DISC	.566	1.000	.334	-.324	.300	.519	.445	-.061	.498	.289
	CRD.INFO	.544	.334	1.000	.272	.422	.319	.441	.248	.546	.325
	EMP.FIRE	-.512	-.324	.272	1.000	-.320	-.289	.479	.114	.494	-.328
	CEL.SETS	.633	.300	.422	-.320	1.000	.455	.548	-.058	.684	.513
	POL.STAB	.362	.519	.319	-.289	.455	1.000	.713	-.089	.471	-.022
	LGL.STR	.510	.445	.441	.479	.548	.713	1.000	.162	.601	.098
	TAX.CORP	-.078	-.061	.248	.114	-.058	-.089	.162	1.000	.002	-.157
	URB.POP	.701	.498	.546	.494	.684	.471	.601	.002	1.000	.654
	ADT.LIT	.618	.289	.325	-.328	.513	-.022	.098	-.157	.654	1.000

A.1.3. Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.848[a]	.718	.644	.36725	.718	9.635	9	34	.000	1.779

a. Predictors: (Constant), ADT.LIT, POL.STAB, TAX.CORP, EMP.FIRE, CRD.INFO, BUS.DISC, CEL.SETS, LGL.STR, URB.POP

b. Dependent Variable: MKT.CAP

A.1.4. ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	11.695	9	1.299	9.635	.000[a]
	Residual	4.586	34	.135		
	Total	16.281	43			

a. Predictors: (Constant), ADT.LIT, POL.STAB, TAX.CORP, EMP.FIRE, CRD.INFO, BUS.DISC, CEL.SETS, LGL.STR, URB.POP

b. Dependent Variable: MKT.CAP

A.1.5. Coefficients

Model		Unstandardized Coefficients		t-values	Sig.
		Co-efficient	Std. Error		
1	(Constant)	-.756	.295	-2.567	.015
	BUS.DISC	.711	.295	3.415	.021
	CRD.INFO	.474	.241	2.964	.058
	EMP.FIRE	-.476	.297	2.604	.118
	CEL.SETS	.389	.229	2.696	.099
	POL.STAB	.166	.192	1.863	.394
	LGL.STR	.205	.200	2.027	.312
	TAX.CORP	-.571	.485	-2.176	.248
	URB.POP	.157	.441	2.129	.898
	ADT.LIT	.652	.408	2.598	.119

Appendix 2: The data

Country Name	MKT.CAP	BUS.DISC	CRD.INFO	EMP.FIRE	CEL.SETS	POL.STAB	LGL.STR	TAX.CORP	URB.POP	ADT.LIT
South Africa	2.78	0.80	1.00	0.73	0.94	(0.03)	0.39	0.31	0.62	0.89
Switzerland	2.35	-	0.83	0.89	1.20	1.21	1.65	0.30	0.74	0.50
Luxembourg	1.84	0.60	-	0.39	1.44	1.44	1.69	0.21	0.82	0.50
Malaysia	1.73	1.00	1.00	0.22	1.09	0.14	0.58	0.34	0.72	0.92
Chile	1.68	0.80	0.83	0.40	0.97	0.61	1.44	0.25	0.89	0.99
Singapore	1.66	1.00	0.67	0.94	1.33	1.12	1.80	0.25	1.00	0.95
Sweden	1.27	0.80	0.67	0.67	1.23	1.08	1.72	0.55	0.85	0.50
Jordan	1.12	0.50	0.33	0.97	1.02	(0.27)	0.24	0.31	0.79	0.92
South Korea	1.07	0.70	1.00	0.12	0.98	0.10	0.91	0.30	0.82	0.50
Papua New Guinea	1.03	0.50	0.50	0.48	0.13	(0.85)	(0.54)	0.42	0.13	0.60
Israel	1.00	0.70	0.83	0.13	1.21	(1.49)	1.22	0.32	0.92	-
India	0.93	0.70	0.67	0.32	0.45	(1.31)	(0.39)	0.63	0.30	0.63
Montenegro	0.90	0.50	0.33	0.66	1.19	0.50	(0.06)	0.27	0.60	0.50
Qatar	0.89	0.50	0.33	0.22	1.55	1.06	0.54	0.11	0.96	0.95
Kuwait	0.88	0.70	0.67	0.21	1.14	0.43	0.18	0.16	0.98	0.94
Thailand	0.87	1.00	0.83	0.37	1.21	(1.22)	0.19	0.37	0.34	0.94
Netherlands	0.84	0.40	0.83	0.82	1.28	0.93	1.79	0.41	0.83	0.50
Spain	0.83	0.50	0.83	0.33	1.11	(0.18)	1.19	0.57	0.77	0.98
Bahrain	0.82	0.80	0.67	0.98	1.35	(0.34)	0.77	0.15	0.89	0.91
Philippines	0.79	0.20	0.50	0.12	0.81	(1.56)	(0.26)	0.46	0.66	0.95
Morocco	0.76	0.70	0.83	0.18	0.80	(0.52)	(0.11)	0.42	0.57	0.56
France	0.75	1.00	0.67	0.57	0.92	0.70	1.34	0.66	0.78	0.50
Denmark	0.75	0.70	0.67	0.50	1.34	1.01	1.90	0.29	0.87	0.50
Japan	0.75	0.70	1.00	0.96	0.90	0.87	0.98	0.49	0.67	0.50
Brazil	0.74	0.60	0.83	0.44	0.90	0.05	0.19	0.69	0.87	0.90
Colombia	0.72	0.80	0.83	0.27	0.92	(1.49)	0.31	0.79	0.75	0.93
Mauritius	0.67	0.60	0.50	0.95	0.85	0.53	0.85	0.24	0.43	0.88
Peru	0.65	0.80	1.00	0.82	0.86	(0.87)	0.45	0.40	0.72	0.90
Norway	0.61	0.70	0.67	0.87	1.11	1.29	1.48	0.42	0.78	0.50
Trinidad and Tobago	0.60	0.40	0.67	0.24	1.47	(0.04)	0.49	0.33	0.14	0.99
Belgium	0.58	0.80	0.67	0.85	1.15	0.80	1.30	0.57	0.97	0.50
New Zealand	0.53	1.00	0.83	0.50	1.09	1.15	1.79	0.34	0.87	0.50
Indonesia	0.51	1.00	0.67	0.06	0.67	(0.89)	(0.38)	0.37	0.54	0.92

Country Name	MKT.CAP	BUS.DISC	CRD.INFO	EMP.FIRE	CEL.SETS	POL.STAB	LGL.STR	TAX.CORP	URB.POP	ADT.LIT
Finland	0.49	0.60	0.83	0.70	1.44	1.38	1.84	0.45	0.64	0.50
United Arab Emirates	0.48	0.40	0.83	0.19	1.54	0.82	0.38	0.14	0.78	0.90
Jamaica	0.47	0.40	-	0.27	1.10	(0.40)	0.30	0.50	0.54	0.86
Bangladesh	0.47	0.60	0.33	0.06	0.34	(1.42)	(0.86)	0.35	0.28	0.56
Fiji	0.47	0.30	0.67	0.76	0.75	(0.15)	(0.68)	0.39	0.53	0.50
Kenya	0.46	0.30	0.67	0.43	0.63	(1.20)	(0.13)	0.50	0.22	0.87
Mexico	0.44	0.80	1.00	0.39	0.75	(0.79)	0.28	0.51	0.78	0.93
Germany	0.43	0.50	1.00	0.23	1.28	0.81	1.58	0.48	0.74	0.50
Kazakhstan	0.42	0.80	0.83	0.93	0.94	0.46	(0.32)	0.30	0.59	1.00
Turkey	0.42	0.90	0.83	0.09	0.87	(1.00)	0.38	0.45	0.70	0.91
Croatia	0.41	0.10	0.67	0.49	1.36	0.61	0.56	0.33	0.58	0.99
Panama	0.41	0.10	1.00	0.45	1.64	0.02	0.40	0.50	0.75	0.94
Poland	0.41	0.70	0.67	0.87	1.17	1.00	0.97	0.42	0.61	1.00
Sri Lanka	0.40	0.40	0.83	0.01	0.68	(0.83)	(0.21)	0.65	0.15	0.91
Egypt	0.38	0.80	1.00	0.05	0.69	(0.91)	(0.18)	0.43	0.43	0.66
Oman	0.37	0.80	0.33	0.95	1.46	0.69	0.51	0.22	0.72	0.87
Portugal	0.36	0.60	0.83	0.08	1.43	0.68	0.82	0.43	0.61	0.95
Lebanon	0.32	0.90	0.83	0.83	0.36	(1.53)	0.04	0.30	0.87	0.90
Cote d'Ivoire	0.31	0.60	0.17	0.42	0.69	(1.55)	(0.91)	0.44	0.50	0.55
Nepal	0.31	0.60	0.33	0.14	0.26	(1.68)	(0.74)	0.38	0.18	0.59
Macedonia	0.29	0.90	0.67	0.69	0.94	(0.47)	0.28	0.11	0.68	0.97
Ukraine	0.29	0.50	0.50	0.86	1.20	(0.10)	(0.55)	0.56	0.68	1.00
Botswana	0.27	0.70	0.67	0.15	0.95	0.91	0.47	0.20	0.61	0.84
Malawi	0.27	0.40	-	0.18	0.17	0.08	(0.57)	0.25	0.20	0.74
Nigeria	0.26	0.50	-	0.42	0.47	(2.05)	(0.78)	0.32	0.50	0.61
Serbia	0.25	0.70	0.83	0.72	1.35	(0.41)	(0.02)	0.34	0.52	0.50
Tunisia	0.24	0.50	0.83	0.80	0.93	0.10	(0.02)	0.63	0.67	0.78
Greece	0.24	0.10	0.83	0.74	1.18	(0.11)	0.65	0.47	0.61	0.97
Czech Republic	0.22	0.20	0.83	0.77	1.36	0.97	1.24	0.49	0.74	0.50
Pakistan	0.22	0.60	0.67	0.14	0.60	(2.70)	(0.60)	0.32	0.37	0.56
Hungary	0.21	0.20	0.83	0.55	1.18	0.71	1.05	0.53	0.68	0.99
Romania	0.20	0.90	0.83	0.94	1.18	0.26	0.66	0.45	0.55	0.98
Cyprus	0.20	0.40	-	0.25	0.90	0.41	1.37	0.23	0.70	0.98
Slovenia	0.20	0.30	0.33	0.51	1.03	0.82	0.75	0.35	0.48	1.00
Vietnam	0.20	0.60	0.83	0.16	1.03	0.13	(0.58)	0.33	0.29	0.93

Country Name	MKT.CAP	BUS.DISC	CRD.INFO	EMP.FIRE	CEL.SETS	POL.STAB	LGL.STR	TAX.CORP	URB.POP	ADT.LIT
El Salvador	0.19	0.50	1.00	0.17	1.23	0.07	0.37	0.35	0.61	0.84
Iran	0.19	0.50	0.67	0.16	0.72	(1.57)	(1.61)	0.44	0.70	0.85
Austria	0.18	0.30	1.00	0.99	1.41	1.09	1.52	0.56	0.68	0.50
Mongolia	0.18	0.50	0.50	0.92	0.83	0.51	(0.28)	0.23	0.58	0.97
Zambia	0.17	0.30	0.83	0.02	0.35	0.48	(0.49)	0.16	0.36	0.71
Argentina	0.17	0.60	1.00	0.10	1.30	(0.01)	(0.69)	1.08	0.92	0.98
Bolivia	0.17	0.10	1.00	0.19	0.73	(0.40)	(0.82)	0.80	0.67	0.91
Ireland	0.17	1.00	0.83	0.79	1.09	1.00	1.65	0.27	0.62	0.50
Iceland	0.16	0.50	0.83	0.88	1.10	1.01	0.91	0.27	0.92	0.50
Lithuania	0.16	0.50	1.00	0.62	1.49	0.66	0.97	0.39	0.67	1.00
Italy	0.16	0.70	0.83	0.90	1.51	0.47	0.85	0.69	0.68	0.99
Guyana	0.15	0.50	-	0.33	0.38	(0.51)	(0.55)	0.39	0.29	0.50
Bulgaria	0.15	1.00	1.00	0.93	1.40	0.38	0.61	0.29	0.72	0.98
Estonia	0.12	0.80	0.83	0.55	2.03	0.64	1.45	0.50	0.70	1.00
Ghana	0.11	0.70	0.50	0.02	0.63	0.04	0.09	0.33	0.52	0.67
Namibia	0.10	0.50	0.83	0.73	0.54	0.75	0.14	0.10	0.38	0.89