INCENTIVES FOR FOREIGN DIRECT INVESTMENTS IN KENYA

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DEDICATION

To Cyprian and Eva Wambugu, thanks for the love and support.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF ABBREVIATIONS

AGOA - African Growth and Opportunities Act

EPZ - Export Processing Zones

FDI – Foreign Direct Investments

GDP - Gross Domestic Products

MNC – Multi National Corporation

ODA – Official Development assistance

UNCTAD – United Nations Commission for Trade and Development

ABSTRACT

The flow of foreign direct investment was the earliest type of resource transfer to developing economies. Foreign direct investment has two major components: portfolio investment and direct investment. Portfolio investment is in the form of equity capital, either share or bond holding, in ventures in developing countries. On the other hand, direct foreign investment enables the foreigner to own the physical productive assets which he operates directly. The purpose of the study was to investigate the incentives of foreign direct investments in Kenya. The objective of the study was to determine the incentives of foreign direct investments in Kenya. The study used correlation design as it was the most convenient method that would capture the objective of the study. The study targeted the multinational companies that have established their regional headquarters in Nairobi. The sampled population was 43 multinational companies in Nairobi. Questionnaires were used as the main data collection method. Data was analysed and presented in form of descriptive statistics. Statistical package for social scientists (SPSS) was used to compute the data and it was presented using table, graphs and pie charts. The study revealed that the incentives for foreign direct investment in Kenya included; market size (23%), cheap labor and cost of production (21%), liberalization of the economy (19%), favourable legal framework (14%), bilateral trade agreements (14%) and political stability (9%). The study recommends that the government should improve the infrastructure; review incentives granted to investors from time to time and also invest heavily in technology so as to attract more investors. The study also recommends further study to be done in other areas in Kenya that were not concern of the study.

CHAPTER ONE: INTRODUCTION

1.1 Background of the study

International business comprises all commercial transactions (private and governmental, sales, investments, logistics, and transportation) that take place between two or more regions, countries and nations beyond their political boundaries. Usually, private companies undertake such transactions for profit; governments undertake them for profit and for political reasons. It refers to all those business activities which involve cross border transactions of goods, services, resources between two or more nations. Transaction of economic resources include capital, skills, people etc. for international production of physical goods and services such as finance, banking, insurance, construction etc (Daniels, Radebaugh&Sullivan, 2007).

One of the economic problems of developing countries is that they do not have enough national savings to finance their investments. They are in constant need of foreign capital in forms of both direct and indirect investments. Initially, they took loans from international commercial banks. But in the 1980s the drying-up of commercial bank lending, because of debt crises, forced many countries to reform their investment policies so as to attract more stable forms of foreign capital, and FDI appeared to be one of the easiest way to get foreign capital without undertaking any risks linked to the debt. Thus, it became an attractive alternative to bank loans as a source of capital inflows (Agiomirgianakis, Asteriou, &Papathoma, 2003).During the 1990’s, foreign direct investment (FDI) by multinational corporations (MNCs) grew at a faster rate than incomes and trade. This growth and the anticipated potential beneficial effects on growth and development, especially of developing and emerging economies have led to attempts by governments to devise policies that attract FDI. It has also renewed discussion and research on the determinants of FDI. The attitude towards inward foreign direct investment (FDI) has changed considerably over the last couple of decades, as most countries have liberalised their policies to attract all kinds of investment from multinational corporations (MNCs). On the expectation that MNCs will raise employment, exports, or tax revenue, or that some of the knowledge brought by the foreign companies may spill over to the host country private sector, many governments have also introduced various forms of investment incentives, to encourage foreign owned companies to invest in their jurisdiction (Hill, 2005).

Companies can enter a foreign market through either exporting or FDI. Exporting is a relatively low-risk and simple vehicle with which to enter a foreign market because it does not involve actual presence in the target market. While relatively low in risk, exporting does not enable a firm to maintain control over foreign production and operations nor benefit from opportunities available only through actual presence in a foreign market. Foreign direct investment (FDI) occurs when a firm invests directly in production or other facilities in a foreign country over which it has effective control. Manufacturing FDI requires an establishment of production facilities abroad (e.g., Coca-Cola has built bottling facilities in about 200 countries), whereas service FDI requires either the building of service facilities (e.g., Disneyland Hong Kong) or the establishment of an investment foothold via capital contribution and building office facilities (e.g., Citigroup’s acquisition of the private banking and financial services firm Confia). Overseas units or entities are broadly called foreign subsidiaries or affiliates. The country in which a foreign subsidiary operates is termed the host country.

1.1.2 Overview of FDIs

The flow of foreign private investment or capital was the earliest type of resource transfer to developing economies and has been in existence before the post-war emergence of official development assistance (ODA) or most recent effort to transfer resources through preferences. FDI has two major components: Portfolio investment and direct investment. Portfolio investment is in the form of equity capital, either share or bond holding, in ventures in developing countries. On the other hand, direct foreign investment enables the foreigner to own the physical productive assets which he operates directly. The flow of resources is essentially carried out by large multinational or transnational corporations with headquarters in the developed nations; flow of financial capital is by private international banks. It is often argued that there is 'no unique established theory of foreign direct investment. Instead, there are various hypotheses emphasizing different macroeconomic and microeconomic factors that are likely to have an effect on foreign direct investment' (Khan, 1990). Thus, there are several factors influencing foreign direct investment. Any effort to discuss conceptual issues on FDI must be aware of sweeping generalizations.

According to UNCTAD (1998) economic factors such as business facilitation, investment promotion (including image-building and investment-generating activities and investment-facilitating services), investment incentives, hassle costs (related to corruption and administrative efficiency), social amenities (for example quality of life) and after investment services are some of the determinants of FDI investments. UNCTAD (1998) lists the principal economic determinants in the host countries. It matches types of FDI by motives of the firms with those principal economic determinants. Where we have a market- seeking type of FDI, it looks for criteria concerning market size and per capital income; market growth; access to regional and global and global markets; country specific consumer preferences and; structure of the markets. In case of FDI of a resource/asset seeking type, the focus would turn on raw materials, low cost unskilled labour as well as skilled labour, technological, innovative and other created assets (like brand names), and physical infrastructure (roads, ports, telecommunications and power).

In contrast to horizontal FDI, vertical or export-oriented FDI involves relocating parts of the production chain to the host country. Availability of low-cost labour is a prime driver for export-oriented FDI. Naturally, FDI in the resource sector, such as oil and natural gas, is attracted to countries with plentiful natural endowments. The third type of FDI, called efficiency-seeking, takes place when the firm can gain from the common governance of geographically dispersed activities in the presence of economies of scale and scope. In 1998, the World Investment Report, UNCTAD (1998) has analysed the determinants of FDI and host country determinants have been classified into the three groups. These are politic factors, business facilitation and economic factors. The absence of a generally accepted theoretical framework has led researchers to rely on empirical evidence for explaining the emergence of FDI.

1.1.3 Foreign Direct Investments in Kenya

Kenya is a relatively big country with a total land area of 580.4 square kms. Its location is strategic within East Africa and has a population of approximately 40 million people. The country is well endowed with a broad range of natural resources, flora and fauna and arable land. Kenya highlands comprise of the most successful agricultural production regions in East Africa. Foreign investment has been of considerable significance in financing development in Kenya not only in the manufacturing but also in the primary and tertiary sectors (Mwega&Ndungu, 2002).

Foreign Direct Investment (FDI) not only provides the African countries with much needed capital for domestic investment, but also creates employment opportunities, helps transfer of managerial skills and technology, all of which contribute to economic development. Recognizing that FDI can contribute a lot to economic development, all governments of Africa including that of Kenya want to attract it. Indeed, the world market for such investment is highly competitive, and Kenya in particular, seeks such investment to accelerate her development efforts. With liberal policy frameworks becoming common place and losing some of their traditional power to attract FDI, Kenya is paying more attention to the measures that actively facilitate it. Hence, the economic determinants remain very important. What is likely to be more critical in the future is the distinctive combination of location advantages, especially, created assets that Kenya can offer potential investors. The level of FDI has been low and stagnant over the past couple of years and well below Kenya's potential. There has also been a worrying trend of foreign investors moving out of Kenya and gravitating to other countries (Kinaro, 2006).

FDI in Kenya has not only been volatile but also low since the 1970s. This led to the stagnation of the manufacturing sector which was largely been dominated by the foreign firms. This decline was blamed on the inward oriented strategy as well as the collapse of the East Africa Community in 1977. Ensuing economic distortions resulted in severe structural constraints and macro economic imbalances and firms failed to develop competitive capabilities to penetrate the international markets. The inward looking policies pursued at the time under import substitution made it difficult to effectively participate and compete keenly in the export markets. As a result the manufacturing industry failed to play a more dynamic role enough to function as an engine of country's growth and did not contribute significantly to foreign exchange (Rasiah and Gachino 2005).

After the disappointing period of the 1990s, Kenya resumed the path to rapid economic growth in 2002 through the implementation of the Economic Recovery Strategy paper which was replaced by vision 2030 after it expired in 2007. During this period the government embarked on establishment of free trade zones, improvement of business climate, infrastructure, and development of incentives among initiatives. These efforts are aimed at building a momentum that can sustain economic growth and promote development. At the centre of these efforts is a commitment to attract foreign direct investment which was hoped would assist in the industrialization process (UNCTAD, 2005).

Foreign firms in Kenya since the 1970s have invested in a wide range of sectors. Most notably they played a major role in floriculture and horticulture, with close to 90 percent of flowers being controlled by foreign affiliates. In the Manufacturing sector

FDI has concentrated on the consumer goods sector, such as food and beverage industries. This has changed in the recent years with the growth of the garment sector because of African Growth and Opportunities Act (AGOA). Of the 34 companiesinvolved in AGOA 28 are foreign most of them concentrated in the Export Processing Zones (EPZs). FDI is also distributed to other sectors including services, telecommunication among others. 55 percent of the foreign firms are concentrated in Nairobi while Mombasa accounts for about 23 percent, thus Nairobi and Mombasa account for over 78 percent of FDI in Kenya. The main form of FDI establishment has been through the form of green fields establishments and Kenya has in total more than 200 multinational corporations. The main traditional sources of foreign investments are Britain, US and Germany, South Africa, Netherlands, Switzerland and of late China and India (UNCTAD, 2005).

1.2 Research Problem

Foreign Direct Investments (FDIs) have grown and continue to grow as well as playing significant roles in growth and development of many economies in the world by contributing to the Gross Domestic Products (GDP). However; In Kenya FDIs have performed below expectations due to the combination of various factors which attract Foreign Direct Investments (FDIs). The determinants of foreign direct investments have become an important topic not only for the governments, policy makers but also for academic research. Moreover; the importance of foreign direct investments to both countries arises in view of dismal performance of previous policies that emphasized more attraction of foreign direct investments in their countries (Mahiti, 2012).

It is now widely acknowledged that FDI has potential benefits that can accrue to developing countries. This view is mainly based on the neo liberal and development economists. They suggest that FDI is important for economic growth as it provides the much needed capital for investment, increases competition in host countrieseconomies, and aids local firms to become more productive by adopting more efficient technology or by investing in human or physical capital. FDI is also said to contribute to growth in a substantive manner because it’s more stable than other forms of capital flows. Kenya has had a long history with foreign firms. In the 1970s it was one of the most favoured destinations for FDI in East Africa. However over the years, Kenya lost its appeal to foreign firms a phenomenon that has continued to the present. In 2008, Kenya launched vision 2030 where it hopes to achieve global competitiveness and prosperity of the nation. This initiative has seen a renewed commitment to attract FDI to assist in the industrialization process. This subject has received little attention in Kenya (Kinuthia, 2010).

A number of studies have been carried out on Foreign Direct Investments and Multi National Corporations in Kenya. Kinuthia (2010) and Kinaro (2006) investigated the determinants of Foreign Direct Investment in Kenya, Gachino (2006) focused on foreign direct investments in the Kenyan manufacturing industry, Chombo (2009) investigated the influence of the global credit crunch on Foreign Direct Investment (FDI) inflows in Kenya. However, these studies have not been exhaustive enough and did not cover all the incentives that may influence MNCs to engage in foreign direct investments in Kenya. It is therefore evident that few studies have been carried out to investigate the incentives of foreign direct investments in the Kenyan context. There is therefore a gap in literature as far as a study on the incentives of foreign direct investments determinants in Kenya is concerned. The following research question is therefore explored: What are the incentives of foreign direct investments in Kenya.

1.3 Research Objective

The objective of this study was to determine the incentives of foreign direct investments in Kenya.

1.4 Value of the Study

This study will add on to the growing body knowledge of international business as far as foreign direct investments is concerned by providing the incentives for foreign direct investment in a developing country like Kenya.

The study will be significant in the sense that Kenya has experienced a decreasing trend of FDI inflows and MNC investments over the years. This study is also important in the sense that FDI stimulates domestic investment, promotes economic growth, creates employment opportunities and promotes transfer of new technology.

The findings of this study will be significant to both academicians and policymakers in the following way; first, it will add to the knowledge of the researchers in this field of study and secondly, it will serve as a guide to both policy makers and academicians.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter presents the literature review. First, a theoretical review is provided focusing on theories that explain the incentives of foreign direct investments. Secondly, the empirical review of the studies that have been done on the incentives of foreign direct investments is made. The research gap is then provided.

2.2 Theoretical Basis

There are many theories which attempt to explain the determinants of FDI. These theories are significant steps towards the development of a systematic framework for the emergence of FDI. However, the capacity of each to serve as a self contained general theory, which could explain all types of FDI (i.e., outward as well as inward FDI at the firm, industry, and country level), has been questioned in the works of various scholars. Some of these theories include internalisation theory, Eclectic theory, Exchange Rates on Imperfect Capital Markets Theory and the product life cycle theory. These are presented below.

2.2.1 Internalisation Theory

Internalization theory holds that the available external market fails to provide an efficient environment in which the firm can profit by using its technology or production resources. Therefore, the firm tends to produce an internal market via investment in multiple countries and thus creates the needed market to achieve its objective. A typical MNE consists of a group of geographically dispersed and goal-disparate organizations that include its headquarters and different national subsidiaries. These MNEs achieve their objectives not only through exploiting their proprietary knowledge but also through internalizing operations and management. Internalization is the activity in which an MNE internalizes its globally dispersed foreign operations through a unified governance structure and common ownership (Buckley and Casson, 1985).

Internalization theorists argue that internalization creates “contracting” through a unified, integrated intra-firm governance structure. It takes place either because there is no market for the intermediate products needed by MNEs (e.g., Falk, a global power transmission manufacturer, must use intermediate goods such as couplings and backstops produced by its Brazilian subsidiary owing to the unavailability from any outside source) or because the external market for such products is inefficient (e.g., IBM’s speech-recognition technology is “transacted” internally among different units because the external market has not been developed enough to properly value and protect such expertise). The costs of transactions conducted at arm’s length in an external market (i.e., a fair price in an open market) may be higher than transactions within an intra-organizational market. The incentives to internalize activities are to avoid disadvantages in external mechanisms of resource allocation or to benefit from an internally integrated and intra-organizational network (Buckley and Casson, 1985). To increase profitability, some transactions should be carried out within a firm rather than between firms and this is one of the reasons why multinational companies exist. In other words, there are transactions that should be “internalized” to reduce transaction costs and hence increase profitability. This theory may answer the question why production is carried out by the same firm in different locations. One of the reasons of internalization is market imperfection. Any kind of economically useful knowledge can be called technology. Mostly, technologies or knowhow can be sold and licensed. However, sometimes, there are technologies that are embodied in the mind of a group of individuals and not possible to write or sale to other parties. This difficulty of marketing and pricing know how forces multinational companies to open a subsidiary in a foreign country instead of selling the technology. In addition, a number of problems may arise if an output of a firm is an input to other firm in other country. For instance, if each has a monopoly position, they may get into a conflict as the buyer of the input tries to hold the price down while the firm that produces input tries to raise it. Nevertheless, these problems can be avoided by integrating various activities within a firm rather than subcontracting the activities (Krugman and Obstfeld, 2003).

2.2.2 The Eclectic Theory

John Dunning developed an eclectic theory of FDI, which is called OLI paradigm. O, L and I refer ownership advantage, location advantage and internalization conditions, respectively. Operating in a foreign country market has many costs and these “costs of foreignness” include a failure of knowledge about local market conditions, cultural, legal and many other costs. Therefore, foreign firms should have some advantages that can offset these costs. Ownership advantage is a firm specific advantage that gives power to firms over their competitors. This includes advantage in technology, in management techniques, easy access to finance, economies of scale and capacity to coordinate activities. Unlike ownership advantages, location advantages are country specific advantages (Soderstein, 1992).

Overall, the eclectic paradigm provides a more comprehensive view explaining FDI than do the product life-cycle theory, the monopolistic advantage theory, or the internalization theory. It combines and integrates country specific, ownership-specific, and internalization factors in articulating the logic and benefits of international production. Although today's international business environment and MNE behaviour are markedly different from what they were two decades ago, when the theory first emerged, the OLI advantages are still vital to explaining why FDI takes place and where MNEs' superior returns come from. The eclectic paradigm, like other theories of FDI, has some limitations, however. First, it does not adequately address how an MNE's ownership specific advantages such as distinctive resources and capabilities should be deployed and exploited in international production. Possessing these resources is indeed important, but it will not yield high returns for the MNE unless they are efficiently deployed, allocated, and utilized in foreign production and operations. Second, the paradigm does not explicitly delineate the ongoing, evolving process of international production. FDI itself is a dynamic process in which resource commitment, production scale, and investment approaches are changing over time (Dunning, 1981).

2.2.3 Exchange Rates on Imperfect Capital Markets Theory

This is another theory which tried to explain FDI. Initially the foreign exchange risk has been analyzed from the perspective of international trade. Itagaki (1981) and Cushman (1985) analyzed the influence of uncertainty as a factor of FDI. In the only empirical analysis made so far, Cushman shows that real exchange rate increase stimulated FDI made by USD, while a foreign currency appreciation has reduced American FDI. Cushman concludes that the dollar appreciation has led to a reduction in U.S. FDI by 25%. However, currency risk rate theory cannot explain simultaneous foreign direct investment between countries with different currencies. The sustainers argue that such investments are made in different times, but there are enough cases that contradict these claims.

2.2.4 The Product Life Cycle Theory

This theory was first developed by Vernon in 1966. A new product is first produced and sold in home market. At the early stage, the product is not standardized. i.e. per unit costs and final specification of the product are not uniform. As the demand for the product increases the product will be standardized. When the home market is saturated, the product will be exported to other countries. The firm starts to open subsidiaries in locations where cost of production is lower, when the competition from the rival firms intense and the product reaches its maturity. Therefore, FDI is the stages in the product lifecycle that follows the maturity stage (Dunning, 1993). Vernon's product life cycle theory is a dynamic theory because it deals with changes overtime. However, it seems that the theory is not confirmed by empirical evidence, as some multinational companies start their operations at home and abroad simultaneously (Chen, 1983).

2.3 Incentives for FDI in Kenya

Dunning (1993) describes three main types of FDI based on the motive behind the investment from the perspective of the investing firm. The first type of FDI is called market-seeking FDI, whose aim is to serve local and regional markets. It is also called horizontal FDI, as it involves replication of production facilities in the host country. Tariff-jumping or export-substituting FDI is a variant of this type of FDI. Because the reason for horizontal FDI is to better serve a local market by local production, market size and market growth of the host economy play important roles. Obstacles to accessing local markets, such as tariffs and transport costs, also encourage this type of FDI. A second type of FDI is called resource-seeking: when firms invest abroad to obtain resources not available in the home country, such as natural resources, raw materials, or low-cost labour. Particularly in the manufacturing sector, when multinationals directly invest in order to export, factor-cost considerations become important.

The role of growth in attracting FDI has also been the subject of controversy. Charkrabarti (2001) states that the growth hypothesis developed by Lim (1983) maintains that a rapidly growing economy provides relatively better opportunities for making profits than the ones growing slowly or not growing at all.Lunn (1980), Schneider and Frey (1985) and Culem (1988) find a significantly positive effect of growth on FDI, while Tsai (1994) obtains a strong support for the hypothesis over the period 1983 to 1986, but only a weak link from 1975 to 1978. On the other hand, Nigh (1985) reports a weak positive correlation for the less developed economies and a weak negative correlation for the developed countries. Ancharaz (2003) finds a positive effect with lagged growth for the full sample and for the non-Sub-Saharan

African countries, but an insignificant effect for the Sub-Saharan Africa sample. Gastanaga et al. (1998) and Schneider and Frey (1985) found positive significant effects of growth on FDI.

Altzinger (1999) found that among 150 Austrian firms investing in CEECs, those specializing in finance and insurance, food and beverages and construction considered market potential to be the most significant factor. Meyer (1996) examined 267 British and German companies that invest primarily in Hungary, which mainly emphasized on the purchasing power of the consumers. Also, the market size in terms of population size that could be a way to proxy expected market growth seemed to be a most important factor for attracting FDI. Market size and growth were the primary motive for market-oriented MNCs.

Artige and Nicolini (2005) state that market size as measured by GDP or GDP per capita seems to be the most robust FDI determinant in econometric studies. This is the main determinant for horizontal FDI. It is irrelevant for vertical FDI. Jordaan (2004) mentions that FDI will move to countries with larger and expanding markets and greater purchasing power, where firms can potentially receive a higher return on their capital and by implication receive higher profit from their investments. Charkrabarti (2001) states that the market-size hypothesis supports an idea that a large market is required for efficient utilization of resources and exploitation of economies of scale: as the market-size grows to some critical value, FDI will start to increase thereafter with its further expansion. This hypothesis has been quite popular and a variable representing the size of the host country market has come out as an explanatory variable in nearly all empirical studies on the determinants of FDI.

Jordaan (2004) claims that, the impact of openness on FDI depends on the type of investment. When investments are market-seeking, trade restrictions (and therefore less openness) can have a positive impact on FDI. The reason stems from the “tariff jumping” hypothesis, which argues that foreign firms that seek to serve local markets may decide to set up subsidiaries in the host country if it is difficult to import their products to the country. In contrast, multinational firms engaged in export-oriented investments may prefer to invest in a more open economy since increased imperfections that accompany trade protection generally imply higher transaction costs associated with exporting. Wheeler and Mody (1992) observe a strong positive support for the hypothesis in the manufacturing sector, but a weak negative link in the electronic sector. Edwards (1990) find a strong positive effect of openness on FDI and

Schmitz and Bieri (1972) obtain a weak positive link. Pärletun (2008) finds that trade openness is positive but statistically significant from zero.

Charkrabarti (2001) claims that wage as an indicator of labour cost has been the most contentious of all the potential determinants of FDI. Theoretically, the importance of cheap labour in attracting multinationals is agreed upon by the proponents of the dependency hypothesis as well as those of the modernization hypothesis, though with very different implications. There is, however, no unanimity even among the comparatively small number of studies that have explored the role of wage in affecting FDI: results range from higher host country wages discouraging inbound FDI to having no significant effect or even a positive association.

The ranking of political risk among FDI determinants remains rather unclear. According to ODI (1997), where the host country owns rich natural resources, no further incentive may be required, as it is seen in politically unstable countries, such as Nigeria and Angola, where high returns in the extractive industries seem to compensate for political instability. In general, as long as the foreign company is confident of being able to operate profitably without excessive risk to its capital and personnel, it will continue to invest. For example, large mining companies overcome some of the political risks by investing in their own infrastructure maintenance and their own security forces. Moreover, these companies are limited neither by small local markets nor by exchange-rate risks since they tend to sell almost exclusively on the international market at hard currency prices.

According to ODI (1997), poor infrastructure can be seen, however, as both an obstacle and an opportunity for foreign investment. For the majority of low-income countries, it is often cited as one of the major constraints. But foreign investors also point to the potential for attracting significant FDI if host governments permit more substantial foreign participation in the infrastructure sector. Jordaan (2004) claims that good quality and well-developed infrastructure increases the productivity potential of investments in a country and therefore stimulates FDI flows towards the country. According to Asiedu (2002) and Ancharaz (2003), the number of telephones per 1,000 inhabitants is a standard measurement in the literature for infrastructure development. However, according to Asiedu (2002), this measure falls short, because it only captures the availability and not the reliability of the infrastructure. Furthermore, it only includes fixed-line infrastructure and not cellular (mobile) telephones.

Mwega and Rose (2007) using panel data of 43 countries with a Kenyan dummy find 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. UNCTAD (2005) argue that Kenya's inability to attract FDI is due to growing problems of corruption and governance, inconsistencies in economic policies and structural reforms, deteriorating public service and poor infrastructure. Todd et al (2005) argues that Kenya officially encourages and grants national treatment to foreigners but that the problem is Kenya's political elites who resent FDI perceiving it to lead to dependency. Himbara (1994) shares similar sentiments. Kareithi (1991) concerned with the impact of foreign-owned media upon the body politic of Kenya argues that foreign ownership undermines both national sovereignty and even the rudiments of political freedom.

The literature remains fairly indecisive regarding whether FDI may be sensitive to tax incentives. Some studies have shown that host country corporate taxes have a significant negative effect on FDI flows. Others have reported that taxes do not have a significant effect on FDI. Hartman (1994), Grubert and Mutti (1991), Hines and Rice (1994), Loree and Guisinger (1995), Cassou (1997) and Kemsley (1998) find that host country corporate income taxes have a significant negative effect on attracting FDI flows. However, Root and Ahmed (1979), Lim (1983), Wheeler and Mody (1992), Jackson and Markowski (1995), Yulin and Reed (1995) and Porcano and Price (1996) conclude that taxes do not have a significant effect on FDI. Swenson (1994) reports a positive correlation.

2.4 Empirical Review

Pye (1998) conducted a survey with a sample of 334 firms from the main European and North American countries in terms of investment into the Czech Republic, Romania, Slovakia, Poland and Hungary between 1989 and 1996. He found that the leading drive in 34 per cent of the sample was market size and its growth potential. Further research suggests that 116 West European firms planning to operate in one of sixteen Central and Eastern Europe (CEECs) share as their primary motive the size of the market, with the exception of Hungary and Czech Republic, where political and economic stability were the dominant factors to attract investment flows (Lankes and Venables, 1997). Moreover, Poland’s size and homogeneity of its market, and its relatively higher personal incomes seemed to be the major factors attracting FDI. The latter applies for the Czech Republic and Hungary, which along with Poland have the highest personal incomes in the district.

Piteli (2009) analysed the determinants of foreign direct investment (FDI) by multinational corporations (MNCs) in developed economies. He compared between EU and non-EU countries, in the context of an estimated equation derived from economic theory, which compares the main demand and supply-side determinants of FDI. The study contributes to the literature in three ways: first, by employing different proxies for demand and supply-side factors; second, by comparing between European and non-European developed countries; third, by testing for the relative importance of total factor productivity (TFP) as a determinant of FDI. The results are in line with theoretical predictions, but point to the importance of TFP as the determinant par excellence of FDI in developed countries. They also highlight differences even within developed European and non-European counties.

Empirical relationship between political instability and FDI flows is unclear. For example, Jaspersen et al. (2000) and Hausmann and Fernandez-Arias (2000) find no relationship between FDI flows and political risk while Schneider and Frey (1985) find an inverse relationship between the two variables. Using data on U.S. FDI for two time periods, Loree and Guisinger (1995) found that political risk had a negative impact on FDI in 1982 but no effect in 1977. Edwards (1990) uses two indices, namely political instability and political violence, to measure political risk. Political instability (which measures the probability of a change of government) was found to be significant, while political violence (i.e. the frequency of political assassinations, violent riots and politically motivated strikes) was found to be insignificant.

Mahiti (2012) examined the determinants of foreign direct investments in East Africa countries of Tanzania and Kenya. The research was carried out at Tanzania Investment Centre (TIC) and the Embassy of Kenya. The study was conducted with the following objectives: To assess the determinants for attracting FDI to East Africa, To assess the difficulties of attracting FDI to East Africa, To determine the efforts done by the selected East African governments in attracting FDI in favour of their countries, To determine the contribution of FDI to the selected countries' social economic development.Both qualitative and quantitative methods were collectively employed in the process of collecting data and information required in this research. The study concluded that Tanzania Investment Centre and Kenya Investment Authority have a lot to do in order to attract more Foreign Direct Investment in

Tanzania and Kenya respectively. This study recommends that it is necessary to attract high quality investment.Also the study notes that such infrastructure as Roads, Airports and Railways need significant improvement for attracting more Foreign Direct Investments in East African Region. Indeed it is important to review incentives granted to Investors from time to time in order to make sure that they serve the intended objectives. Finally to ensure that new technologies are transferred to Tanzania and Kenya so that the two countries become competitive in terms of technologies.

Kinaro (2006) investigated the determinants of Foreign Direct Investment in Kenya. The main objective of the study was to identify the key factors that influence FDI decisions in Kenya. This study concludes that the coefficient of determination of the model ($R2 = 0.75$) shows that 75 percent of the variations in FDI is explained by the explanatory variables which include economic openness, human capital, real exchange rate, inflation FDI of the previous year. The researcher obtained the expected signs from all the variables in the empirical model. The results indicate that both economic openness and human capital affects FDI positively in the short run. Likewise, inflation and real exchange rate have a negative influence on FDI inflows in the short and long run respectively.

Kinuthia (2010) investigated the main drivers of foreign direct investment (FDI) in Kenya. Few studies have investigated the reasons for low levels of FDI in Kenya and most of these studies are based on macroeconomic data. This study provides fresh evidence on the determinants of FDI based on a survey of foreign firms in Kenya in 2007. The study findings reveal that most of the foreign firms in Kenya are marketing firms and that the most important determinants are market size, political and economic stability, bilateral trade agreements and a favourable climate. In addition the three main impediments to FDI inflow to Kenya are political instability, crime and insecurity, and institutional factors most notably corruption.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter describes the methods that will be used in the collection of data pertinent in answering the research questions. It is divided into research design, population and sample design, data collection, and data analysis methods.

3.2 Research Design

The study used a correlation design. This is because this method most captured the objectives of the study. In this manner, the study was able to establish the relationship between the variables in the study. The study sought to establish the incentives of foreign direct investments and therefore this research design helped in evaluating these incentives. The research design, therefore, was appropriate to be used in the study.

3.3 Population of the study

The population of this study comprised all the multinational companies that have established their African or regional headquarters in Nairobi. According to Kenya Investment Authority, there are 43 Multinational companies with their headquarters in Nairobi (Appendix 1). A survey of all the companies was conducted since the population is not large.

3.4 Data collection

For purposes of this study, primary data was obtained through a questionnaire that was structured to meet the objectives of the study. The questions were both open and closed.The questionnaires were then administered by the researcher in order to capture all the issues required and also to avoid low response rates. Secondary data was obtained from various websites such as the Central Bank website and the Kenya Investment Authority website. Secondary data was on the various incentives that drive MNCs to invest in the country through FDI. Data collected on incentives of FDI were for the last two years (2011-2012).

3.5 Data Analysis and Presentation

The collected data through questionnaires was entered into the Statistical Package for Social Sciences (SPSS) analysis software as well as into the MS Spreadsheets. The analysis was done using descriptive statistics (percentages and mean scores), and regression analysis.

Data presentation was in form of descriptive statistics such as frequency distribution, percentages and tables. The strength of the model was tested using Pearson Correlation Coefficient and 95 percent confidence level.

The study used a form of the following linear regression model

Y(FDI) = a + b1Infra+ b2LegFra + b3Corr + b4PoRi + b5 MakSz + €

Where:

Infra – levels of infrastructure in host country

LegFra – legal framework in host country

Corr – level of corruption in host country

PoRi – level of political risk in host country

MarSz – the market size of host country

a – is the constant

€ - Error term

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND INTERPRETATION

4.1 Introduction

The chapter will present, analyze, and interpret data according to the objectives of the study. The data obtained is presented in tabular form and in descriptive statistics such as pie charts and bar graphs. The chapter is further sub divided into several sections that are pertinent to the subjects under study.

4.2 Research Findings

4.2.1 Response Rate

The targeted population was the management of 43 multinational companies in Kenya. Out of targeted 43 respondents, 43 responded given a response rate of 100%. This is presented in table 4.1

Table 4.1: Response Rate

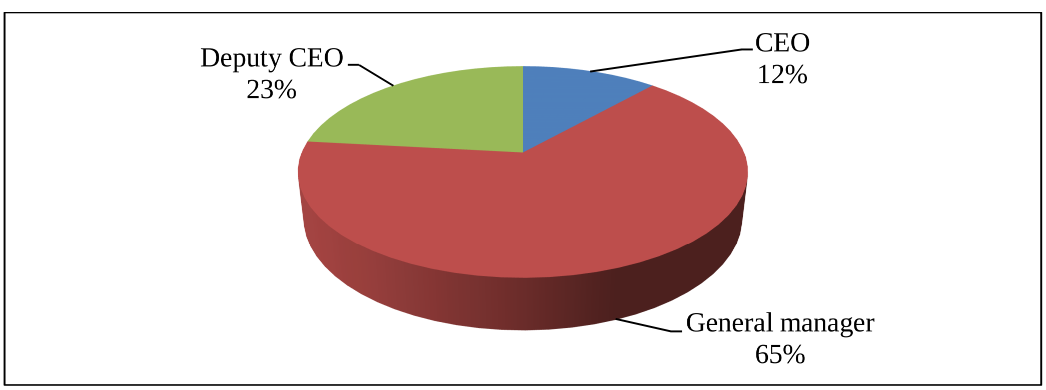
	Targeted population	**Response rate**
Respondents	43	100

Source: researcher (2013).

4.2.2 Distribution by Designation

The respondents were requested to indicate their designation. 65% of the respondents were general managers, 23% were deputy CEOs and 12% were CEOs. The findings are presented in figure 4.1

Figure 4.1: Distribution by Designation

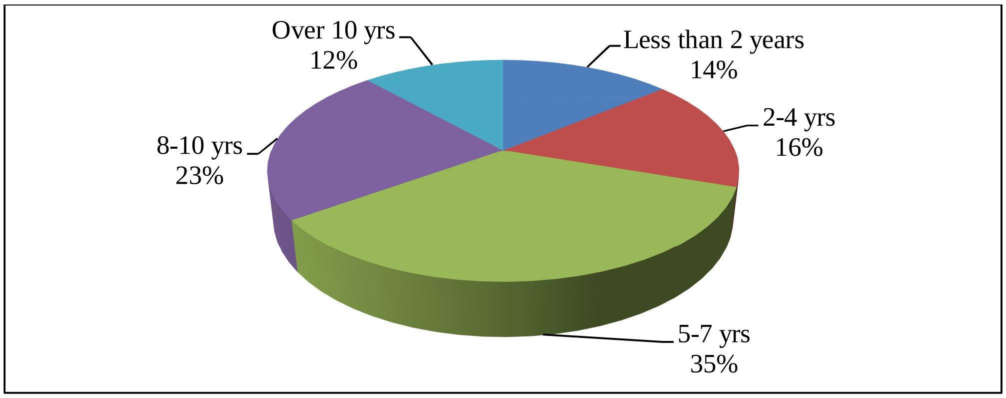


Source: Researcher (2013).

4.2.3 Distribution by Number of Years Worked in Company

The respondents were asked to indicate the number of years they have worked in the company. According to the findings, 35% worked for 5-7 years, 23% 8-10 years, 16% 2-4 years, 14% less than 2 years and 12% for over 10 years. The study indicates that the majority of the respondents had worked in the company for over 5 years; therefore they are well placed to know the incentives for foreign direct investments and therefore contribute relevant information for the study. The findings are presented in figure 4.2

Figure 4.2 Distribution by Number of Years Worked in Company



Source: Researcher (2013).

4.2.4 Distribution by Sectors

The researcher requested the respondents to indicate the sector that their company operates in. according to the findings, 60% of the international companies are in manufacturing sector, 35% in service sector and 5% in agriculture sector. The findings are presented in table 4.2

Table 4.2: Distribution by Sectors

Sector	**Frequency**	**Percentage**
Agriculture	2	5
Manufacturing	26	60
Services	15	35
Total	**43**	**100**

Source: Researcher (2013).

4.2.5 Distribution by Year of Commencement in Kenya

The researcher sought to find out the year that the companies were established in Kenya. According to the findings, 47% of the respondents indicated that their companies were established in Kenya between 2000-2009, 23% between 1990-1999, 9% between 1980-1989, 9% between 2010-present, 7% between 1970-1979 and 5% before 1970. The findings indicate that majority of the companies were established in Kenya between the year 2000 and 2009. The findings are presented in table 4.3

Table 4.3: Distribution by Year of Commencement in Kenya

Year	Frequency	Percentage
Before 1970	2	5
1970-1979	3	7
1980-1989	4	9
1990-1999	10	23
2000-2009	20	47
2010- present	4	9
Total	**43**	**100**

Source: researcher (2013).

4.2.6 Distribution by Purpose of Entity

The respondents were asked to indicate the purpose of their entity. According to the findings, 60% of the respondents indicated that their purpose is to produce/ make whole or part of the products, 28% indicated that they sell products same as parent, 7% are output distributors and 5% sells products supplied by a group. The findings are presented in table 4.4.

Table 4.4: Distribution by Purpose of Entity

Purpose	Frequency	Percentage
Sells products supplied by a group	2	5
Produces/ makes whole or part	26	60
Sells products same as parent	12	28
Output distribution	3	7
Total	**43**	100

Source: Researcher (2013).

4.2.7 Incentives for Foreign Direct Investments in Kenya

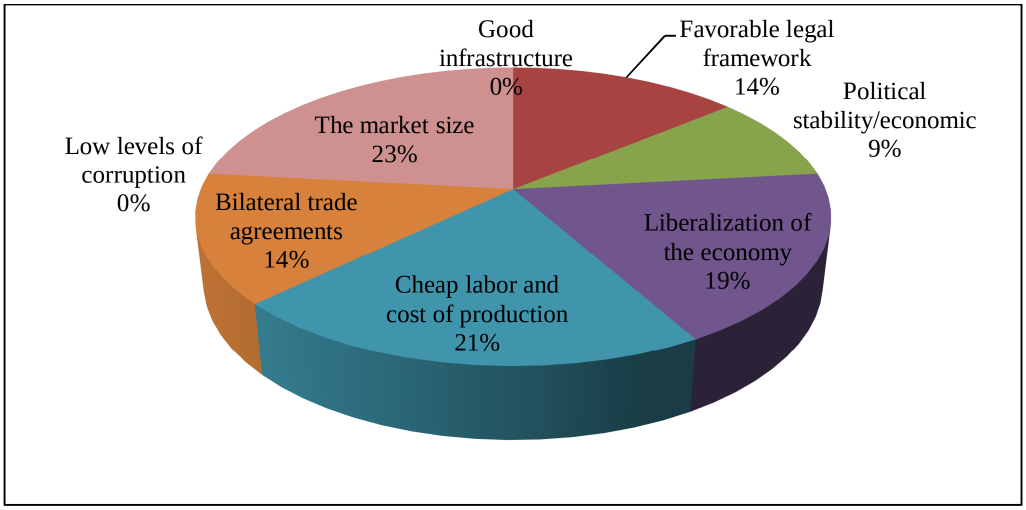
In order to find out the incentives for foreign direct investment in Kenya, the researcher requested the respondents to indicate the main incentive for their company to invest in Kenya. 23% of the respondents mentioned the market size as incentive, 21% mentioned cheap labour and cost of production, 19% indicated liberalization of the economy, 14% mentioned favourable legal framework, 14% mentioned bilateral trade agreements and 9% mentioned political stability/economic. Notably, no respondents mentioned good infrastructure and low levels of corruption. The findings are presented in table 4.4 and figure 4.3

Table 4.5: Incentives for Foreign Direct Investments in Kenya

Incentive	Frequency	Percentage
Good infrastructure	0	0
Favourable legal framework	6	14
Political stability/economic	4	9
Liberalization of the economy	8	19
Cheap labour and cost of production	9	21
Bilateral trade agreements	6	14
Low levels of corruption	0	0
The market size	10	23
Total	**43**	100

Source: Researcher (2013).

Figure 4.3: Incentives for Foreign Direct Investment in Kenya



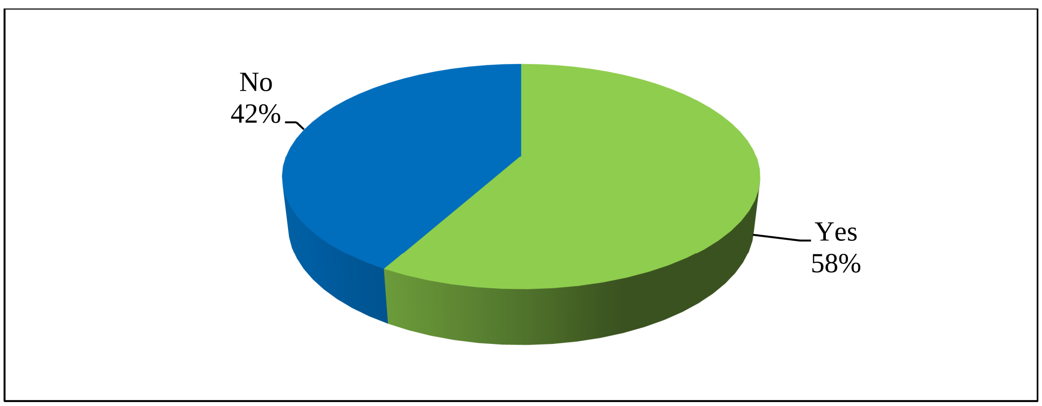
Source: Researcher (2013).

The findings indicate that the main incentive for foreign direct investment in Kenya is market size, followed by cheap labour and low cost of production, liberalization of economy, favourable legal framework, bilateral trade agreements and political stability/ economic. The findings correlate with Kinuthia (2010) who stated that most foreign firms in Kenya are marketing firms and that the most important determinants are market size, political and economic stability, and bilateral trade agreements. The findings however revealed that low level of corruption was not one of the incentives as Kenya has high corruption index. This finding was affirmed by UNCTAD (2005) that argued that the Kenya's inability to attract FDI is due to growing problems of corruption and governance. Kinuthia (2010) also affirmed this by mentioning corruption as one of the impediments of flow of foreign direct investments in Kenya.

4.2.8 Government Assistance during Entry

The researcher sought to find out if the government offered any assistance to the parent company during entry and the form of assistance offered. According to the findings, 58% of the respondents agreed that they had been offered assistance by the government during entry while 42% disagreed. The findings are presented in figure 4.4

Figure 4.4: Government Offered Any Assistance to the Parent Company during Entry



Source: researcher (2013).

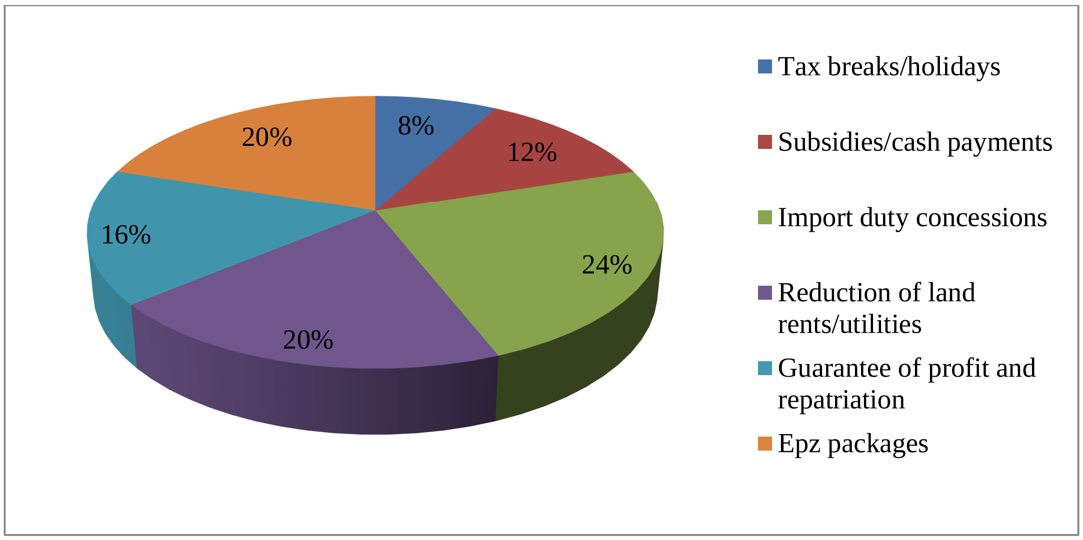
The researcher then went ahead and asked the respondents the form of assistance that the government offered. According to the findings, 24% of the respondents indicated that the government offered import duty concessions, 20% mentioned EPZ packages, 20% indicated reduction of land rents/ utilities, 16% pointed out guarantee of profit and repatriation, 12% indicated subsidies/cash payments, and 8% mentioned tax breaks/ holidays. The findings are presented in table 4.6 and figure 4.5

Table 4.6: Forms of Government Assistance

Forms of Government Assistance	Frequency	Percentage
Tax breaks/holidays	2	8
Subsidies/cash payments	3	12
Import duty concessions	6	24
Reduction of land rents/utilities	5	20
Guarantee of profit and repatriation	4	16
EPZ packages	5	20
Total	**25**	**100**

Source: Researcher (2013).

Figure 4.5: Forms of Government Assistance



Source: Researcher (2013).

The findings indicate that the government does offer assistance to parent companies of multinational companies when they enter the country. The same was affirmed by Todd et al (2005) who argued that Kenya officially encourages and grants national treatment to foreigners. However, Todd et al (2005) noted that Kenyan's political elites oppose this move as they resent FDIs perceiving it to lead to dependency.

Kareithi (1991) shares same sentiments and argues that foreign ownership undermines both national sovereignty and even rudiments of political freedom.

4.2.9 Factors Influencing Decision to Invest in Country

The researcher requested the respondents to indicate the extent to which the given factors influence the decision to invest in a country. The respondents were given a scale of 1-5 as follows: 1- great extent, 2- moderate extent, 3- neutral, 4- low extent and 5- no extent.The means of the responses given were calculated using the following formula: Mean= ∑ scores/N. Where ∑ scores is the summation of all responses given and N is the total number of respondents (43 in the case of this study). The findings were interpreted using the following criterion: mean of 1.00-1.49= great extent; mean of 1.50 – 2.49=moderate extent; mean of 2.50-3.49=neutral; mean of 3.5 to 4.49= low extent; and mean of 4.50-5.00- no extent.

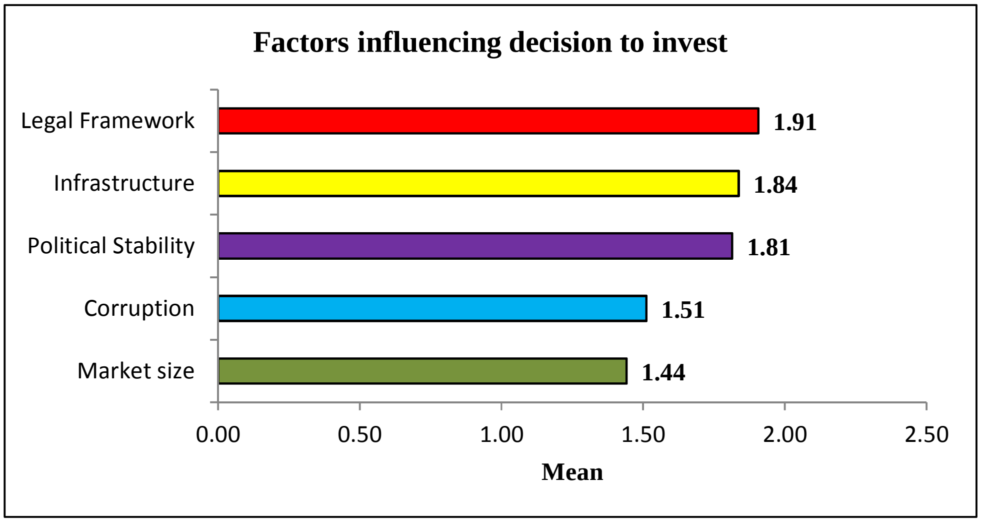
According to the findings, market size with mean of 1.44 was the greatest factor influencing the decision to invest in a country. This was followed by factors that were deemed to affect the decision to invest to a moderate extent. These included: corruption with a mean of 1.51; political stability (1.81); infrastructure with mean of 1.84 and; legal framework (with mean of 1.91). The findings are presented in table 4.7 and Figure 4.6.

Table 4.7: Factors Influencing Decision to Invest

	Rating					
Factors influencing decision to invest	**1**	**2**	**3**	**4**	**5**	**Mean**
Market size	25	17	1	0	0	1.44
Corruption	23	18	2	0	0	1.51
Political Stability	17	20	3	3	0	1.81
Infrastructure	20	13	7	3	0	1.84
Legal Framework	19	14	6	3	1	1.91

Source: Researcher (2013).

Figure 4.6 Factors Influencing Decision to Invest



Source: Researcher (2013)

The researcher went on to determine the correlation between the five factors market size, corruption, political stability, infrastructure and, legal Framework. All the factors under investigation showed strong positive correlated between themselves. The strongest correlation occurs between market size and corruption (1.00). This was followed by corruption and legal framework as well as market size and legal framework each with r values of 0.98. Political stability and corruption followed with an r value of 0.96. Correlation between infrastructure and market size as well as corruption and infrastructure had an r value of 0.96 as well. The detailed findings are showed in Table 4.8 shows the detailed findings.

Table 4.8: Pearson's correlation between various factors Influencing Decision to Invest

	Market size	Corruption	Political Stability	Infrastructure	Legal Framework
Market size	1.00				
Corruption	1.00	1.00			
Political Stability	0.93	0.96	1.00		
Infrastructure	0.96	0.96	0.88	1.00	
Legal Framework	0.98	0.98	0.93	0.99	1.00

These findings show that corruption may bring affect market sizes since it alters the way business if done. Political instability and corruption may lead to failure infrastructure. On its part, the legal framework and create room for corruption. All in all the various factors are intrinsically related in their overall influence on FDIs decision to invest.

Furthermore, the findings indicate that the major factors influencing decision to invest are market size and corruption. The findings correlate with Jordaan (2004) who mentioned that FDI will move to countries with larger and expanding markets and also greater purchasing power. Altzinger (1999) also affirms this by stating that foreign companies specializing in finance and insurance, food and beverages and construction considered market potential to be the most significant factor. The study reveals that political stability and infrastructure influence decision to invest to a moderate extent. Various studies, however, reveals that ranking of political stability still remains unclear as they are conflicting views. According to ODI (1997), political stability is not a significant factor as some foreign companies invest even in areas where there is political instability, provided the host country owns rich natural resources. High returns in the extractive industries seem to compensate for political instability. However, Loree and Guisinger (1995) and Edwards (1990), found that political risk had a negative impact on FDI. On the part of infrastructure, ODI (1997) agrees with the study findings that infrastructure can influence decision to invest. According to ODI (1997), poor infrastructure can be seen as both obstacle and an opportunity to invest.For the majority of low-income countries, it is often cited as one of the major constraints. But foreign investors also point to the potential for attracting significant FDI if host governments permit more substantial foreign participation in the infrastructure sector. Jordaan (2004) claims that good quality and well-developed infrastructure increases the productivity potential of investments in a country and therefore stimulates FDI flows towards the country.

4.3 Conclusion

The findings of this study show that the multinational companies that participated in the study came from all of the three major sectors and had variant demographic characteristics hence provided a balanced view of subject under investigation. The majority of the respondents stated that the purpose of their entity is to produce or make whole or part of the products. The study revealed the main incentives for foreign direct investment in Kenya as the market size, cheap labour and cost of production and liberalization of the economy. The study also revealed that the government did offer assistance to the parent company during entry. The assistance was majorly in form of import duty concessions and EPZ packages and reduction of land rents/utilities. The study discloses that the major factors that influence decision to invest in the country are market size and corruption. These are followed by infrastructure, legal framework and political stability in the order of diminishing importance. The following chapter will present summary of findings, conclusion and recommendations.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The purpose of this study was to investigate the incentives of foreign direct investments in Kenya.The objective of the study was to determine the incentives of foreign direct investment in Kenya.

5.2 Summary of Findings

This section will present summary of the findings according to the objectives.

5.2.1 Incentives of foreign direct investments in Kenya

The study revealed that incentive of foreign direct investments in Kenya are; market size, cheap labour and cost of production, liberalization of the economy, favourable legal framework and political stability/ economic. The study revealed that the government had offered assistance to parent companies during entry. This assistance included; import duty concessions, EPZ packages, reduction of land rents/ utilities, guarantee of profit and repatriation, subsidies/ cash payments and tax breaks/ holidays.

5.3 Conclusion

From the findings, it can be concluded that market size, cheap labour and cost of production, liberalization of the economy, favourable legal framework and political stability/ economic are the incentives of foreign direct investment in Kenya. The Kenyan government has also spurred the flow of FDIs in the country through offering assistance in terms of import duty concessions, EPZ packages, reduction of land rents/ utilities, guarantee of profit and repatriation, subsidies/ cash payments and tax breaks/ holidays.

5.4 Recommendations of the study

This study recommends that;

The government should improve infrastructure such as roads, airports, and railways so as to attract foreign direct investments in Kenya. The Kenya highway authority should ensure that the Kenyan roads and highways are always in good condition and are highly maintained. The railways corporation should be restructured and the government should invest in new railway systems, trains and technology so as to ensure that the railway transport is effective and efficient. More airports and airstrips should be built and the existing ones to be upgraded to international standards. Improvement of transport system will attract investors as the cost of transport will reduce hence reducing substantially cost of production.

The government should also review incentives granted to investors from time to time in order to make sure that they serve the intended objectives. The government should liberalize trade and remove prohibitive taxes so as to encourage more investors in the country. The country should also ensure that they participate in bilateral and multilateral trade agreements so as to promote trade with other countries.

Finally, the government should invest heavily in technology so as to become competitive in terms of technologies. This will be in terms of digitalizing key government offices to ensure efficiency and effectiveness.

5.5 Recommendations for Further Studies

The study focused on 43 multinational companies that are headquartered in Nairobi, Kenya. The aim of the study was to investigate incentives for foreign direct investments in Kenya. The researcher recommends more research on the incentives for foreign direct investment to be carried out in other areas that were not concern of the study.

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APPENDICES

Appendix 1: Multinational Companies

1. Germany BASF
2. BhartiAirtel
3. Cisco Systems
4. Chartis
5. Citibank
6. Coca Cola
7. Eltek Kenya Limited
8. General Electric
9. Google
10. GSM Association
11. Heineken
12. Huawei
13. IBM
14. Intel Corporation
15. Kaspersky Lab
16. Kiva
17. LG
18. Mastercard
19. Motorola Solutions
20. Nokia/Siemens
21. Pfizer
22. Pricewaterhouse Coopers
23. Qualcomm
24. Research in Motion
25. RTI International
26. Sage Group
27. Sony
28. Standard Chartered Bank
29. Stratlink Global
30. TNT Express Worldwide (K) Ltd
31. Toyota
32. Visa Inc.

33. British American Tobacco
34. Nestle Kenya
35. Weetabix East Africa Limited
36. Bata Shoe Company
37. Cadbury East Africa
38. Procter & Gamble
39. Biersdoff
40. Barclays
41. Deloitte and Touche
42. Ernest & Young
43. Samsung Electronics

Appendix 2: Secondary Data collection form

Year	FDI	Infrastructure	Legal framework	Corruption	Political stability	Market size
2011						
2012						
Average						

Appendix 3: Questionnaire

Answer these questions as truthfully as possible. There is no right or wrong answers. The responses will be kept confidential.

Section 1: General Information

1. Which Company do you work for?

   ....

2. What is your designation?

   ……………………………………………………………………………….

3. How long have you been working for the company?

   Less than 2 years ( )

   2-4 years ( )

   5-7 years ( )

   8-10 years ( )

   Over 10 years ( )

4. Which sector does your company operate in?

   Agricultural ( )

   Manufacturing ( )

   Services ( )

Section 2: Study Questions

Nature of Entity

5. When did your parent company commence operations in Kenya?

   Before 1970 ( )

   1970 - 1979 ( )

   1980 - 1989 ( )

   1990 - 1999 ( )

   2000 - 2009 ( )

   2010 – Present ( )

6. What is the main purpose of your entity in relation to the parent company?

   Sells products supplied by group ( )

   Produces/ Makes/ whole or part ( )

   Sells products same as parent ( )

   Output distribution ( )

Incentives of FDI into the country

7. What led to the parent company making the decision to invest in Kenya?

Good Infrastructure ( )

Favourable legal framework ( )

Political Stability/Economic ( )

Liberalization of the economy ( )

Cheap labour and cost of production ( )

Bilateral trade agreements ( )

Low levels of corruption ( )

The market size ( )

8. Did the government offer any assistance to the parent company during entry?

Yes ( )

No ( )

9. What form of assistance did the government offer?

Tax Breaks/Holidays ( )

Subsidies/Cash Payments ( )

Import duty concessions ( )

Reduction of land rents/Utilities ( )

Guarantee of profit and repatriation ( )

EPZ Packages ( )

Others ( )

Use the key 1-5 for the following question

1) Great Extent 2) ModerateExtent 3)Neutral

4) Low extent 5) No extent

To what extent did the following factors influence the decision to invest in the country

		1	2	3	4	5
10.	Infrastructure					
12.	Legal Framework					
13.	Corruption					
14.	Political Stability					
	Market size					