

**THE EFFECT OF TAX INCENTIVES ON FOREIGN DIRECT
INVESTMENTS IN KENYA**

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DECLARATION

I, the undersigned, declare that this research project is my own work and has never been presented in any other university or college for a degree or any other award.

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This research project has been submitted for examination with my approval as the University Supervisor.

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DEDICATION

This project is dedicated to my darling wife and Children .Your support and inspiration during my studies enabled me to complete this project. I'll always value and esteem you people highly.

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It has been an exciting and instructive study period in the University of Nairobi and I feel privileged to have had the opportunity to carry out this study as a demonstration of knowledge gained during the period studying for my master's degree. With these acknowledgements, it would be impossible not to remember those who in one way or another, directly or indirectly played a role in the realization of this research project. Let me, therefore, thank them all equally.

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Finally, yet importantly, I take this opportunity to express my deep gratitude to the lasting memory of my loving family, my colleagues at the National Treasury and friends who are a constant source of motivation and for their never ending support and encouragement during this project.

ABSTRACT

FDI creates employment and acts as a vehicle of technology transfer, provides superior skills and management techniques, facilitates local firm's access to international markets and increases product diversity. Most countries strive to attract FDI because of its acknowledged advantages as a tool of economic development. The study sought to establish the effect of tax incentives on Foreign Direct Investments in Kenya.

The study was descriptive and adopted a descriptive research design which was used to give the researcher a comprehensive picture of the variable relationship since the method is the only means of accurately measuring and giving statistical inferences. The data was collected from secondary data (tax incentives and Foreign Direct Investment) sources collected from Kenya Revenue Authority (KRA), Treasury and Kenya National Bureau of Statistics (KNBS). Descriptive statistics, correlation and multiple linear regression models were used in data analysis.

The study established that Kenya has various tax incentives including capital investment allowances offered to resident companies such as Industrial Building Allowance (IBA) granted on capital expenditure incurred on the construction of an industrial building, investment deduction granted to encourage development in manufacturing industries, farm works deduction granted at the rate of 50 % per annum for two years, Shipping Investment Deduction granted at the rate of 40% on capital expenditure, and mining allowance which is granted to a person who incurs capital expenditure on searching for, discovery, testing and winning access to minerals; expenses incurred in obtaining acquisition rights over deposits; expenses related to purchase of machinery and buildings together with the development, general administration and management prior to commencement of production. This is granted at the rate of 40% in the first year and 10% from the second to the seventh year. It was established that on investment incentives, investment deduction ($p = .047$) and mining operation deduction ($p = .038$) have positive effect on FDI, while industrial allowance ($p = .054$) has a negative effect. On trade related incentives, export processing zones ($p = .008$) and tax remissions export office ($p = .009$) had positive effect on FDI while manufacture under bond ($p = .004$), as an incentive, had negative effect on FDI. The study concludes that tax incentive would have a positive resultant effect on FDI and recommends that Government need to evaluate its tax incentives policy, and weigh against the benefits that accrue with the intention of spurring investment including introducing evidence based tax incentives that would minimize tax evasion.

ABBREVIATIONS

EAC	- East African Community
EP/IZ	- Export Processing and Industrial Zones
EPZ	- Export Processing Zones
FDI	- Foreign Direct Investment
GDP	- Gross Domestic Product
GLS	- Generalized Least Square
IMF	- International Monetary Fund
LDC	- Least Developed Countries
MNC	- Multinational Corporations
MUB	- Manufacturing under Bond
MOU	- Memorandum of Understanding
OECD	- Organization for Economic Co-operation and Development
OLI	- Ownership, Location and Internalization
SADC	- Southern African Development Community
SRS	- Stratified Random Sampling
UCC	- User Cost of Capital
UN	- United Nations
VAT	- Value Added Tax

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

FDI creates employment and acts as a vehicle of technology transfer, provides superior skills and management techniques, facilitates local firm's access to international markets and increases product diversity. Most countries strive to attract FDI because of its acknowledged advantages as a tool of economic development. This view is supported by Nwankwo (2006) study on Nigeria which stated that FDI is an engine of economic growth and development in Africa where its need cannot be over emphasized, (Nwankwo, 2006).

Most countries however have been facing a common challenge on how to ensure investment policies are grounded in the overall development strategy and that the policies are coherent and synergetic at both national and International levels to attract considerable FDI. However there are various factors that impact negatively on FDIs and especially so in Africa. The common image painted of Africa is that of a high-risk investment region. African economies thus have to go that extra mile in order to dispel such misconceptions. Several measures have been adopted by various economies to attract foreign direct investment. Such include tax incentives, liberalizing and simplifying trade laws and regulations for admission and establishment of foreign investment projects, providing guarantees for repatriation of investment and profits, improvement of infrastructure, provision of cheap inputs and establishing mechanisms for the settlement of investment disputes.

Faced with the pressures of globalization of capital movement and the threat that companies will relocate unless provided with concessions such as more lax regulations and lower taxes, governments have responded by promoting tax incentives to attract and retain investment capital. Having limited economic options the countries in the region have made tax competition a central part of their development strategy to attract and

retain the companies in their countries. The study contends that tax incentives and the ensuing competition have largely benefited foreign multinational at the expense of Government revenue, local authorities, domestic enterprise, Workers, and the environment. They have only managed to attract short-term investments which build no linkages to domestic economy and encourage exploitive Competition (Morisset, 2003).

Tax incentives thus commonly used as a policy tool to attract and retain foreign direct investment (FDI). Tax incentives thus are “measures designed to influence the size, location or industry of an FDI investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors. Tax incentives confer benefits on foreign investors in the form of tax expenditures that represent a statutorily favourable deviation from the normal benchmarks of a country’s tax system. Compared to direct financial incentives, such as loan schemes, grants and subsidies, tax or fiscal incentives are a more realistic policy tool for developing countries, such as China, to attract FDI, because there is no immediate need for governments to find cash to fund relevant new investment projects, (Nwankwo, 2006).

1.1.1 Tax Incentives

Tax incentives are defined as all measures that provide for more favorable tax treatment of certain activities or sectors compared to what is granted to general industry . They are also defined as deductions, exclusions or exemptions from tax liabilities, offered as inducements to engage in special activities such as investments in manufacturing sector for a certain period. Tax incentives are granted to attract Foreign Direct Investments (FDIs) and to promote specific economic policies so as to encourage investments in a particular sector or zone as is the case with the Export Processing Zones in Kenya.

Proponents of tax incentives often argue that lower tax burdens give investors a higher net rate of return and therefore free up additional income tax for re-investment. The Host Country thus attracts increased FDIs, raises its income and also benefits from the transfer

of technology. It is also argued that in Less Developed Countries (LDCs), it is imperative to provide tax incentives to investors given that such countries usually have very poor investment climates such as volatility in politics, dilapidated infrastructure, high cost of doing business and macro-economic instability (Basu and Srinivasan, 2002).

A 2006 Report by the African Development Bank and IMF focusing on tax incentives in East Africa confirmed that, based on empirical evidence available, investment incentives particularly tax incentives are not an important factor in attracting Foreign Direct Investments. The IMF report further indicated that, most countries that have been most successful in attracting FDI have not offered large tax or other incentives and that providing such incentives was not sufficient to attract FDI, if other factors or conditions are not in place more important factors in attracting FDI are good quality infrastructure, low administrative costs in setting and running businesses, political stability and predictable macro-economic policy (Basu and Srinivasan, 2002).

1.1.2 Foreign Direct Investments

A large body of literature examining determinants of FDI begins with a partial equilibrium firm-level framework based in industrial organization and finance to motivate empirical analysis. These studies then typically examine how exogenous macroeconomic factors affect the firm's FDI decision, with the primary focus on exchange rate movements, taxes, and to a more limited extent, tariffs. Earlier studies often then use industry-level (or even country-level) data to explore these hypotheses, while more recent work has had firm- and plant-level data available to more appropriately match the firm-level theory (De Mooij and Ederveen, 2003).

1.1.3 Effect of Foreign Direct Investment in Kenya

The effects of Foreign Direct Investment have often been praised as an economic success, one that has successfully coped with globalization. They have been cited as a good if not perfect example of what good economic policies can do towards achieving economic

development. It is argued that the incentives provided by the governments have attracted FDI and directly contributed to the growth of the sector. The premises underpinning the case for tax incentives in developing countries are first that investment is needed to foster more rapid growth; and second that tax breaks can be effective in stimulating investments (Ndemo, 2008).

In Kenya therefore, tax incentives are account for a very significant tax revenue loss. Government figures show that losses from trade related tax incentives, including those provided in the Export Processing Zones (EPZs) were at least Kshs.12 billion (US\$ 133 million) a year in tax incentives. The Kenya Government recognizes that the current level of tax incentives present a problem and has committed itself to rationalizing and reducing the incentives through tax reforms. However, there are major questions as to how far, and how quickly, the Government is really prepared to go.

1.1.4 Relationship between FDI and Tax incentives in Kenya

While FDIs face many constraints, lack of well-structured and attractive tax incentives invariably appears in previous surveys as a major hurdle to realizing growth in FDIs. Tax incentives form an essential component of Governments' investment promotion strategies world over. Countries have experimented with a range of tax incentives in their attempt to attract Foreign Direct Investment (FDI), boost growth, diversify production and promote technological transfer. Taxes affect the net return on capital and should, at least in the mind of numerous policymakers, influence the capital movements between countries (Morisset & Pirna, 2001).

In the 1970s Kenya was the most favoured destinations for FDI in East Africa. However over the years, it lost its appeal to Transnational Companies (TNCs) a phenomenon that has persistent to the present (Wafula, 2012). Kenya currently ranks third in the East African Community in attracting Foreign Direct Investment (FDIs) after Tanzania and Uganda (UNCTAD, 2012). It has been overtaken by the two economies due to lack of natural resources and also the high cost of doing business among other factors. In the year

1997 to 2011, Kenya's FDI was about 0.6 percent of Gross Domestic Product, which is below the African average of 1.7 percent and relatively low compared to neighboring countries like Rwanda, Uganda and Tanzania. Kenya's FDI declined to 22 percent last year, compared to 40 percent and 36 percent in Uganda and Tanzania, respectively (Kinuthia, 2010).

In June 2008, Kenya launched its long-term development blue-print, vision 2030 where it envisions to create a globally competitive and prosperous nation with a high quality of life by 2030. This initiative has seen a renewed commitment by the government in establishing investment policies embedded in an institutional frame work based on the rule of law that adheres to high standards of public governance and transparent and efficient procedures for investors. The Government recognizes the significant role played by foreign direct investment towards the achievement of Kenya's long-term development plan, the Vision 2030 (Ministry of Planning and National Development, 2008). FDI usually represents a long-term commitment to host country and can contribute significantly to gross fixed capital formation in developing countries like Kenya. The government is thus placing a strong emphasis in positioning itself as a preferred capital destination not only in East Africa but also in Africa at large.

1.2 Research Problem

Foreign direct Investments play a significant role in growth of economies worldwide. The role of tax incentives in promoting foreign direct investments has been the subject of many studies, but their relative impact in Kenya has not been clearly established. In Kenya few studies have been conducted on factors influencing FDIs. Kinaro (2006) using time series analysis found that FDI in Kenya is determined by economic openness, human capital, real exchange rate, inflation, and FDI in the previous periods. Using panel data for Sub Saharan African Countries, Kenya included, Opolot, Mutenyo and Kalio (2008) established that market potential, openness to trade, infrastructure, urbanization, and rate of return on investment positively affect foreign direct investment inflows to

Sub-Saharan Africa, while macroeconomic instability is a disincentive to foreign direct investment.

Mwega and Rose (2007) using panel data of 43 countries with a Kenyan dummy found that Kenya is not different from other countries and that FDI is determined by growth rates, terms of trade shocks, external debt ratio and quality of institutions. The studies that have been so far conducted were cross-country studies, usually employing comparative analysis using some of the African or developing countries including Kenya. It thus became very imperative to carry out an empirical investigation to find out the factors that influence FDI decisions in Kenya. Kenya as a country has been experiencing decline in FDI and especially so in the Export Processing Zones despite the many incentives available to firms located in Export Processing Zones.

The EPZ has access to good if not excellent infrastructure including roads, electricity, and water. There are also centralized licensing offices making it easy for the firms to get regulatory approvals within shortest time possible. Since the establishment of EPZ in 1990 the response in FDI flow has not been as good as had projected. Further there has been decline in the flow of FDI into EPZs. For example in the year 2009, Kenya only managed to get US\$ 141 million in FDI inflows compared to Uganda which got US \$800 and Tanzania US \$655 million (UNCTAD, 2008) despite the fact that Kenya may be having superior infrastructure, more developed regulatory system and more skilled labor among other factors compared to its neighbors. In the recent times, EPZ management has raised concern on the impending closure and or relocation of TNCs from EPZ (Wahito, 2012).

According to Morisset and Pirnia (2001), taxes affect the net return on capital and therefore influence the capital movements between countries. The role of tax incentives in promoting investments has been the subject of many studies; however their relative impact in the flow of FDI in Kenya has not been clearly established. It is against this backdrop therefore that this study seeks to fill the existing gap by carrying out a research on the impact of tax incentives on FDI in Kenya with special reference to the firms. True to the findings of IMF, the wide range of tax incentives provided by Kenya and her

fellow Partner States in the EAC are needed leading to harmful tax competition in the EAC region, this study thus sought to answer the question; what are the effect of tax incentives on Foreign Direct Investments in Kenya?

1.2 Objective of the Study

To establish the effect of tax incentives on Foreign Direct Investments in Kenya.

1.3 Value of the Study

In 2006, according to the IMF, the amount of revenue foregone in Kenya to tax incentives was one percent (1%) of the GDP. These resources could be targeted at development programmes that can sustain economic growth, transform our economy and create job opportunity for the citizenry.

In view of the foregoing, the study is of help to the Government in assessing whether there is need to grant tax incentives to attract FDIs considering that the incentives are very expensive to the economy and that such incentives may not be the most significant determinants of the FDIs. The significance of this study also centres on the need for tax incentives to be targeted and focused on specific sectors for the benefit of the economy.

1.5 Research Hypothesis

In order to find answers to the question raised in the research question, the following hypotheses are necessary:

- (a) H_0 : Tax incentives have an effect on Foreign Direct Investments.
- (b) H_1 : Tax incentives do not have an effect on Foreign Direct Investments.

CHAPTER TWO

LITERATURE REVIEW

2.1: Introduction

This chapter summarizes the information from other researchers who have carried out their research in the same field of study. The specific areas covered here are theoretical orientation, empirical review and the conceptual framework.

2.2: Theoretical Review

The theoretical approach to the role of tax incentives on investments can be explained in the terms of compensation for externalities and the infant-industry fostering policies of the host Government. Corporate investment activities not only generate returns through the sale of produced goods, but also create positive externalities resulting from such factors as economies of scale, the diffusion of new knowledge, or the upgrading of labor skills (UNCTAD, 2012). A firm, however, cannot be compensated sufficiently for generating these externalities due to imperfect market conditions, providing an essential rationale for incentives in this regard. In other words, producers cannot benefit from the externalities they generate, creating a conflict between private and social rates of return. It can be argued that an incentive to private investors, compensating them for providing these externalities might be warranted. (Ochumbo, (2009).

The same principle applies to tax incentives for foreign investors. FDI involves more than the flow of capital: it typically entails the internal utilization of intangible assets, e.g., technology and managerial expertise that often are specific to a given firm. If these

intangibles benefit the subsidiary exclusively in their transfer from the parent firm, the rate of return will fully capture the net benefits of an investment, and no incentives are required. However, to the extent that these intangibles generate major beneficial effects for the rest of the host economy which are not enjoyed by the MNCs, then incentives should be provided to compensate them. Therefore a host country's Government provides tax incentives in return for these positive externalities.

Also, scholars try to establish the need for tax incentives in relation to a Government's economic policies in terms of infant-industry protection. When a foreign firm invests progressively in an infant-industry where local firms enjoy Government protection, the investment benefits are less reflected in the investing firm's return than in the growing industry. Tax reduction and grants thus need to be offered to these firms to compensate foreign investors for the lack of returns due to the host country's industrial policy (Blankenau 2005).

2.2.1 Optimal Tax Theory

Optimal tax theory is the study of how best to design a tax to minimize distortion and inefficiency subject to raising set revenues through distortionary taxation. A neutral tax is a theoretical tax which avoids distortion and inefficiency completely. Other things being equal, if a tax-payer must choose between two mutually exclusive economic projects (say investments) that face the same pre-tax risk and returns, the one with the lower tax or with a tax break would be chosen by the rational actor.

With that insight, economists argue that generally taxes distort behavior. For example, since only economic actors who engage in market activity of "entering the labor market" get an income tax liability on their wages, people who are able to consume leisure or engage in household production outside the market by say providing housewife services in lieu of hiring a maid are not taxed or are taxed lightly.

The incidence of sales taxes on commodities also leads to distortion if say food prepared in restaurants are taxed but supermarket bought food to be prepared at home are not taxed at purchase. This differential taxation of commodities may cause inefficiency (by discouraging work in the market in favor of work in the household). Ramsey (1927) developed a theory for optimal commodity sales taxes. The intersection on downward sloping demand curve and upward sloping supply curves implies that there is producer surplus and consumer surplus. Any sales tax reduces output and imposes a deadweight loss (DWL). If we assume non varying demand and supply elasticities, then a single uniform rate of tax on all commodities would seem to minimize the sum area of all such DWL triangles. Ramsey proposed that we assume suppliers were all perfectly elastic in their responses to price changes from tax and then concluded that taxes on goods with more inelastic consumer demand response would have smaller DWL distortions. The DWL triangles are now called Harberger triangles (after Arnold Harberger). Modern theory of optimal taxation looks for marginal deadweight losses, and can be used to evaluate the efficiency of tax reforms (Mayshar 1990).

2.2.2: Normative Theory

The theory is also divorced from the practical considerations of tax administration. Despite these shortcomings, this prescriptive theory is presented uncritically in textbooks and is commonly the basis of advice offered to policy makers.

The theory developed here describes how the development of the institutional structure of government creates a set of incentives as well as constraints within which governments and other actors operate. These incentives shape the path of development, and different governments may evolve in different ways, not all of which are efficient. Tax policy-making and tax administrative reform therefore evolve simultaneously and symbiotically. The institutional theory developed here provides a generalizable framework that we believe can be used to better understand the development of tax policy and administration across time and cultures. It offers an attractive model for description, explanation and prediction.

2.2.3: Taxes in the Theory of Investment Behavior

A simple theory of investment postulates that the desired stock of capital for any firm is proportional to the target level of output. Hence, the desired change in the capital stock each year that is, net investment is proportional to the expected change in output. It follows that the ratio of net investment to GDP depends on the expected rate of GDP growth. This is called the “accelerator” model because it shows that investment rises when output growth accelerates and falls when output growth decelerates (even if the growth rate is still positive).

In other words, an economy on a rapid growth path attracts a high rate of investment, while a stagnant or shrinking economy offers no inducement for net investment aimed at the domestic market. Of course, capital investment is itself a determinant of growth. Hence, we have an interactive system that can create either a virtuous circle of high growth and high investment, or a vicious circle of low growth and low investment.

A more realistic version of the model, called the “flexible accelerator,” recognizes that the desired capital stock depends not only on output, but also on the user cost of capital (UCC), defined below. In this model investment takes place as long as the value of the added output from an investment exceeds the UCC in other words, when the benefits exceed the cost. From this basic condition one can readily incorporate tax considerations into the analysis. In particular, tax elements heavily influence the UCC, which is the cost per year of deploying capital in an investment project.

A higher user cost of capital reduces the set of viable investment projects. It also provides an incentive for companies to pursue more labor-intensive projects. Conversely, a lower UCC expands the set of viable investment projects, and favors capital-intensive projects. Note that the net impact of tax breaks on job creation is ambiguous, since the changes in investment and labor intensity work in opposite directions. The result may be a very sluggish investment response. The antidote is to reduce uncertainty by establishing a track record of dependable policy management and political stability.

2.3 The Impact of Tax Incentives In Promoting Foreign Direct Investment

International experience has shown that political stability, sound economic development, big market, rich human resources, constantly improving legal environment and government services are main factors for absorbing foreign investment, and the tax preference is only one factor.

Ndeche, (2002) underscored his comments by noting that the new EIT tax rate, 25%, was relatively low, internationally competitive and was conducive to enhancing enterprise competitiveness and attracting foreign investment. Clearly, Kenya has not abandoned its commitment to attracting FDI through the use of taxation policy. Indeed, it seems that the new regime is aimed at influencing the shape of FDI activity rather than its volume. Furthermore, whilst the final form of the 2008 EIT Law was vigorously debated in Kenya, and it was clear for some time that many tax incentives for FDI would be abolished after Kenya joined the WTO, the appetite for foreign investment in Kenya did not diminish. To date, the prediction made above has been borne out by international reaction to the 2008 EIT Law changes to Kenya's tax incentive regimes. This has been generally positive – except for the criticism that the law and its Detailed Rules are simply not detailed enough!

2.3.1: Tax Holidays

As stated above, the widespread use of tax holidays was inherited from the tax incentive regimes in the 1980's where they played a major part in Kenya's tax policy in attracting foreign investors to invest in preferred regions. However, it has been widely accepted that tax holidays are the least effective and efficient form of tax incentive. They have been

criticized as serving no specific purpose and for being unfocused. As pointed out in most studies, the major pitfalls of tax holidays are: firstly, they can be administratively burdensome although at first sight they are a simple form of tax incentive; secondly, they are prone to manipulation, resulting in revenue loss that cannot be predicted in advance; thirdly, they are rarely effective to attract long-term projects; and fourthly, it is not unusual that some normal regimes would be able to achieve the same effects that tax holidays may achieve with controllable revenue loss, thus making tax holidays inefficient (Devereux, Lockwood and Redoano, 2004).

Turning specifically to the tax holidays provided, Kenya has moved from a blanket exemption, commencing in the first profit-making year, for two years plus a 50% reduction in tax for the next three years, for all production-oriented FIEs scheduled to operate for at least 10 years, to a more targeted set of exemptions, three years exemption followed by a 50% reduction in tax rate for the next three years, for enterprises involved in environmental protection, resource conservation, and infrastructure projects, commencing in the first revenue producing year. Certain agricultural activities, including forestry, animal husbandry and fishing operations, are exempt from EIT. All these areas reflect key Kenyan economic policies aimed at promoting the development of large-scale and long-term public infrastructure and primary industry.

In major sectors like Agriculture, forestry, animal husbandry, resource conservation and environmental protection, dealing firstly with agriculture and related activity, according to statistics on sectoral distribution of FDI in Kenya provided by the Ministry of Commerce, the cumulative contract value of FDI in agriculture, forestry, animal husbandry and fishery account for about 2% of Kenya's cumulative FDI inflow as of

2006. Although FDI in these industries only represents a small percentage of Kenya's total FDI, their contract value is considerably higher when compared with other industries, they are a core concern of the Kenyan government, and arguably justify preferential tax treatment for what is very typically longer-term investment.

The 2008 Income Tax Law also grants tax holidays to enterprises engaged in infrastructure projects receiving key support from the State. Previously, construction was promoted in many geographic areas, particularly those where development priority was encouraged. In theory, the advantages of granting tax holidays to enterprises engaging in these projects seem plausible. Infrastructure projects normally require a relatively large capital injection in their start up years. During this period, which may be fairly lengthy, these enterprises generally operate at a loss. Even when they start to become profitable, for tax purposes the losses incurred in the start up years can be carried forward up to five years to offset taxable income earned during later years. When they eventually start making profits, it is of course possible that the carry-forward period has expired, and this interaction with the loss carry-forward provisions may mean that the cost of this incentive is reduced.

A long-term tax holiday, namely the three year exemption plus the three year 50% reduction applying in this area, can help large-scale construction enterprises to neutralize the tax effects described above. To the extent that an enterprise engaged in infrastructure projects does not manipulate its profits to avoid tax, such as through aggressive transfer pricing, an extended tax holiday can operate in a positive way to encourage it to invest more in the startup period of the project and thus speed up the development of long-term activities which the central government has encouraged and supported. From a design

perspective, the fact that the tax holiday now commences when an enterprise starts to earn revenue is less prone to abuse than the former system when the tax holiday only commenced from the first *profit* making year.

Extended tax holidays are also helpful in assisting the economic development of remote areas. In practice, however, the benefits of this tax incentive are doubtful. According to statistics provided by the Ministry of Industrialization and Enterprise Development, as at the end of 2006 the cumulative FDI inflow in western Kenya accounted for only 4.25% of Kenya's total FDI, with realized investment spread over 36,902 projects (accounting for only 6.21% of the total number of investment projects). This percentage is extremely low if we take into account the fact that western Kenya includes over one-third of Kenya's provincial administrative regions. Furthermore, in recent years FDI inflow in western Kenya has decreased and most of the investment in infrastructure projects carried out has been directly financed by the central government.

On a positive note however, the average realized investment in a single investment project in western Kenya is about US\$800 million, a figure just slightly lower than that in eastern Kenya, which is US\$120 million. As indicated above, the influence that tax holidays exerted on FDI in remote areas was questionable. Under the 2008 EIT Law, tax holidays targeted specifically at remote areas were abolished, with very limited exceptions. Kenya is now seemingly adopting a more focused approach to promote economic development in its underdeveloped regions. First, the geographic scope of these regions is strictly defined as the five autonomous regions and autonomous prefectures and counties in other provinces. Second, the central government grants the discretion to local governments in deciding whether or not to provide further tax

incentives to enterprises at the cost of their portion of EIT revenue collected. It is likely that the central governments will still assume the major role in promoting economic development in these remote areas, especially for financing large infrastructure projects, while local governments only provide supplementary funds.

Formerly, as stipulated by the LAW, short tax holidays were available for high-technology enterprises. For these enterprises, tax holidays were valuable because they could be extended if an enterprise remained a high-technology enterprise. But their effect in promoting technology progress throughout Kenya was largely limited by the requirement that to be eligible for tax holiday, an enterprise must be established in designated areas. Under the 2008 EIT Law however, tax holidays are available for all qualifying transfers of technology for income earned in a taxable year from the transfer of ownership of technology, with the excess subject to a 50% reduction of the normal tax rate.

The above analysis of the tax holidays available under the 2008 EIT Law suggests that the substantially reduced and more focused activities in which Kenya seeks to encourage FDI by virtue of this incentive are not egregious from a tax policy perspective, particularly given the transitional state of Kenya's economic development. They should assist in helping achieve Kenya's policy goals as far as they can be deduced by allowing its taxation system to encourage FDI for government supported activity (Lucas, 2008). And the encouraged projects generally seem to be long-term in nature.

All this however begs the question of whether, in Kenya's next phase of tax reform, tax holidays are the most cost effective means of pursuing those goals and whether they

could be better assisted in a more efficient and transparent way. For instance: in relation to promoting investment in remote areas, would enhanced deductions for employment costs generally and accelerated deductions for purchasing capital equipment be more effective and efficient; and in relation to promoting technology transfer would an expanded super deduction for R&D expenses and investment credits for purchasing necessary capital equipment be more appropriate? In terms of tax policy generally, and tax incentive design specifically, the answers are virtually certain to be “yes”. Simply put, there does not seem to be sufficient evidence to show that the activities targeted for tax holidays in the 2008 EIT Law are those which are particularly, as distinct from generally, sensitive to taxation so as to render them as the most effective and efficient tax incentive. (Lucas, 2008). Cost impact is the cost of a service compared to the outcomes it produces. It is the relative costs and impact of proposed strategies and interventions, either demonstrated or probable. Thus cost impact can be said to be the ability to generate sufficient value to offset an activity's cost. The value can be interpreted as revenue in the case of a business. A standard tool used by economists to study economic growth is an empirical framework called growth accounting (Globerman, 2002). Given the rate of population growth, the growth of per capita income is driven by investment in physical capital investment in human capital, and productivity growth. The cost-impact accrued from tax incentives contribute in transforming and harnessing manufacturers' competitiveness.

2.3.2: Reduced Enterprise Income Tax Rate

Incentives taking the form of reduced corporate income tax rates seem less liable to the harsher criticisms directed at tax holidays. But they came under sustained attack in Kenya

prior to 2008 when, as indicated above, they only applied to a small group of enterprises (FIEs) and not to domestic enterprises. Furthermore, since different preferential tax treatment could apply to FIEs according to the locations or industries in which they operated, criticism also arose because the profits of the same type of entity could be taxed at different rates (Judson, 1998). Both these criticisms have been met by the 2008 EIT Law which taxes all enterprises, both domestic and FIEs, on the same basis.

Furthermore, the scope of tax rate reductions under this law has been significantly cut down and focused only in the key areas of certain agricultural and technology related operations. As a general matter, a reduced rate of income tax in these priority areas creates a modestly incentivized tax environment for FIEs and do not seem unreasonable from a tax policy perspective, provided that the relevant authorities ensure that the enterprises meet, and continue to meet, the conditions established to qualify for this incentive.

2.3.3: Accelerated Depreciation

As indicated above, accelerated depreciation for certain capital assets can be regarded as a form of tax incentive. Although in theory it only defers tax payment, enterprises may benefit in receiving the time value of deferred taxes. In other words, the cost of acquiring the asset may be written off more quickly than would be allowed under the normal depreciation schedules. For some initial investments however, the benefit of this incentive may not be fully realized if any resultant losses are unable to be carried forward within the statutory five year period. Thus, it would seem more meaningful if an

enterprise were able to start using accelerated depreciation methods after the initial investments were completed and the enterprise commenced making profits (Lewis 2008).

Since the availability of accelerated depreciation is normally targeted to accelerate purchases of new equipment, promote capital investment, modernization and growth, and is not simply restricted to new investors, it does not seem inappropriate for the 2008 EIT Law to continue allowing enterprises that need to frequently upgrade their equipment to adopt accelerated depreciation methods (Jensen, 2006). This incentive, whilst not likely by itself to increase FDI in Kenya, seems a reasonable measure to help promote investment in areas which the Kenyan government deems desirable.

2.4.4: Reinvestment Incentives

Although the main objective of granting a tax incentive for reinvestment of profits to foreign investors is to retain foreign investment in the host country, this incentive and the former exemption from withholding tax for dividends paid by FIEs have been abolished in the 2008 EIT Law. This abolition accords with Alex Easson, (2008) conclusion that by provided that host country has a reasonably generous system of depreciation allowances, there would seem to be little need to provide a further inducement. Moreover, the international system itself provides a built-in incentive to reinvest profits where they are made, rather than repatriating them: reinvesting profits avoids withholding tax in the host country and usually also avoids tax liability in the host country.”

2.3.5: Favourable Deduction Rules

The super deduction rule for R&D expenses, which is retained in the 2008 EIT Law, is intended to promote technology development activity in Kenya. The benefit of promoting R&D through tax incentives is that they encourage business to perform R&D while leaving it to the recipient and to market forces to determine the projects undertaken.

However, citing Technology Park in Kenya as an example, one of the “Big 4” accounting firms noted that none of the companies in this hi-technology incubator had obtained approval for the R&D incentive since the policy became effective several years ago. According to their experience, the impact of this incentive suffered from major flaws and could not achieve its goal in promoting technology innovation. (Judson, 1998).

Their major arguments are: Firstly, the super deduction rule was not well coordinated with Kenya’s loss carry forward rules (as was the case with the accelerated depreciation rule noted above). This is acknowledged by the Kenyan State Administration of Taxation’s circular which states “the super accrued portion in excess of an FIE’s taxable income may not be deducted or carried forward”. Thus, taxpayers may only benefit from the incentive if they have taxable income in the relevant year after offsetting operating losses carried forward from previous years. Secondly, the administrative process of approving the super deduction is complicated by the stringent documentation requirements imposed by the local tax authorities (Dunning, 1999). Thirdly, the content

of the rules is thin and various technical points have not been clarified by the local tax authorities.

These arguments concerning the super deduction rule seem to apply equally to the 2008 EIT Law version and indicate that a seemingly well-targeted tax incentive can be of little use if not well administered. As discussed above in the context of accelerated depreciation, it seems unlikely both in theory and in practice for this incentive by itself to attract increased FDI to Kenya; but it is not unreasonable to assume that it may assist to promote the development of a more technologically advanced economy that the Kenyan government wishes to encourage. (Diamond, 1994).

2.4 Relationship between Tax Incentives and Attraction for FDIs

The Government of Kenya is providing a wide range of tax incentives to businesses to attract greater levels of FDI into the Country. The SADC MOU on Taxation (2002) defines tax incentives as fiscal measures that are used to attract local or foreign investment capital to certain economic activities or particular areas in a Country. According to Morisset (2003), tax incentive is a reduction in the corporate income tax rate, through tax or temporary rebates for certain types of investments or companies. This is supported by Fakile and Adegbile (2011)'s study which stated that tax incentives are part of the tax system of developing countries and usually established by governments in order to grant foreign investors more attractive conditions to invest in their country.

The website http://www.businessdictionary.com/definite/tax_incentive.html also define a tax incentive as a deduction, exclusion or exemption from tax liability, offered as an enticement to engage in a specified activity such as investment in Capital goods for a

certain period. Tax incentives are the fiscal form of investment incentives and include corporate income tax holidays and reductions in tax rates. Non fiscal or non-tax incentives include direct subsidies like Government grants, loans and guarantees for target projects. Tax incentives are granted to attract FDI and/or to promote specific economic policies, such as to encourage investment in certain sectors.

In Kenya, tax incentives are mainly provided for under the Income Tax Act, Value Added Tax Act and the EAC Customs Management Act; The Incentives include: a ten (10) year corporate income tax holiday for EPZs, exemption from import duties and VAT on machinery, raw materials, Manufacturing under Bond (MUBs) for Exports, Investment allowance of 150% on Capital investments and EAC Duty Remission Scheme for manufacture of goods for export.

There are legitimate reasons to favour the use of tax incentives for investments but also strong reasons to believe that the fiscal and economic costs may be very high relative to the benefits. In some Countries the tax incentives have failed to stimulate much investment. However, in a few interesting cases, the incentives have been eliminated without harming investment inflows into the Host Country.

Tax incentives are widely used in developing Countries including Kenya to attract FDIs. However, Kenya should strengthen her institutional capacity for economic analysis of tax incentives. Better analysis will lead to better policies and greater Cooperation in the design of the tax incentive programmes. Unless a compelling case can be made based on a careful economic and financial analysis, policymakers in Kenya should guard against

generous tax incentives programs that have little effect on investment or job creation while adversely affecting revenue, tax administration, productivity and equity.

2.5 Determinants of Foreign Direct Investments

Foreign Direct Investments (FDIs), according to the IMF guidelines are defined as foreign investments in which the investor owns more than ten percent (10%) of the stock that is invested. This generally refers to investments by multinationals in foreign controlled corporations such as affiliates or subsidiaries.

FDI flows consist of two broad categories, (a) direct net transfers from parent Company to a foreign affiliate, either through equity or debt, and (b) reinvested earnings by a foreign affiliate. Estimates by OECD suggest that mergers and acquisition account for more than sixty percent (60%) of all FDI in developed Countries (OECD, 2000). Other components of FDI are joint ventures and equity increases which comprises of investments in financial capital. FDI is important because the different components may respond differently to taxes (Auerbach and Hassett, 1993).

Decisions by multinationals to undertake FDI are usually complex since they involve strategic decisions. The most widely accepted theory of FDI is probably the eclectic approach developed by Dunning (1981). For a multinational that seeks to maximize the value of the firm, FDI is attractive if the so called OLI condition is met, referring to Ownership, Location and Internalization (OLI). First, there must be an ownership advantage for the multinational relative to ownership by local firms. This may have something to do with specific technological or organizational knowledge of the multinational, but could also relate to tax issues. Second, it must be attractive for the

multinational to produce abroad because of some comparative locational advantage. Otherwise, the multinational would have chosen to export rather than to invest. Finally, it should be attractive to undertake activities within the multinational rather than buying or leasing them from other firms.

Taxes can affect all three OLI conditions. For instance, it can affect the tax treatment of a foreign firm, relative to domestically owned firms. The tax rate can also be a factor that determines the attractiveness of a location for undertaking investment. However, taxes are one of the many potential locational factors. Other factors include a good infrastructure, the availability of workers with good knowledge, proximity to markets, or the proximity of other businesses due to network and agglomeration

2.6: Empirical Review

Tax incentive is any tax provision granted to a qualified investment project that represents a favorable deviation from the provisions applicable to investment projects in general (King, 2007). Thus, the key feature of a tax incentive is that it applies only to certain projects. Impact of tax incentives is usually taken to mean the extent to which investment tax incentives stimulate investment. This definition focuses on the amount of investment, yet the quality of investment is at least as important as the quantity.

However, there is little evidence that complex tax incentive schemes are any more successful than simple CIT regimes that focus on taxing all forms of investment at low, uniform rates. The relative impact of special tax incentives such as tax holidays and differential tax rates has not been well studied in large cross-section or panel data. However, several country-specific studies have concluded that special tax incentives have

not been cost-effective. For example, Estache and Gaspar (1995) find that extensive tax incentives result in significant revenue losses compared to the investment generated. Similarly, Boadway, Chua, and Flatters (1995) find that tax holidays are of little value for the target firms, and Halvorsen (1995) finds that rates of return in supported projects are so high that they would have occurred even without incentives.

Studies also find that taxes are generally not the most important factor affecting investment. For example, in a study of 45 countries, Wei (2000) finds that reducing the level of corruption would have approximately the same effect on FDI as a reduction in the CIT tax rate of 30 percentage points. Similarly, surveys of investors have generally found that the tax system is significantly less important than a country's basic economic and institutional environment (OECD 1995, Wunder 2001). Wunder (2001), for example, finds that, in a survey of 75 Fortune 500 companies, only 4 identify tax factors as being the most important variable in their investment decisions.

Recent models of economic growth focus on the sources of productivity growth. These theories emphasize determinants such as knowledge externalities, economies of scale in production, and a "catch-up" effect. Knowledge externalities arise when knowledge-building activities not only enhance productivity for the immediate production unit, but also create diffuse, lasting, and cumulative efficiency benefits for the economy. When these spill-over effects are significant, private decision makers will systematically underinvest in knowledge-building activities because investors have no incentive to take into account the gains that accrue to others. In effect, advances in knowledge are a type of public good. This provides a justification for cost-effective interventions to strengthen the incentives for knowledge-generating activities such as investments in science and

technology, education and training, capital investment to upgrade production facilities, or foreign direct investment involving technology transfer, (Blankenau and Simpson, 2004).

The importance of scale economies has been understood for centuries, but only recently has it been incorporated into formal growth theory. For many (though not all) production processes, a larger scale yields lower unit costs, higher productivity, and greater competitiveness. This is an important reason for pursuing outward-looking strategies, particularly in low-income countries where the domestic market is very small compared to vast opportunities in regional and global market (Graham, 2001).

Finally, the catch-up effect suggests that poor countries ought to have the best prospects for rapid growth. This is ironic because most poor countries have not achieved rapid growth. The basis for the idea is that poor countries can benefit from a deep pool of existing knowledge (Globerman 2002). They can also supplement domestic resources with foreign capital and know-how, and take advantage of large global markets. Statistical evidence strongly confirms the validity of the idea, and reveals that poor growth performance in poor countries stems largely from policies and institutions that inhibit investment and undermine productivity. With appropriate and consistent policies and institutions, poor countries should be in a position to achieve high rates of growth as evidenced by more than a few remarkable success stories over the past 40 years, (Palomba, 2002). The immediate implication is that a successful growth strategy must be seriously concerned with the impact of policies on productivity, innovation, and knowledge acquisition.

Investment in physical capital is one determinant of economic growth, but not the most important one. This is why Easterly and Levine, emphasize that “something else” beyond capital accumulation accounts for most of the differences in economic growth across countries. Similarly, Michael Porter’s influential theory of competitiveness highlights the importance of productivity. According to Porter, policies fostering investments that depend on continued subsidies or protection are “simply inappropriate... no matter what the stage of development of a nation’s industry, (Porter 1998). Even more sharply, Devarajan, Easterly and Pack (2002) provide evidence showing that “investment is not the constraint on African development.” Their empirical analysis indicates that low growth rates in Africa are primarily due to low and declining productivity resulting from policies that foster and sustain inefficient production activities. In short, neglect of the productivity component in the growth equation can totally undermine the benefit of higher investment and impair the quest for prosperity.

The use of tax incentives is wide-spread even though the available empirical evidence on the cost effectiveness of such incentives in stimulating investment is highly inconclusive according to a study carried out by Zee Stotsky and Levy, (2002).The study identified three types of empirical studies that can provide information on the importance of tax incentives as determinants of investments. The three studies are by Chirinko (1993), MacMillan, Pandolfi and Salinger (1990) and Shah and Toye (1978).

A review of the literature on investment behavior a decade ago, by Chirinko (1993), reported that variables reflecting the User Cost of Capital (UCC), which includes tax effects, had only a small effect on investment. In contrast, output variables had a large effect, in line with the accelerator model. But Chirinko also concluded that investment

models in general produced weak results. Perhaps the most important lesson from this early work is that one does not get strong and consistent results about investment behavior from macro-economic models.

In order to overcome this problem many researchers began to use micro economic data which produces a far larger sample size and more discerning statistical tests. Using the data, the Researchers have found that variables reflecting the UCC, including tax effects, are statistically significant and quantitatively important determinants of investments. Zee Et Al (2002) has cited several estimates of the elasticity of investment with respect to the UCC in the range of -0.5 to -0.1. This means that a 10% reduction in the UCC, due to lowering financing costs or tax benefits, tend to increase investment by 5 – 10%. This is a large effect.

The main message of this research are that tax incentives can stimulate investments, but that a Country's overall economic characteristics may be more important for the success or the failure of industries than any tax incentive package and even if tax incentives stimulate investment, they are not generally cost effect (Zee Et Al, 2002, page 1506). In any case, even a review of econometric studies of FDI into Africa, by Basu and Srinivasan (2002), does not even mention tax effects nor does an earlier IMF study on investment in Africa by Hadjimichael Et Al (1995).

Surveys of business decision makers are often used as a source of information on determination of investment in developing Countries. Mc Millan, Pandolfi and Salinger (1990) report on a survey of American electronics companies that invest in labour – intensive operations in developing countries, is a good example in this case. When the

Companies were asked to list their top five concerns for an investment decision, only 10% of the respondents listed tax incentives – ranking well below infrastructure, political stability, skilled labour, and proximity to Customers and suppliers. The study also asked respondents to rank 95 “investment factors” in terms of importance for location decisions. On a scale of 1 (low) to 5 (high), tax holidays obtained a score of 4.0. Yet 19 other factors scored higher, including the overall corporate tax rate (with a score of 4.26). Topping the list were power, telecommunications, intellectual property rights and skilled labour.

In 1999 – 2000, the World Bank conducted a survey of firms in 15 Countries in Sub-Saharan Africa. The survey revealed that “taxes and regulations” were viewed as a major or moderate concern by just 33 percent of the respondents, the lowest for all reported categories. In comparison, more than 60% of the respondents viewed financing, inflation, corruption and infrastructure as serious constraints. Thus, survey evidence show that respondents place a lower weight on tax factors in the overall decision process, even though tax variables can have a significant effect on the final decisions.

Case studies also provide a source of empirical information on the determinants of investment. One of the earliest reviews of fiscal incentives in developing countries (Shah and Toye, 1978) set the stage by citing three studies in Mexico, Jamaica, and Pakistan, which showed that most investment decisions were not affected by tax considerations. Another study on Brazil, however, showed that investment in the North East region did not depend critically on tax benefits.

Most case studies assign tax considerations an insignificant role (as long as the tax system is reasonably well structured), and emphasize the role of non-tax factors in investment decisions. In some cases, such as Mauritius and Ireland, generous tax incentives have undoubtedly lured investors. And in others such as Uganda and Indonesia, the elimination of incentives had no effect on the flow of investments – providing real world “experiment” to prove that selective incentives are not needed if the underlying investment climate is attractive.

A 2010 study by B. Kinuthia on determinants of FDI in Kenya, confirmed that the main reasons for firms investing in Kenya are access to the local and regional market, political and economic stability and favourable bilateral trade agreements: fiscal concessions offered by EPZs were mentioned by only 10% of the businesses sampled.

Another 2005 study by M. S. Kiragu on determinants of FDI in Kenya based on the generalized least square model (GLS) revealed that economic openness is the most significant determinant of FDI inflows in Kenya. Other variables that were significant determinant of FDI inflows included growth rate of GDP, credit availability, the exchange rate and internal rate of return. The rest of the remaining variables including tax incentives, inflation rate were statistically insignificant.

Empirical evidence shows that tax incentives are generally not sufficient to attract major flows of investments. Mauritius, Costa Rica, Ireland and Malaysia (Technical Report SADC Region) are examples of successful countries attracting investments that offer many advantages to investors other than tax breaks, such as stable economic and political

conditions, a well-educated labour force, good infrastructure, open trade for exporters, dependable rule of law, and effective investment promotion systems.

Furthermore, experiences such as in Uganda and Indonesia, where tax holiday and selective tax incentives programmes were terminated in favour of a more attractive general tax regime, reinforce the theory that tax incentives are not effective in attracting investment or stimulating economic development.

2.7 Chapter Summary

The conclusion that can be drawn from the empirical literature on determinants of investment is that tax incentives do not affect investments in some circumstances, but in general it is not a primary consideration for investors.

Tax incentives can be costly and are rarely the key determinants to investments. Moreover, while low rates of taxation may promote investment, there is minimal evidence that discriminatory tax incentives are better placed to promote investment than simple, uniform regimes with low to moderate rates of taxation. Indeed, if anything, evidence shows that the latter is preferable and if tax incentives are to be used, accelerated depreciation is likely to be more efficient and have fewer drawbacks than tax holidays. The Policy question is, whether time is ripe for a review and rationalization of tax incentives and the exemption regime, in light of the amount of revenue forgone.

To the extent that tax incentives do not effect investments, it is important to bear in mind that the tax burden can be reduced in two ways by making the general tax system more attractive, or by offering selective incentives. The empirical literature provides no clear guidance about which approach is preferable. On the one hand, some econometric

evidence suggests that carefully targeted incentives are more cost effective than general tax reductions. On the other hand, some survey results and case studies indicate that the overall tax system is much more important to investors than specific tax incentives.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter contains research methodology that was used for the study. Research methodology gives details regarding the procedures used in conducting the study. The chapter discusses the research design, target population, sampling procedure and design, data collection instrument and procedures and data analysis.

3.2 Research Design

This study was descriptive in nature and a census method was used since the aim of this study is to establish the effect of tax incentives on Foreign Direct Investments in Kenya. Descriptive research according to Kothari (1990) is a powerful form of quantitative analysis. This design is preferred because it enables the researcher describe the area of research and explain the collected data in order to establish the differences and similarities with our frame of reference within a given period of time (time of research).

In addition, the method permits gathering of data from the respondents in natural settings resulting in a description of the data, whether in words, pictures, charts, or tables. Moreover, much of the data to be collected from the respondents was quantitative in nature. On the other hand a census is the procedure of systematically acquiring and recording information about the members or items of a given population. This design will give the researcher a comprehensive picture of the variable relationship since the method is the only means of accurately measuring and giving statistical inferences.

According to Mugenda and Mugenda (1999), research design is the outline plan or scheme that is used to generate answers to the research problems. It is basically the structure and plan of investigation. Empirical research methods course bridges the gap between the theoretical foundations of models and its practical application, (Kerlinger, 1986). The study was carried out through a cross-sectional survey. This research design is of empirical nature because of the nature of data collected.

3.3 Population of the Study

According to Mugenda and Mugenda (1999), a target population is one the researcher wants to generalize the result of the study. Therefore the research comprised of all the Enterprises in the EPZs and Industrial Zones.

3.4 Sample Technique

Since the population of the study is not very large, the study was a census and thus the researcher focused on the whole population. This ensured that all elements of the population are targeted and interviewed and as such was highly representative of the enterprises in the zones.

3.5 Data Collection Method

The study applied data from secondary sources. The researcher employed secondary data from such sources like Kenya National Bureau of Statistics, Kenya Investment Authority, Export Processing Zones Authority, Kenya Revenue Authority, KIPPRA, Companies

registry, various company websites, Public libraries and national budget and other Government records. The use of secondary data was justified on the basis that some of these sources have information that is very pivotal to this study.

3.6 Data Analysis

Statistical package for social scientists (SPSS) software version 17 was used to analyze the data. The quantitative data was analyzed by using descriptions statistics, metrology such as frequency distribution tables, percentages and pie charts. Pearson Correlation Analyses was used to examine the relationship between the independent variables (tax incentives) and the dependent variable (FDI). Further, linear regression dimension of independent variable and dependent variable. Tests were estimated to determine the significance of the relationship and the coefficient of determination (r^2) was estimated. The multiple linear regression analysis was of the form:

$$Y = \beta_0 + \beta_1 X_1 + \varepsilon$$

Whereby Y represent the foreign direct investment as proxied by the ratio of FDI inflows to GDP, β_0 is regression model constant, β_1 is the regression mode coefficient, X1 is tax incentive proxies (investment and trade related incentives). while ε is the model's error term. The investment and trade related incentives were the function of:

$$INV = f(ID, IA, FWA, MOD)$$

$$TRA = f(EPZ, MUD, TREO)$$

Whereby INV is investment related incentives, IA is industrial allowance, FWA is farm works allowance, MOD is mining operation deduction, TRA is trade related incentives, EPZ is export processing zones, MUB is manufacture under bond and TREO tax remissions export office. Thus, the regression models were:

$$Y = \beta_0 + \beta_1 ID + \beta_2 IA + \beta_3 FWA + \beta_4 MOD + \varepsilon \quad (i)$$

$$Y = \beta_0 + \beta_1 EPZ + \beta_2 MUD + \beta_3 TREO + \varepsilon \quad (ii)$$

The chosen variables are the most common tax incentives granted by the Host countries to attract FDIs. The data collected for the variables and their inclusion in the model will establish whether tax incentives have effect on FDIs.

CHAPTER FOUR

DATA ANALYSIS AND DISCUSSIONS

4.1 Introduction

This chapter presents the analysis of data findings on tax incentives and their influence on FDIs. It presents the both the descriptive statistics and the inferential analysis in seeking to establish the effect of tax incentives on Foreign Direct Investments.

4.2 Descriptive Statistics

The study sought to establish the effect of tax incentives on FDIs in Kenya. It achieved at this by standardizing the data using the ratio of FDI inflows to the GDP. Figure 4.1 shows that FDI in Kenya has not only been volatile from 1990s but also low since the 1970s. The low but volatile FDI inflows after the 1970s owes to the turbulent East-African relationship with foreign investments. Kenya for instance, encouraged and formulated trade and tax policies that encouraged indigenization of the Kenyan economy. The country, thus, lost its overall appeal to foreign investors in addition to its political unrest and corruption. This instability affected the entire region in terms of drawing FDI away from East-Africa, including Kenya.

Up until 1992 there are some minor fluctuations, but the overall trend remained the same. A sharp increase in 1992 could owe to Investment Deduction Allowances (IDA) which was introduced in 1991 to encourage new investment. After 2000 Kenya has witnessed a small improvement in attracting FDI, followed by a significant growth after 2006. In 2007, the Economic Recovery Strategy paper expired and was replaced by the Kenyan

Vision 2030. With this vision the Kenyan government hopes to reach global competitiveness and there was a special focus on attracting more FDI. Examples of reforms to attract more FDI are the establishment of free trade zones, improvement of infrastructure and the development of incentives. The Figure shows a significant growth in FDI in 2007, which can be partially explained with the reforms implemented during the year. Other reason for the big upsurge in FDI in both 2000 and 2007 are new investments in mobile telephone companies, an accelerated offshore borrowing by private companies to finance electricity generation and the privatization of telephone operator Telkom Kenya.

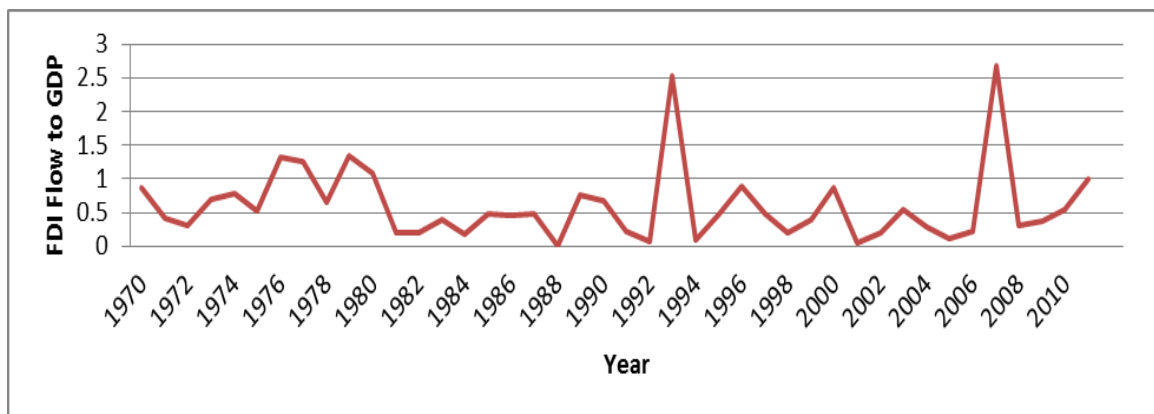


Figure 4.1: Ratio of FDI to GDP

4.2.1 Tax Incentives

In Kenya the pertinent tax incentives include: tax holidays, investment allowances and tax credits, accelerated depreciation, special zones, investment subsidies, tax exemptions, reductions in tax rates and indirect tax incentives. These tax incentives can be regrouped into investment promotion incentive and trade related incentives. These are presented in Table 4.1.

Kenya has capital investment allowances which are offered to resident companies and take the form of capital allowances offered to those investing in capital projects. These include; first, Industrial Building Allowance (IBA) granted on capital expenditure incurred on the construction of an industrial building. A rate of 2.5% per annum is applied to the qualifying cost of the construction of an industrial building and 10% per annum is applied on the qualifying cost of a hotel building. Second is investment deduction granted to encourage development in manufacturing industries and granted once at 100% in the first year of use, to any person who incurs capital expenditure on construction of a new building and installation therein of new or old manufacturing machinery.

Third is farm works deduction granted at the rate of 50 % per annum for two years to the owner or tenant of any agricultural land who incurs capital expenditure on the construction of farm works. Fourth is Shipping Investment Deduction granted at the rate of 40% on capital expenditure and to qualify the purchase must be that of a new, unused power driven ship of more than 495 tonnes or on the purchase and subsequent refitting for the purpose of shipping business of a used power driven ship of more than 495 tonnes. Fifth is mining allowance which is granted to a person who incurs capital expenditure on searching for, discovery, testing and winning access to minerals; expenses incurred in obtaining acquisition rights over deposits; expenses related to purchase of machinery and buildings together with the development, general administration and management prior to commencement of production. This is granted at the rate of 40% in the first year and 10% from the second to the seventh year.

4.2.1 (a) Tax Incentive Trend 2003 – 2012

On tax incentives within the period, Table 4.1 shows that revenue losses due to investment deduction was highest in 2004/05 (Ksh14,703 million), 2010/11 and 2011/12 financial years. Industrial allowance, farm works allowance, and mining operation deductions were also at their highest in 2004/05 financial year. These losses however led to higher FDI inflow in the ensuing years. Losses incidental to issuance of export processing zones, manufacture under bond and tax remissions export office, were highest in the periods 2011/12 and 2012/13 periods.

Table 4.1: Revenue Loss Over 2003/04-2012/13 from Tax Incentives in Kenya

Financial Year	Investment Deduction	Industrial Allowance	Farm works allowance	Mining operation deduction (MOD)	Export Processing Zones (EPZ)	Manufacture under Bond (MUB)	Tax Remissions Export Office (TREG)
	Investment Incentive (Million)				Trade Related Incentives (Million)		
2003/04	4,031	481	814	203	103	20	2,979
2004/05	14,703	1,021	1,130	715	1,712	310	2,537
2005/06	4,323	539	1,256	45	5,300	937	3,974
2006/07	4,295	298	609	70	6,694	721	7,951
2007/08	11,842	494	876	215	5,804	96	6,149
2008/09	9,477	325	8	384	5,557	137	9,869
2009/10	9,973	278	242	215	8289	358	10,502
2010/11	12,505	201	92	198	9,478	345	11,911
2011/12	12,357	178	103	165	10,791	406	13,319
2012/13	11,504	214	84	191	12,797	393	14,767

Source: KRA (2013)

4.2.2 Tax Incentives and FDI's Growth

The study sought to establish how tax incentives affect foreign direct investments using multiple linear regression analysis. The study looked at both the investment and trade related incentives. The regression model was of the form:

$$Y = \beta_0 + \beta_1 X_1 + \varepsilon$$

Whereby Y represent the foreign direct investment as proxied by the ratio of FDI inflows to GDP, β_0 is regression model constant, β_1 is the regression mode coefficient, X_1 is tax incentive proxies (investment and trade related incentives), while ε is the model's error term.

4.2.3 Investment Incentives

Investment incentives are tax incentives are mainly in place to promote investment. In establishing how investment incentive by looking at variables: investment deduction, industrial allowance, farm works allowance, and, mining operation deduction (MOD). The regression analysis, thus, becomes:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Whereby Y represent the FDI inflows to GDP, X_1 is investment deduction, X_2 is industrial allowance, X_3 is farm works allowance, and X_4 is mining operation deduction.

Table 4.2 shows that there is a very good linear association between the dependent and independent variables used in the study. This is shown by a correlation (R) coefficient of 0.842. The determination coefficient as measured by the adjusted R-square presents a strong relationship between dependent and independent variables given a value of 0.675.

This depicts that the model accounts for 67.5% of the total variations in the FDI inflows while 32.5% remains unexplained by the regression model.

Durbin Watson test was used as one of the preliminary test for regression which to test whether there is any autocorrelation within the model's residuals. Given that the Durbin Watson value was close to 2 (2.047), there was no autocorrelation in the model's residuals.

Table 4.2: Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
.842 ^a	.709	.675	.535937	2.047

- (a) Predictors: (Constant), Mining operation deduction (MOD), Farm works allowance, Investment Deduction, Industrial Allowance
 (b) Dependent Variable: Foreign Direct Investment (% of GDP)

The ANOVA statistics presented in Table 4.3 was used to present the regression model significance. An F-significance value of $p = .127$ was established showing that there is a probability of 2.7% of the regression model presenting a false information. Thus, the model is significant.

Table 4.3: Analysis of Variance

	Sum of Squares	df	Mean Square	F	Sig.
Regression	3.491	4	.873	3.039	.027a
Residual	1.436	5	.287		
Total	4.928	9			

- (a) Predictors: (Constant), Mining operation deduction (MOD), Farm works allowance, Investment Deduction, Industrial Allowance
 (b) Dependent Variable: Foreign Direct Investment (% of GDP)

From the findings in Table 4.4, the multiple linear regression equation becomes:

$$Y = 0.253 + 0.003X_1 - 0.042X_2 + 0.017X_3 + 0.032X_4 \quad p = .027$$

From the model, when other factors (mining operation deduction (MOD), farm works allowance, investment deduction, industrial allowance) are at zero, the ratio of FDI flow to GDP becomes 0.253. The model further shows that, apart from industrial allowance, other investment incentive indicators were positively related with FDI inflows. That is, holding other factors (mining operation deduction (MOD), farm works allowance, industrial allowance) constant: a unit increase in investment deduction would lead to a 0.003 (p = .015) increase in the ratio of FDI inflows to GDP in Kenya. A unit increase in farm works allowance would lead to a 0.017 (p = .047) increase in FDI inflows and a unit increase in Mining Operation Deduction (MOD) would lead to 0.032 (p = .038) increase in FDI inflows. However, the findings show that a unit increase in industrial allowance would lead to a 0.042 (p = .054) decrease in FDI inflows in Kenya.

Table 4.4: Regression Coefficients

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	.253	.724		.350	.741		
Investment Deduction	.003	.000	.555	1.496	.015	.423	2.365
Industrial Allowance	-.042	.017	-14.382	-2.506	.054	.002	565.152
Farm Works Allowance	.017	.006	10.592	2.614	.047	.004	281.579
Mining Operation Deduction (MOD)	.032	.014	8.280	2.317	.038	.005	219.019

(a) Dependent Variable: Foreign Direct Investment (% of GDP)

4.2.4 Trade Related Incentives

Trade related incentives seek to promote export. The study looked at how such incentives influence FDI inflows by assessing export processing zones (EPZ), manufacture under bond (MUB) and tax remissions export office (TREO). The regression model was:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \epsilon$$

Whereby Y represent FDI inflows to GDP, X_1 is export processing zones, X_2 is manufacture under bond, and X_3 is tax remissions export office.

Table 4.5 presents a good linear association between the trade-related incentives and FDI as shown by a correlation (R) coefficient of 0.882. The determination coefficient shows that the linear relationship was strong relations given a value of 0.667. This depicts that the trade related incentives account for 66.7% of the total variations in the FDI inflows. Durbin Watson test result of 1.986 depicts that there is no autocorrelation.

Table 4.5: Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
.882 ^a	.778	.667	.427053	1.986

(a) Predictors: (Constant), Tax Remissions Export Office (TREO), Manufacture under Bond (MUB), Export Processing Zones (EPZ)

(b) Dependent Variable: Foreign direct investment (% of GDP)

The ANOVA statistics presented in Table 4.6 established an F-significance value of $p = .022$ was established. This shows that there is a probability of 2.2% of the regression model presenting false information.

Table 4.6: ANOVA

	Sum of Squares	df	Mean Square	F	Sig.
Regression	3.833	3	1.278	7.006	.022a
Residual	1.094	6	.182		
Total	4.928	9			

(a) Predictors: (Constant), Tax Remissions Export Office (TREO), Manufacture under Bond (MUB), Export Processing Zones (EPZ)

(b) Dependent Variable: Foreign direct investment (% of GDP)

Model established was:

$$Y = 2.083 + 0.001X_1 - 0.003X_2 + 0.0001X_3 \quad p = .022$$

From the model, when other factors (export processing zones (EPZ), manufacture under bond (MUB) and tax remissions export office (TREO)) are at zero, the ratio of FDI flow to GDP becomes 2.083.

The findings further shows that when manufacture under bond (MUB) and tax remissions export office (TREO) are at a constant, a unit increase in Export Processing Zones would lead to a 0.001 increase in FDI. A unit increase in tax remissions export office (TREO) would lead to a 0.0001 while keeping export processing zones (EPZ) and manufacture under bond (MUB) constant. The study further shows that a unit increases in manufacture under bond (MUB) would lead to a -.003 decrease in FDI flow into Kenya.

Table 4.7: Regression Coefficients

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	2.083	.433		4.807	.003		
Export Processing Zones (EPZ)	.001	.000	3.042	3.887	.008	.060	16.548
Manufacture under Bond (MUB)	-.003	.001	-1.233	-4.477	.004	.488	2.050
Tax Remissions Export Office (TREO)	.0001	.000	-2.868	-3.793	.009	.065	15.450

a. Dependent Variable: Foreign direct investment (% of GDP)

4.3 Summary & Interpretation of the Findings

The study sought to establish the ratio of FDI inflows to the GDP. The study findings show that FDI in Kenya has not only been volatile from 1990s but also low since the 1970s. The low but volatile FDI inflows after the 1970s owes to the turbulent East-African relationship with foreign investments. Kenya for instance, encouraged and formulated trade and tax policies that encouraged indigenization of the Kenyan economy. The country, thus, lost its overall appeal to foreign investors in addition to its political unrest and corruption. This instability affected the entire region in terms of drawing FDI away from East-Africa, including Kenya. Up until 1992 there are some minor fluctuations, but the overall trend remained the same. A sharp increase in 1992 could owe to Investment Deduction Allowances (IDA) which was introduced in 1991 to encourage new investment. After 2000 Kenya has witnessed a small improvement in attracting FDI, followed by a significant growth after 2006.

The multiple regression analysis therefore have shown a positive association between the effect of tax incentives and Foreign Direct Investments. The study findings are in line

with FDI attraction with further tax revenue reduction informs of tax incentive may be counterproductive if care is not taken for many reasons. For example Adeola (2011), opined that it is note-worthy to emphasize that there is enormous untapped investment opportunities that exist in the Nigerian economy for the investment appetite of both local and foreign investors.

Therefore, by awarding an incentive in terms of lower tax rate or exemption on one foreign firm may be countered by increased levies on other tax bases on other local firms resulting in multiple taxation. Edmiston, Mudd & Talev (2003), contended that government may attempt to shift tax liabilities from firms that receive incentives to the ones that do not. Edmiston, Mudd, Valev (2003), also contents with this results that there is evidence that much of the foreign investment in the transition economies have been driven by location-specific factors such as attractive privatization deals, new market and geographical location. They argued that tax incentives leave a country worse off in terms of reduced tax revenue.

Moreover, the continuing implementation of tax incentives pose management difficulties for tax administration and require well developed accountability system. This view is supported by OECD (2006); Morisset (2003); UNCTAD (2000). In their studies, they argued that tax incentives have many costs such as in the difficulty of administering them effectively, which can distort allocation of resources. Morisset (2003), opined that using tax instruments to attract FDI, favours tax incentives, but tax incentive is a reduction in the corporate income tax rate, through tax holidays or temporary rebates. Morisset (2003), OECD (2003) argue, that the tax incentives approach have had mixed results, and have been contested by OECD countries and multilateral organizations because they have

often been associated with suspicious capital flows. Morisset (2003), stated that the question is whether or not the new investment would have come to the country if it had offered incentive or none at all, if yes, then free-rider investors benefit while the treasury loses and the economy reaps no net gain. These problems illustrate the need to clearly evaluate the impact of tax incentives on FDI both locally and globally.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The chapter presents summary of the key findings, conclusions from the findings and recommendations there-to. The chapter, further, summarizes area for further research given the limitations of the study. The study sought to establish the effect of Tax Incentives of FDIs in Kenya. It achieved at this by standardizing the data using the ratio of FDI inflows to the GDP. Figure 4.1 shows that FDI in Kenya has not only been volatile from 1990s but also low since the 1970s. The low but volatile FDI inflows after the 1970s owes to the turbulent East-African relationship with foreign investments. Kenya for instance, encouraged and formulated trade and tax policies that encouraged indigenization of the Kenyan economy.

First, this study established that Kenya has capital investment allowances which are offered to resident companies and take the form of capital allowances offered to those investing in capital projects. These include; first, Industrial Building Allowance (IBA) granted on capital expenditure incurred on the construction of an industrial building. A rate of 2.5% per annum is applied to the qualifying cost of the construction of an industrial building and 10% per annum is applied on the qualifying cost of a hotel building. Second is investment deduction granted to encourage development in manufacturing industries and granted once at 100% in the first year of use, to any person

who incurs capital expenditure on construction of a new building and installation therein of new or old manufacturing machinery.

Third is farm works deduction granted at the rate of 50 % per annum for three years to the owner or tenant of any agricultural land who incurs capital expenditure on the construction of farm works. Fourth is Shipping Investment Deduction granted at the rate of 40% on capital expenditure and to qualify the purchase must be that of a new, unused power driven ship of more than 495 tonnes or on the purchase and subsequent refitting for the purpose of shipping business of a used power driven ship of more than 495 tonnes. Fifth is mining allowance which is granted to a person who incurs capital expenditure on searching for, discovery, testing and winning access to minerals; expenses incurred in obtaining acquisition rights over deposits; expenses related to purchase of machinery and buildings together with the development, general administration and management prior to commencement of production. This is granted at the rate of 40% in the first year and 10% from the second to the seventh year.

5.2 Conclusions

During the 1970s Kenya was one of the most favoured destinations for FDI in East-Africa. A literature review carried out for the current project by Mooij and Ederveen (2005) finds most studies reporting a negative relationship between taxation and FDI, but with a wide range of estimates of the tax elasticity of FDI. The variability in elasticity estimates may not be surprising, given the degree of heterogeneity in the data employed. In other words, one might expect a priori that the sensitivity of FDI to taxation would vary and depend on host country conditions and policies (including the level of corporate

tax rates), types of industries/business activities covered, the time period examined, and other factors.

The introduction of tax incentives in Kenya were broadly aimed at promoting investment, Foreign Direct Investment and employment creation. Yet, no cost and benefit analysis study has ever been undertaken to ascertain the net benefit of such programs. A study by World Bank Investment Climate Advisory Services in 2009 shows that for many developing countries, tax incentives do not effectively counterbalance unattractive investment climate conditions such as poor infrastructure, macroeconomic instability, security and rule of law, weak governance and small markets.

Further, a study by the Kenya Revenue Authority (KRA) estimated that the total amount of revenue loss in Kenya over six years (the period between 2003/04-2008/09) is estimated at Kshs. 220.8 billion as reflected in table 4.1. Of these, investment related incentives and export related incentives accounted for 72.4% 27.6% respectively. On average, this translates to Kshs. 36.8 billion revenue and 1.7% of GDP forgone annually in the six years period under study. Quite notable is that the figure could be slightly higher if all tax incentives were included in the study. On a comparative basis, revenue loss from tax incentives for some countries as percentage of GDP are: 0.4% for Uganda, 3.9% for Tanzania, 4.7% for Rwanda and 1.7% for Malaysia.

5.3 Recommendation for Policy and Practice

It is therefore important for the government to evaluate its tax incentives policy, and weigh against the benefits that accrue with the intention of spurring investment in the country. Some of the policies the government should reconsider include but not limited

to: focus on improving the investment climate by addressing issues related to security, governance, tax issues, and infrastructure among others as opposed to providing blanket tax holidays as an alternative. Available data indicate that taxes forgone cannot fully compensate the investor for shortcomings associated with poor investment climate.

Given that tax incentives erode the tax base, the government should consider introducing evidence based tax incentives, by undertaking research to ascertain empirical outcomes of already existing incentives.. This is hardly the case in Kenya, and tax incentives are introduced through lobbying and in an ad hoc manner. Tax incentives in Kenya are rarely reviewed to assess whether they have accomplished the purpose for which they were introduced. There should be continuous review to ensure relevance and effectiveness.

Tax competition - A dangerous side effect of tax incentives is tax competition, a 'race to the bottom', as countries attempt to entice investment away from their neighbors through lower taxes. As the country is most likely to lose out on this competition, Kenya should be at the forefront of EAC efforts in regional tax harmonization. Rationalize the incentive regime: There is growing international consensus that countries are best served with a low stable tax regime with few exemptions. This, as opposed to a complex tax code that emerges from the attempt to provide incentives to tackle shortcomings in the investment climate. Focus should be on ensuring exporters have duty free access to inputs and that all businesses enjoy a low tax rate with no exceptions or exemptions. A similar approach is needed with respect to personal taxation.

Do away with 150% Investment Deduction Allowance (IDA) to investments outside the municipalities of Mombasa, Nairobi and Kisumu. There is no evidence that investors

have invested in rural areas. In addition, there are also challenges in defining what constitutes areas outside these municipalities. Do away with tax holidays: Several countries have stopped giving tax holidays and have replaced them with uniform tax regime of low tax rates and highly selective and limited tax incentives. Tax holidays lead to ‘tax shopping’ with companies exiting as soon as the holiday expires. This has been amply demonstrated in Kenya’s EPZ’s. In addition, they could simply lead to tax shifting where Double Taxation Treaties (DTA’s) exist.

Considering policy trends, a broad observation is growing pressure to provide an internationally competitive tax system. While neutrality and equity considerations may argue in favour of increased (not reduced) taxation of foreign source income, for example through introducing or tightening anti-deferral or anti-exemption rules, many countries indicate that they generally are not in a position to move in this direction, given that other countries do not apply such rules, or apply less rigorous provisions.

5.4 Limitations of the Study

Indeed, the literature review suggests that the influence of tax on FDI is complex and depends on a number of difficult to measure factors, with additional empirical work required to better understand the role of taxation amongst key factors influencing FDI location decisions.

For policy-makers and academic researchers alike, accurate estimates of the FDI response to host country taxation are difficult to make, given the need to consider jointly tax and non-tax factors in different locations, and the prospect that the tax elasticity of FDI may vary considerably across business activities, host countries and time.

A complicating factor is that the possible impact of host country tax on FDI will differ across countries with varying host country characteristics (non-tax factors). Finally, another limitation is on the use of regression model. All regression techniques can only ascertain relationships, in this case between FDI (dependent variable) and tax incentives (independent variable), but we can never be sure about the underlying mechanisms in the model.

5.5 Suggestions for Further Research

Given that tax incentives erode the tax base, the government should consider introducing evidence based tax incentives, by undertaking research to ascertain empirical outcomes of already existing incentives. This is hardly the case in Kenya, and tax incentives are introduced through lobbying and in an ad hoc manner. Tax incentives in Kenya are rarely reviewed to assess whether they have accomplished the purpose for which they were introduced. There should be continuous review to ensure relevance and effectiveness.

Tax competition - A dangerous side effect of tax incentives is tax competition, a 'race to the bottom', as countries attempt to entice investment away from their neighbors through lower taxes. As the country is most likely to lose out on this competition, Kenya should be at the forefront of EAC efforts in regional tax harmonization. Rationalize the incentive regime: There is growing international consensus that countries are best served with a low stable tax regime with few exemptions. This, as opposed to a complex tax code that emerges from the attempt to provide incentives to tackle shortcomings in the investment climate. Focus should be on ensuring exporters have duty free access to inputs and that

all businesses enjoy a low tax rate with no exceptions or exemptions. A similar approach is needed with respect to personal taxation.

Moreover, to do away with 150% Investment Deduction Allowance (IDA) to investments outside the municipalities of Mombasa, Nairobi and Kisumu. There is no evidence that investors have invested in rural areas. In addition, there are also challenges in defining what constitutes areas outside these municipalities. Do away with tax holidays: Several countries have stopped giving tax holidays and have replaced them with uniform tax regime of low tax rates and highly selective and limited tax incentives. Tax holidays lead to 'tax shopping' with companies exiting as soon as the holiday expires. This has been amply demonstrated in Kenya's EPZ's. In addition, they could simply lead to tax shifting where Double Taxation Treaties (DTA's) exist.

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