

**AN INVESTIGATION OF THE EFFECTS TAXATION ON FOREIGN DIRECT
INVESTMENT IN KENYA**

BY:

GEOFFREY TSALWA IMBAYI

**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE
REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF
SCIENCE IN FINANCE SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI**

NOVEMBER 2013

DECLARATION

This research project is my original work and has not been submitted for a degree award at the University of Nairobi or any other university.

SignatureDate

GEOFFREY TSALWA IMBAYI

REG NO: D63\76291\2012

This Research project has been submitted for presentation with my approval as University Supervisor.

Signed..... Date

SUPERVISOR:

DR. JOSIAH ADUDA

Department of Finance and Accounting,

School of Business,

University of Nairobi

DEDICATION

I give my warm dedication to my lovely wife Harriette Kadzo and my children Mark, Shanice and Mathew(Buji).

ACKNOWLEDGEMENTS

My acknowledgements go to my supervisor Dr. Josiah Aduda who has been with me throughout the research. I also thank Mr. James Ambuso who has been very supportive in the entire course, without forgetting my colleagues Mr. Ian Khisa and Mr. Jonah Rao.

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ABBREVIATIONS AND ACRONYMS

ARDL	Autoregressive Distributed Lag
EPZ	Export Processing Zones
FAO	Food and Agriculture Organisation
FDI	Foreign direct investment
FKE	Federation of Kenya Employers
GDF	Global Development Finance
GDP	Gross Domestic Product
HDI	Human Development Index
IFI	International Financial Institutions
ILO	International Labour Organization
IMF	International Monetary Fund
IMF	International Monetary Fund
MDGs	Millennium Development Goals
MNC	Multinational Corporation
OECD	Organization for Economic Co-operation and Development
OLI	Ownership-specific; Location-specific; and Internalization
PARE	Price-Adjusted Rate of Exchange
R&D	research and development
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program

US United States (of America)

WTO World Trade Organization

ABSTRACT

In recent years, the globalization process has led to the emergence of new issues. Not only have companies tended to become more mobile, but also governments have to deal with this new dimension in the design of their national tax policy. The gradual elimination of barriers to capital movements have stimulated governments to compete for FDI in global markets as well as reinforced the role of tax policy in this process. The empirical evidence on whether tax differences influence the location of FDI is reviewed by Hines (1997), but the evidence is rather mixed. The studies cited show a lack of universal agreement concerning which factors drive FDI in which countries and the nature of the relationships of taxation with FDI. The purpose of the study is to investigate the effect of taxation on foreign direct investment in Kenya. This study adopted a descriptive research design. It was a time series correlation study with the values of FDI as the dependent variable while the independent variables was taxation with exchange rates, taxes, inflation, levels of GDP rate and openness being the moderating variables. The target population composed of Investment Promotion Centre and Chamber of Commerce and industry. Secondary data involved the collection and analysis of published material and information from other sources such as the Kenya National Bureau of Statistics. The sample data for this study was for the period spanning 1992 to 2002. This study used regression analysis model in which the dependent variable was the percentage annual percentage change in FDI inflows to Kenyans. From the study findings and discussion, the study concludes that taxation affect the level of inflow and the location of foreign direct investment. The study recommends that policy planners and implementers should put in place effective mechanisms to control inflation because inflation has a direct effect on FDI inflows in Kenya. It should be established which behavioural factors affect FDI inflows into Kenya.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The globalization of economies has increased the mobility of labor and capital, accelerating the efficient and international utilization of human and capital resources. As many developed countries face aging demographics combined with declining fertility rates, it is assumed that savings rates will fall and international competition for capital is likely to become ever more intense (Hansson and Olofsdotter, 2010). Countries have recognized the importance of attracting foreign direct investment as a means of revitalizing their economies and stimulating growth. This has prompted many countries to work on developing favorable conditions to promote foreign direct investment.

Foreign direct investment (FDI) has been recognized as an important resource for economic development. Many people argue that the flows of FDI could fill the gap between desired investment and domestically mobilized finance. It also may increase tax revenues and improve management, technology, as well as labour skills in host countries (Todaro and Smith, 2003). Additionally, FDI may help the host country to break out of the vicious cycle of underdevelopment (Hayami, 2001).

Many scholars widely believe that the benefits accrued from FDI may include the acquisition of new technology, employment creation, human capital development, contribution to international trade integration, enhancing domestic investment, and increasing tax revenue generated by FDI (Jenkins and Thomas, 2002). Developing countries in Asia, Africa and Latin America have, increasingly, come to see FDI as a source of economic development, modernization, income growth and employment. This

is apparently reflected by their currently pursued economic policies, which explicitly intended to improve domestic conditions in order to attract FDI and to maximize the benefits of the presence of FDI in their domestic economies. Over the past few decades these countries have implemented broad ranging economic reforms, including the liberalization of their foreign trade and investment regimes and domestic markets and privatization of state companies, which has had an effect on the flow and nature of foreign investment (Tambunan, 2008).

Global trends in FDI flows to developing countries have increased both in quality and in quantity in the recent past. FDI flows reached \$70 billion in 1993 and nearly \$180 billion in 1999 (GDF, 2003). According to Global Development Finance report (GDF, 2003), FDI has slipped from \$179 billion in 1999 to \$143 billion in 2002, but it still remains a dominant source of financing for developing countries (Hung, 2001).

As a step in that direction, one country after another, has reduced their corporate tax rate in recent years. In January 2008, Germany reduced its corporate tax rate (federal tax and basic tax rates) from 25% to 15%, bringing down its effective corporate tax rate from about 39% to about 30%. Britain reduced its corporate tax rate from 30% to 28% in April 2008. The effective corporate tax rates of Europe's major countries currently hover around 30%. Europe's second-tier countries, including the Netherlands, Finland, and Denmark, reduced their corporate tax rates between 2005 and 2007, and their effective corporate tax rates now stand at around 25%. Czech Republic, Poland, Slovakia, Hungary, and other countries that joined the EU in 2004, reduced their corporate tax rates between 2004 and 2008, with their effective corporate tax rates now ranging around 20%. Meanwhile, in Asia too, Hong Kong, Singapore, and other countries have reduced their

corporate tax rates, adding a global dimension to the trend of reducing corporate tax rates. It is necessary to note, however, that many countries have expanded their tax bases in conjunction with reducing their corporate tax rates. Germany and Britain have broadened their tax bases, for example by revising their depreciation regulations, in order to limit the decrease in tax revenues as a result of the reduction in the corporate tax rate (Chaves, 2010).

In 1989, the Washington Consensus of the International Financial Institutions (IFIs) laid down new guidelines, with the support of the IMF and the World Bank, to help developing countries to catch up with the developed world. They drafted a list of ten recommendations, which included items like; trade liberalization, tighter fiscal policy, the privatization of government enterprises and the liberalization of inward Foreign Direct Investment (FDI). These policies were meant to reduce the involvement of governments and increase reliance on the private sector. Many developing countries have adopted at least some of these neoliberal policies, however, with debatable results (Westerberg, 2011).

Scholars like Stiglitz (1998) and Rodrik (2002) did not agree with the guidelines of the Washington Consensus and offered a different set of policies that were an antithetic. Rodrik (2006) contended that the neoliberal policies had not had success, but were still being followed mostly due to ideological reasons, contrary to empirical evidence. The International Labour Organization's (ILO) acknowledged in the World of Work Report (2008), that the gap between rich and poor countries, as well as the gap between the rich and the poor inside many countries, was expanding.

However, many defend the modern pattern of economic integration. Dollar and Kraay (2002) claim that modern globalization has decreased inequality between countries and inside countries. Zhang (2006) posits that the best way for a country to develop, is to open its economy and integrate into the world economic system.

As part of international investment flows, foreign direct investment (FDI) has gained much attention by researchers on globalization and tax competition. For Kenya and other developing countries, attracting FDI has been a key aspect of its outward-oriented development strategy, as investment is considered a crucial element for output growth and employment generation (Kayonga, 2008).

1.1.1 Foreign Direct Investment

Foreign Direct Investment (FDI) refers to investments, which are meant to be lasting and are directed towards businesses located outside the economy or country of the investor. FDI usually includes such investment types as wholly owned subsidiaries, joint ventures and mergers and acquisitions. FDI comprises of three different, namely, equity capital, reinvested earnings and other capital, which mainly consists of intra-company loans (UNCTAD, 2002).

The foreign investor should own at least 10% of ordinary shares or voting power of an enterprise. The investor has to own more than 10%, in a case where there is no effective voice in management, or own less, if still maintaining an effective voice in management (OECD, 1996). In the case of FDI, the investor has intentions to exercise control over the enterprise. Dunning (2001) stated that on top of financial assets, FDI also refers to intellectual capital and transfer of technology. This definition included technology,

knowledge, capital and financial assets, which are moved abroad. Alfaro et al. (2009) added that FDI can also foster linkages to local firms. These linkages can be very beneficial to the host economy, if the country in question is able take advantage of them.

1.1.2 Effect of Taxation on FDIs

As described above, many countries have reduced their corporate tax rates, but there are a variety of factors that influence foreign direct investment, and the effects of the corporate tax on foreign direct investment are not self-evident. As countries followed one another in reducing their corporate tax rates, in January 2008, the OECD published its report entitled “Tax Effects on Foreign Direct Investment”. As highlighted by this, the question of how much are the effects of the corporate tax on foreign direct investment is now a subject of increasing global interest (Tomonori, 2012).

Konrad and Kovenock (2009) offer a theoretical framework of competition for FDI and agglomeration economies. In the static version of their model, agglomeration forces are expected to be larger in countries that previously have received large amount of FDI. Since agglomeration economies give an opportunity to have higher taxes, deviations in tax rates across countries is then determined by differences in the stock of FDI. At the same time, the two-fold nature of FDI suggests that higher taxes deter new flows of FDI. Thus, this could be seen as a trade-off between competing for new FDI with low taxes or take advantage of agglomeration forces and tax old FDI.

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) (Eke, 2003). However, in Kenya

FDIs have performed below expectations due to the combination of various factors which attract Foreign Direct Investments (FDIs). Although many relevant investment authorities have targeted many developed countries, by extending their services, their coverage has remained minimal and much effort is needed to attract Foreign Direct Investments which at the end will contribute to sustainable development in the country.

1.1.3 FDI in Kenya

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. FDI has risen in Kenya from the 1990s due to the liberalization of the economy. It is mainly concentrated in the manufacturing sector and is mainly Greenfield in nature (Kinuthia, 2010).

Most of FDI in Kenya is export oriented and market seeking. The most important FDI determinants are market size in Kenya as well as within the region, political and economic stability in both Kenya and its neighbours and bilateral trade agreements between Kenya and other countries. The most important FDI barriers in Kenya are political and economic instability in Kenya, crime and insecurity, institutional factors such as corruption, delayed licenses and work permits among other factors (Kinuthia, 2010).

There has been high volatility to FDI flows in Kenya and the FDI has not played an important role in the Kenyan economy despite the reforms that had been undertaken and the many incentives provided to foreign investors. In the period 1997–2001, FDI was about 0.6% of GDP, a ratio that was below the African average of 1.9%. Since the 1980s, Kenya has faced declining net inflows compared with neighbouring countries like Uganda and Tanzania. While Kenya accounted for about 87% of cumulative net FDI into East Africa in the early 1980s, by 2001 that share was down to 21%, compared with 40% and 36% for Uganda and Tanzania, respectively. The country has, therefore, lost its competitiveness in attracting FDI (Ajayi, 2006).

FDI in Kenya has mainly gone into agriculture, manufacturing and services. In 2001, Kenya had about 114 multinational corporation (MNC) affiliates; many of them in both the industrial and tertiary sectors with others attracted by the natural resources especially those in agro-industry and the cement industry. The FDI flows into these sectors originated in Western Europe and the United States. On the other hand, the foreign firms located at the export processing zones (EPZs) are mainly from Sri Lanka and India, even though US firms account for 10% and UK firms for 2% of investment in EPZs (Ajayi, 2006).

In Kenya, there is a positive and strong relationship between foreign direct investment and economic growth and thus the impact of FDIs on the country's economy is strong. Since there is a positive and strong relationship between foreign direct investment and economic growth in Kenya, this study investigated and find out the factors that determine FDI in Kenya.

1.2 Statement of the Problem

In recent years, the globalization process has led to the emergence of new issues. Not only have companies tended to become more mobile, but also governments have to deal with this new dimension in the design of their national tax policy. The gradual elimination of barriers to capital movements have stimulated governments to compete for FDI in global markets as well as reinforced the role of tax policy in this process. This recent competitive trend has to be offset by the increasing pressure that governments face to harmonize their tax policies within regional (or international) agreements. A second important issue has been the recognition that tax policies of the home and host countries are interconnected and that this link influences the behavior of multinationals (Tomonori, 2012).

The empirical evidence on whether tax differences influence the location of FDI is reviewed by Hines (1997), but the evidence is rather mixed. This could quite possibly be due to the fact that any difference that tax systems (worldwide versus territorial) have on FDI arises from firms that are in an excess limitation position under the worldwide system. Firms that are in an excess credit position face the host tax rate on the margin just as under the territorial system. Thus, one might expect it to be difficult to discern any difference

Studies carried out in Kenya have shown the level of FDI to Kenya to be low, both in absolute and relative terms. There is by now also quite strong empirical support that FDI flows do respond to tax rates (De Mooij & Ederveen, 2006, Feld & Heckemeyer, 2009). Hidaka and Maeda (1994) and Maekawa (2005), Opinion is still divided over whether or not tax influences FDI, which requires further research in the future. Depending on

whether a specification of FDI in logs or levels is chosen, previous studies find negative or no effects on FDI (Davies, 2003b; Blonigen and Davies, 2004a,b; Davies, 2004). In this regard, Blonigen and Davies (2004a) indicate that empirical models of FDI should be formulated in logs rather than levels. However, based on such a specification recent research does not identify a significant impact of exogenous tax treaties on FDI (Blonigen and Davies, 2004a).

Much of the research done, for instance by, Ayanwade and Bamire (2004) and Azam (2010) found positive relationships between GDP, exchange rates, inflation and openness and FDI, and negative relationship with taxation. The studies have shown that the factors strongly determine the level of FDI inflows into a country. However, other studies have found the relationships to be of a different nature. For instance, Eke (2003) found that GDP caused FDI instead of FDI causing GDP. Another study by Osinubi and Amaghionyeodiwe (2009) did not find any significant relationship between FDI and exchange rates as posited by other researchers. Local studies done on FDI include Kinaro (2006), Ajayi (2007) and Nyamwange (2009). The studies indicate that the factors that drive FDI depend on the environment within which the study is carried.

The studies cited show a lack of universal agreement concerning which factors drive FDI in which countries and the nature of the relationships of taxation with FDI. Further, no study has been done in Kenya to determine the effect of taxation on foreign direct investment in Kenya. It is in the line of the above argument that this study intends to identify and understand the effect of taxation on foreign direct investment in Kenya.

1.3 Research Objectives

1.3.1 General Research Objective

To investigate the effect of taxation on foreign direct investment in Kenya

1.3.2 Specific Research Objectives

The specific objectives of this Study were:

- i. To establish the taxation rate on foreign businesses in Kenya
- ii. To examine the effects taxation on foreign direct investment in Kenya

1.4 Value of the Study

This research will fill up the gap that requires to be filled by providing an explanation of the relationship between foreign direct investment and taxes. Scholars will therefore find this research useful because the findings will contribute towards the discussion concerning how foreign direct investment relates to taxes. These findings will be used as reference points by future researchers.

The findings of this study will also raise international awareness to Bilateral and multilateral agencies and will make the donor community know the real situation in Kenya. This will make them follow the suggestions and examples of other donor nations who are already aware of the situation and have embarked on development projects, rather than donating fiscal cash assistance which often stand the risk of being swindled or embezzled into private bank accounts This will go a long way to drive Kenyans out of the doldrums and to improve on their living standards.

Further, the study is useful to policy makers in Kenya. Country competitiveness is not only improved by implementing economic policies that bring forward growth and stability, but also by promoting changes that will strengthen democracy, law & order, and a coherent institutional framework that is in synch with the dynamism of international trade, markets and practices. By coherent policies and institutional framework, there are many instances in which governments have to work and redouble their efforts. Areas such as political transparency, low corruption, applicability of legislation to business decisions and protection of rights, will create trust in the investor, increasing the chances of attracting FDI. The government which is interested in the welfare of Kenyans will be able to tell whether the policies that are being undertaken to promote foreign direct investment in Kenya are the right policies. The study will single out the Kenyan specific factors that explain the variability in FDI. This will provide direction to the policy makers on how to control the behaviour of FDI to the country's advantage.

The economic planners will benefit from the findings of this paper for the finding will enable them look critically at how foreign direct investment is affected by taxation and come up with better ways of handling foreign businesses in the country.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter discusses the Product Life (Vernon) Theory, the O.L.I (Electic) Paradigm, Internalization Theory, Neoclassical Theory and the Keynesian Theory of Economics. The discussion of these theories provides the theoretical literature review for this research. The second part looks at the empirical work that is related to this research and the conceptual framework.

2.2 Theoretical Literature Review

There is a large body of theoretical and empirical literature viewing taxation as an important determinant of a country's locational attractiveness for investors (Hines, 1999; Gresik, 2001; de Mooij and Ederveen, 2003). 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. Agarwal (1980), Parry (1985), Itaki (1991) can be given as examples.

2.2.1 Product Life (Vernon) Theory

International product life cycle theory explains both trade and FDI. The theory was developed by Vernon (1996) and explained why the manufacturers move from the policy of exporting to the policy of FDI. Vernon theory is more pertinent to the initial entries of

manufacturer in to foreign markets than to MNEs that have FDI already in place. UNDP (2011) emphasized the dynamic model of FDI and explains that the innovations are likely to be made in an advanced country like the US.

Vernon Theory divided the development of products in to three stages. The first stage is the new product stage. In this stage the product is introduced to the market to satisfy mainly the needs of the local consumers, though there could be some for export. In the second stage, the product is becoming mature and well known and standardization is done. There are tendencies of the firm to diversify into new markets. In the third stage, the product becomes completely standardized; foreign firms meet tough competition from local firms; and the firms start divesting in the less developed countries where costs are low. This theory is related to this study since it provides one of the motivations that lead to firms investing in other countries for strategic reasons.

2.2.2 The O.L.I (Electic) Paradigm

The OLI paradigm is combined to three different FDI theories that sum up to O+L+I. A general framework for explaining international production was offered by the eclectic paradigm. According to the paradigm there are three variables including Ownership-specific (O); Location-specific (L); and Internalization (I). OLI is the intersection of macroeconomic theory of international trade (L) and the micro economic of the firm (O and I). There are variables of Ownership advantage including tangible assets (natural main power, and capital endowment) and also intangible assets (technology and information, managerial, marketing and entrepreneurial skill and organizational systems) (Dunning, 2001).

The variables of location specific refer to market structure; government legislation and policies; and the political, legal and culture environment that have been undertaken by FDI. Finally, the internalization variable refers to inherent flexibility of the company, product capacity and market by the way of its own internal subsidiaries (Dunning, 2000).

The OLI paradigm suggests that MNEs develop competitive O advantages at home and then transfer these abroad to specific countries (depending on L advantages) through FDI, which allows the MNE to internalize the O advantages. In contrast to the eclectic paradigm, internalization theory is mainly used to explain the choice of entry mode. Using Dunning's own reasoning, it is apparent that there is a close linkage between O and I advantages in that a knowledge-type O advantage needs to be internalized. This theory is related to this study in that it singles out the environment of a country as a provider of advantages or disadvantages that can be an attraction or a discouragement to FDI. Such advantages and disadvantages make up the independent variables of this study.

2.2.3 The Internalization Theory

Internalization theory was developed by efforts of Buckley and Casson (1976), Rugman (1981), and Hennart (1982). The theory asserts that at firm-level the MNE will exert proprietary control (ownership) over an intangible, knowledge-based, firm-specific advantage. In internalization theory, all firm-specific advantages are efficiency-based. The knowledge advantage arises from a transaction cost economics explanation, whereby the public good nature of knowledge is remedied through the hierarchy of a firm overcoming this situation of market failure.

The other types of firm-specific advantages, such as brand advantage, skills in management, and organizational capabilities, are also efficiency-based and are compatible with the resource-based view and the value creation aspects. In short, internalization theory applies transaction cost economics and the resource-based view to explain the efficiency aspects of MNEs. This theory is related to this study for it provides the motivation as to why firms invest in different environments depending on how they turn the factors in an environment into profitability depending on the internal advantages in the firms. The advantages in the environment make up the independent variables of this study.

2.2.4 Neoclassical Theory

Early neoclassical theories explain international capital flows with differentiated rates of return across countries that lead to capital arbitrage, with capital seeking the highest return. Cockcroft and Riddell (1991) argue that the future investment flows are directly related to the package of incentives, which influence the expected rate of return; the security of the investment; the scope and speed with which companies are able to disinvest. The tax regime; investment code or guidelines; and overall macroeconomic policies are all elements affecting FDI.

Despite these changes, there is still need for action for improvement of factors that inhibited investment. These factors include lack of formal legislation, lack of legal infrastructure such as patents, price controls, labour legislation, taxation policy and foreign exchange controls. Cockcroft and Riddell (1991) suggest that addressing these problems would certainly help improve the foreign investment climate.

According to Meier (1994), the major supply-side determinant of FDI in developing countries is the expectation of higher returns or higher profits by firms. Developed countries will tend to invest in poorer countries that have higher rate of return (Ekpo, 1996).

2.2.5 Keynesian Theory of Economics

Development aid to least developed countries has its origin in the colonial period, although the issue of development was not important either to colonies or to the relationship between richer and poorer countries in 1950s (Riddell, 1992). This came as a result of Keynesian economics exemplified by, for instance, Rostow, Chenery, Strout and Rosentein-Rodan. Their concern was how to transform what is perceived as backward areas and unproductive societies into dynamic and growing economies (Riddell, 1992). Aid has been provided to accelerate developing economies, hence the role of outside capital is not directly to raise the standards of living but to make a transition in the economy and bring about sustainable growth (Tomonori, 2012). The economic motive was also in th self interest of the developed nations to invest in developing nations to raise their own welfare. If the rate of interest is higher than the productivity of capital in developed countries and lower in developing countries, both parties will gain. If there are under-utilised resources in developed countries, which could not be activated due to balance of payments constraints, international aid will be mutually profitable by channeling such resources to developing countries (Brandt Report, 1980)

2.3 Empirical Literature Review

Studies of the effects of taxation on FDI have generally taken the perspective that, whatever its benefits to firms are, they must be balanced against the tax consequences of carrying out FDI. The tax systems of both the firm's home country and potential host countries can affect the incentives concerning FDI as well as how to finance a given pattern of FDI. Theoretical treatments of these questions are presented in Alworth (1988) and Gersovitz (1987). The limited empirical literature on the effect of taxes on multinationals' behavior is summarized in Tomonori (2012).

Empirical study focusing on the effect of taxation on the time series of FDI in the United States was pioneered by Angelo and Lehmann (2012). Using annual data from 1965 to 1979, he estimated the response of FDI, separately for investment financed by retained earnings and transfers from abroad, to three variables: the after-tax rate of return realized by foreign investors in the United States, the overall after-tax rate of return on capital in the United States, and the tax rate on U.S. capital owned by foreigners relative to the tax rate on U.S. capital owned by U.S. investors. The first two terms are meant to proxy for the prospective return to new FDI, the first term being more appropriate for firms considering expansion of current operations and the second more applicable to the acquisition of existing assets that are not expected to earn extraordinary returns based on production of differentiated products or possession of superior technology. The relative tax term is designed to capture the possibility that tax changes that apply only to U. S . investors will, by affecting the valuation of assets, alter the foreign investor's cost and therefore the return to acquiring the asset. Hartman's regression results reveal both a positive association of after-tax rate of return variables with the ratio to U.S. GNP of FDI

financed by retained earnings and a negative association of the FDI-GNP ratio with the relative tax rate on foreigners compared to domestic residents. The model does not explain transfers from abroad as well as retained earnings, although coefficients of all three variables have the expected sign and are significantly different from zero. From this research, Hartman concludes that the effect of taxes on ϵ_{31} , both that implied by reinvestment of earnings and that accomplished by explicit transfer of funds, is quite strong.

Tomonori (2012) paper provides the insight into the effect of corporate income tax on foreign direct investment. The enhanced liquidity of labor and capital through globalization has accelerated the efficient and global utilization of human resources and capital. Considering this situation, many countries are acutely aware of the importance of attracting foreign direct investment in order to vitalize and promote economic growth. Many countries, therefore, have been providing and developing attractive environments for investments, and have lowered their corporate tax rates one after another. However, there are many elements which affect foreign direct investment and the effect of corporate tax on foreign direct investment is not necessarily apparent. Tomonori therefore empirically analyze foreign direct investment based on a panel of bilateral foreign direct investment flows among OECD 30 countries over 1985 – 2007. In this paper, Tomonori further address the dynamic panel data analysis (System GMM) through the expansion of the static panel data analysis in the previous research. This is why Tomonori recognize that the current scale of foreign direct investment may be influenced by the investment level of the previous year. Tomonori confirmed the expected result in the empirical analyses, namely, that the current scale of foreign direct investment is influenced by the

investment level of the previous period. These studies also implied that the impact of corporate tax on foreign investment is significantly negative.

Slemrod (2001) paper investigates how the tax system of the U.S. and the capital-exporting country combine to affect the flow of foreign direct investment (FDI) into the U.S. First, using aggregate data, it corroborates earlier work suggesting that the U.S. effective tax rate does influence the amount of FDI financed by transfers of funds, but not the amount financed by retained earnings. The data are then disaggregated by major capital-exporting countries to see if, as theory would suggest, FDI from countries which exempt foreign-source income from taxation is more sensitive to U.S. tax rates than FDI from countries which attempt to tax foreign-source income. The data analysis does not reveal a clear differential responsiveness between these two groups of countries, suggesting either difficulties in accurately measuring effective tax rates or the availability of financial strategies which render the home country tax system immaterial in affecting the return on FDI.

Tavares, Ângelo and Lehmann (2012) presents the fundamental elements of the conceptual background that explain how and under which circumstances taxation may be a significant factor underlying FDI decisions. Then it proceeds with an extensive review of the qualitative and quantitative literature on the topic. Finally, it draws several relevant conclusions on the main patterns that can be extracted from the evolution of the literature on this field. In this chapter Tavares, Ângelo and Lehmann arrive at three major findings concerning the effect of taxes on FDI, and Tavares, Ângelo and Lehmann uncover one interesting puzzle worthy of further research. First, from the literature review it becomes clear that both FDI and taxes are concepts covering heterogeneous phenomena, and

therefore to compare studies, results or to make judgments on the relationship between taxes and FDI, the working definitions of FDI and taxes that are being used needs to be clearly established and understood. Second, based on the review of the qualitative literature, it becomes clear that while taxes are an important aspect of FDI decisions among managers, they are probably not the main driver of the decision. Moreover, taxes may only play a 'marginal' role compared with other determinants of FDI. Third, looking carefully at the quantitative literature as a whole, there is not a straight answer that permits to unequivocally say that lower taxes increase FDI attraction. Finally, a puzzle emerges from the tension between what policy makers believe and what the studies show. The review in this chapter puts in evidence that while policy makers believe lowering taxes increases the attractiveness of their territories vis-à-vis FDI, the facts show that taxes appear only to play a marginal role compared with other determinants of FDI.

Hansson and Olofsdotter (2010) empirically analyze the impact of corporate tax rates and agglomeration economies on FDI using panel data on bilateral FDI flows and stocks in the enlarged European Union. The novelty of the paper is that it explicitly deals with agglomeration forces and how these may explain differences in tax policies between new and old member countries. The empirical analysis closely follows the implicit underlying model where the foreign direct investment decision is seen a two-step procedure: first, whether to invest or not, and second, the amount of FDI to invest. The paper makes use of recent data on corporate tax rates for all 27 EU member countries and covers the period 1995-2006. Hansson and Olofsdotter find that there are large differences in determinants of FDI going to EU15 and to the new member countries. First, tax differentials mainly seem to influence FDI flows to new members. Second, when it

comes to agglomeration economies, these appear to play a somewhat more important role for the amount of investment made within the EU15. In addition, significant differences are found between the determinants of the extensive and intensive margins of the FDI decision.

Joosung (1994) estimates empirically the degree to which the tax systems of both home and host countries affect foreign direct investment (FDI). Joosung presents evidence that tax rules significantly affect capital flow from FDI. Home country taxes in particular appear to significantly affect the behavior of FDI. By identifying the incentives associated with different tax parameters in the home and host countries, the author identifies different channels through which taxes affect FDI. The home-country statutory tax rate is claimed to measure the incentive effect of potential home-country surtaxes on new FDI; the home-country effective tax rate is shown to measure how taxes affect the substitution of investment in one country for investment in another. The host country's effective tax rate should represent either the incentives for FDI in that country or simply the amount of foreign tax payments that are creditable against the home tax liability on the FDI. The most robust of the statistical results - using data on investment in the United States by ten other countries between 1980 and 1989 - shows that the home-country statutory tax rate significantly hurts FDI when the country makes foreign-source income subject to home-country taxation. (The same variable has no significant effect on FDI from those countries that exempt foreign-source income from home-country taxation.) The author found that the coefficient of the home country's statutory and effective tax rates take the opposite sign in the estimated equations; this supports the presence of different channels through which home country tax systems influence FDI. The weak

performance of the host-country tax variable in the estimated equations suggests that the host-country tax does not affect decisions about where to invest FDI as much as is conventionally perceived. The host country tax largely represents credible foreign taxes for many investors.

Chaves (2010) examines the impact of taxes on trade in goods and foreign direct investment. The four taxes examined in this analysis are average effective tax rates which approximate actual taxes levied on consumption, labor income, combined labor and consumption, and capital income. Chaves developed a gravity model of international trade and from this model hypothesize that for all four taxes, higher rates lead to decreases in exports. In addition, Chaves hypothesize that higher taxes lead to decreases in inward FDI. In a panel analysis, Chaves estimate the effect that each of these four taxes has on bilateral trade and FDI. The hypotheses are supported in the long-run cases, indicating that all four types of taxes disrupt the flow of international trade and investment.

Also, Wolff (2007) considers how different sub-components of bilateral FDI flows react to corporate tax rates using data on the EU25 from 1994 to 2003. Although there appear to be some differences across different components of FDI, Wolff (2007) does not find any significant effect of corporate taxes on total FDI flows. On the other hand, Bellak & Leibrecht (2009) investigate FDI inflows to eight new member countries during the period 1995-2003. They find quite strong negative effects of bilateral tax differences and estimate the semi-elasticity, i.e. the percentage change in FDI in response to a one percentage point increase in the tax rate, to be about -4.3.3 The reason, they argue, is that

they use average effective as opposed to statutory corporate tax rates where the effective tax rate is considered to be a more appropriate measure of the overall tax burden.

Macro economic constraints arising from a collapse in the IMF's Structural Adjustment Program (SAPs) in 1986, massive destruction of infrastructure due to El Nino rains and weak institutions had all contributed to economic stagnation (Phillip and Obwana, 2000). Hence, although Kenya introduced a number of instruments to promote FDI and export oriented industrialization during this period, these efforts did not yield much.

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. Gachino (2006) 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.

Mahiti (2012) did a study to examine 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. Data were collected through Questionnaires, Interviews and Documentary Review. Questionnaires were open-ended questions, which allowed individuals to express their views concerning FDI in Tanzania and Kenya. Interviews were conducted on the basis of predetermined interview guide. Thus both qualitative and quantitative methods were collectively employed in the process of collecting data and information required in this research.

After Analysis of the data, tests of questionnaires were carried and presented in tables for easy interpretation. From findings, a researcher has 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. Tanzania and Kenya have been trying to attract FDI through the provision of some incentives to encourage FDI in inflow; however it is doubtful to ascertain the extent to which such initiatives will manage to attract the quality of 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.

Opolot et al (2008) find using panel data for Sub Saharan African countries, Kenya included 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. Other variables such as government consumption, financial development, natural resources, wage and political rights are found to be insignificant.

Kinaro (2006) using time series analysis finds that FDI in Kenya is determined by economic openness, taxation, human capital, real exchange, inflation, and FDI in the previous periods.

Nyamwange (2009) did a study on foreign direct investment in Kenya. The purpose of this study was to identify the key factors that influence FDI decisions in Kenya and to explore the empirical relationship between FDI and economic growth in Kenya. The findings of the study revealed that the main determinants of FDI in Kenya are market size (proxied by GDP), taxation, stable macroeconomic policies and a level of human capital that is tolerable by investors. There is no significant relationship of human capital to overall economic growth which suggests that there is a shortage of skilled labour in the Kenya

2.4 Effect of Taxation on FDIs

The relationship of the corporate tax rate on foreign direct investment is a well documented area in which much research has been done. The OECD reports that most studies have found that a 1% decrease in corporate tax leads to a 0-5% increase in FDI. There is, however, a wide variation in the findings of studies on corporate tax, which is in

part due to studies being based on aggregate FDI flows data, whereas the impact of tax on FDI is at the firm-level.

Studies using firm level datasets have primarily examined the impact of tax on US FDI overseas due to the availability of data on the operations of US subsidiaries overseas. One of the most important studies of US FDI into Europe by Devereux and Griffith (1998) found that a 1pp reduction in UK effective average corporate tax rate would increase US FDI into the UK by 1%. A more recent study by the Deutsche Bundesbank (2005) of German firm-level investment overseas finds a 1:2 ratio between tax rates and the impact on FDI, with FDI into the EU countries more sensitive to changes in the tax rate. The Deutsche Bundesbank study also found market size (using GDP as a proxy) and labour costs were the other factors having a significant impact on the location of FDI.

Gordon and Hines (2002) and de Mooji and Ederveen (2003) document a comprehensive survey of the existing research on this particular subject. The former review concludes “our findings derived from empirical analyses over the past 15 years confirm that tax influences the level and location of foreign direct investment”. Also among the existing research literature, Devereux and Freeman (1995) and Bénassy-Quéré et al. (2005) focus on two-way inbound and outbound foreign direct investment between countries. Devereux and Freeman (1995) empirically analyze foreign direct investments among seven major trading countries (1984 through 1989) and conclude that “tax has no statistically significant effect on decisions whether to invest at home or abroad, while tax influences decisions in which countries to make foreign direct investments”. Bénassy-Quéré et al. (2005) empirically analyze foreign direct investments among 11 OECD countries (1984 through 2000) and find that “a reduction of one percentage point in the

(statutory) corporate tax rate of a host country causes an increase of about 4 percent in inbound foreign direct investment in that country”.

The most recent study of the impact of corporate tax on FDI into the EU (Hansson and Olofsdotter, 2010) found that FDI in Western Europe is most strongly influenced by GDP and agglomeration (using the proxy track record of FDI) and that corporate tax has a more important impact on the amount of FDI rather than the decision to invest.

Agostini and Tulayasathien (2003) conducted a survey study in which they sought to find out the impact of state corporate taxes on FDI. The data used for the study was got from The Bureau of Economic Analysis and included FDI by state and by source country for major investing countries in the United States. These countries were Australia, Canada, France, Germany, Japan, the Netherlands, Switzerland, and the United Kingdom. The results showed that the property factor in the apportionment formula of taxes had an important impact on the effective state corporate income tax rate that investors face and, therefore, on the fraction of FDI that states received.

In another study Slemrod (1990) conducted aimed at investigating the effect of both U.S. and home country taxation on FDI in the United States. The results of the study generally supported a negative effect of U.S. effective rates of taxation on the total FDI and new transfers of funds. However, deeper and detailed analysis did not show significance responsiveness to taxation due to the sophisticated nature of the American tax system.

A study by Cummins and Hubbard (1995) examined the effects of taxation on foreign direct investment using previously unexplored panel data on outbound foreign direct investment by subsidiaries of U.S. multinational firms. The data set was constructed from

the Compustat Geographic Segment file. Approximately 6,500 companies reported information from their foreign operations, segregated by geographic segment. Both U.S. and foreign-incorporated firms report sales, operating income, and fixed assets. The study found that FDI was very sensitive to the taxation policy of the country into which the FDI flowed.

De Mooij and Ederveen (2003) provides an even more detailed discussion of the literature than that provided here and finds a median tax-elasticity of FDI of -3.3 across 25 studies. However, some of the more well-placed articles in the literature have highlighted why such a number may be quite misleading. As these papers point out, the effects of taxes on FDI can vary substantially by type of taxes, measurement of FDI activity, and tax treatment in the host and parent countries. Another important issue is that a MNE potentially faces taxes in the host and the home countries. Countries have different ways of addressing this double taxation issue, which further complicates expected effects of taxes on FDI.

The potential for these tax treatments to affect the analysis of FDI and taxation first played a large role in the literature as researchers began to examine the impact of a significant US tax reform in 1986 on inward US FDI. Scholes and Wolfson (1990) hypothesizes that US FDI from MNEs under worldwide systems would likely increase when US tax rates increased. This seemingly counterintuitive notion comes from the realization that with a credit system, for example, the MNE would not see any increase in its tax liability under a worldwide taxation system. On the other hand, the US domestic investors (and MNEs under a territorial tax system) would bear the full brunt of the added

US tax liabilities. With firms all bidding for the same assets in the US, the worldwide-tax MNEs would be advantaged and invest more.

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.

2.5 Chapter Summary

The empirical studies reviewed have shown that FDI is strongly affected by taxes. However, the relationships are not universal, but context dependent. None of the studies has shown the nature of the relationship in Kenya. This study wishes to fill this gap by analyzing the effects taxation on foreign direct investment in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the methodology that was used to conduct the study. It specifies the research design, what the target population was, how data was collected and the method of data analysis.

3.2 Research Design

This study adopted a descriptive research design. The design was chosen since it is more precise and accurate since it involves description of events in a carefully planned way. It also portrays the characteristics of a population fully (Babbie, 2002). Further, Mugenda and Mugenda (2003) opined that the descriptive research collects data in order to answer questions concerning the current status of the subject under study.

It was a time series correlation study with the values of FDI as the dependent variable while the independent variables was taxation with exchange rates, taxes, inflation, levels of GDP rate and openness being the moderating variables. Regression analysis was used to find the relationship between FDI and independent variable (taxation) since the relationship expected was linear.

3.3 Target Population

According to Ngechu (2004), a population is a well defined or set of people, services, elements, events, group of things or households that are being investigated. Further, Mugenda and Mugenda (2003) explain that the target population should have some

observable characteristics, to which the researcher intends to generalize the results of the study. The target population composed of Investment Promotion Centre and Chamber of Commerce and industry.

3.4 Sampling Procedure

Ngechu (2004) underscores the importance of selecting a representative sample through making a sampling frame. From the population frame the required number of subjects, respondents, elements or firms was selected in order to make a sample. Due to the population size of Investment Promotion Centre and Chamber of Commerce and industry, the research took a census approach. A census is where data is collected from all members of the population (Hair, Celsi, Money, Samouel, & Page, 2011).

3.5 Data collection

Secondary data involved the collection and analysis of published material and information from other sources such as the Kenya National Bureau of Statistics. The data required for this study included the corporate tax rates for foreign business; annual values of Foreign Direct Investment in Kenya at current US Dollar rates; the IMF PARE; inflation rates; levels of GDP rate, annual values of GDP, annual values of imports and exports. The sample data for this study was for the period spanning 1992 to 2002. Only the annual values for the 20 years were used for the analysis. The data was electronically collected from the Kenya National Bureau of Statistics.

3.6 Data Analysis

This study used regression analysis model in which the dependent variable was the percentage annual percentage change in FDI inflows to Kenyans. The independent variables was corporate tax rates for foreign business while the dummy variable were exchange rates, taxes, inflation, levels of GDP rate and openness. The multiple regression analysis was used to determine how each of the dependent variables relates to annual FDI rates. The regression analysis took the form below:

$$Y = \alpha + \beta_1(X_1) + \beta_2(X_2) + \beta_3(X_3) + \beta_4(X_4) + \beta_5X_4 + \epsilon$$

Where,

Y = Annual rate of change in FDI

X_1 = Corporate taxation rate on foreign businesses

X_2 = Annual rate of change in the IMF PARE

X_3 = Annual inflation rate

X_4 = Annual GDP growth rate

X_5 = Rate of openness (Openness = Imports +Exports)

α = The constant of regression

β_i = The sensitivity of FDI rate of change to the dependent variable i

ϵ = The error term.

The t – tests at 95 % confidence level was used to determine the statistical significance of the constant term, α , and the coefficient terms, β_i . The F – tests was used to determine whether the regressions is of statistical importance at 95 % confidence level.

The coefficient of determination, R^2 , and the Adjusted R^2 were used to determine how much variation in FDI rates is explained by variation in the independent variables. The analysis was done using SPSS version 21.0. The results obtained from the models were presented in tables to aid in the analysis and ease with which the inferential statistics were drawn.

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION OF FINDINGS

4.1 Introduction

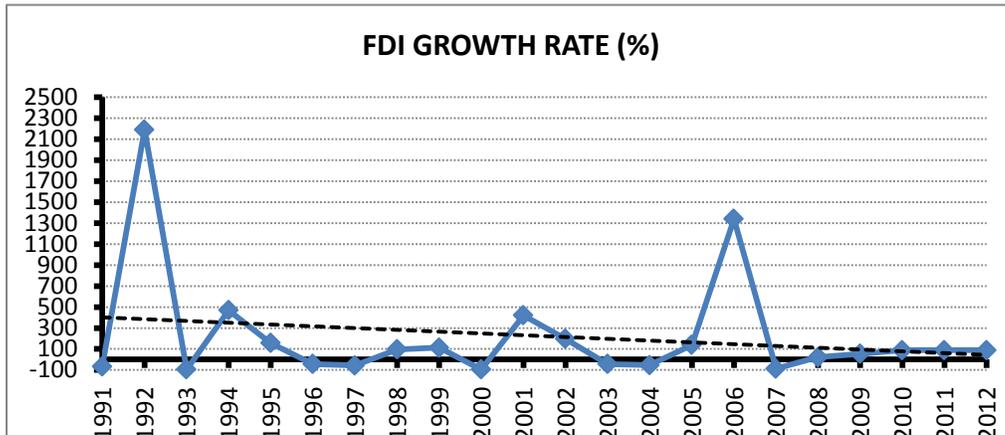
This chapter focuses on the presentation of data and interpretation. The first part presents the analysis of the data ending with the regression results. The second part of this section deals with the summary and the interpretation of the findings.

4.2 Data Presentation

4.2.1 FDI Growth Rate

Fig. 4-1 shows the values of the annual rates of change in FDI for the period covering 1991 to 2012. The highest levels of reduction in FDI were realized in 1993 (-94.00%), in 2000 (-95.22%) and in 2007 (-86.89%). The highest levels of increase in FDI were realized in 1992 (2189.05%), in 1994 (468.98%), and in 2006 (1338.67%). The average growth in FDI growth was 237.04% found as the arithmetic mean of the annual rates. As shown by the bold dotted line, the trend of the growth in FDI in Kenya has been reducing since 1991 indicating that the incremental flows of FDI into Kenya has been tending towards being stationary.

Figure 4. 1: FDI Growth Rate

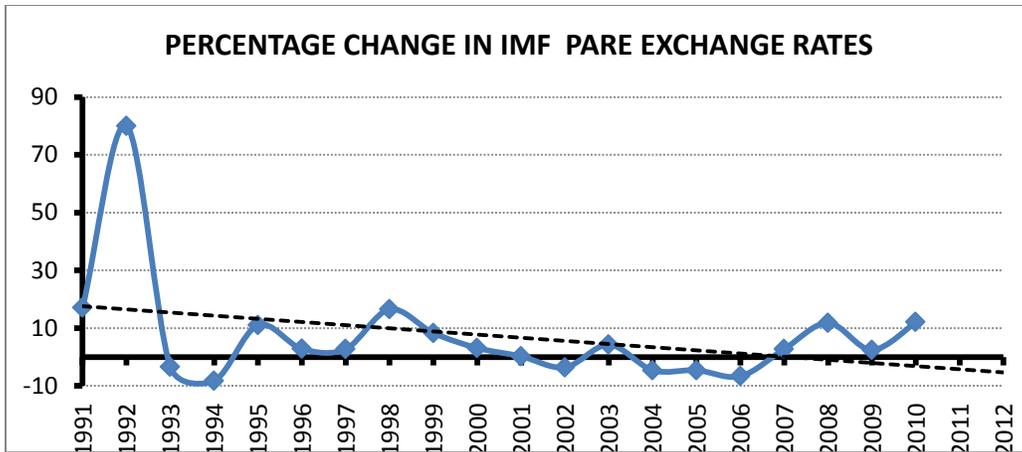


(Source: Prepared by Researcher with Data from KNBS)

4.2.2 Exchange Rates

Fig. 4-2 shows the percentage changes in the price-adjusted rate of exchange (PARE) across the period covering 1991 to 2010 according to the IMF. The mean annual exchange rate in PARE was 7.22%. The greatest drop in the PARE was in 1992 when it rose by 80.03% while the greatest drop was in 1994 when it dropped by 8.24%. The trend line showed in the figure shows a downward direction in the rates of change in the PARE.

Figure 4. 2: Percentage Changes in PARE Exchange Rates

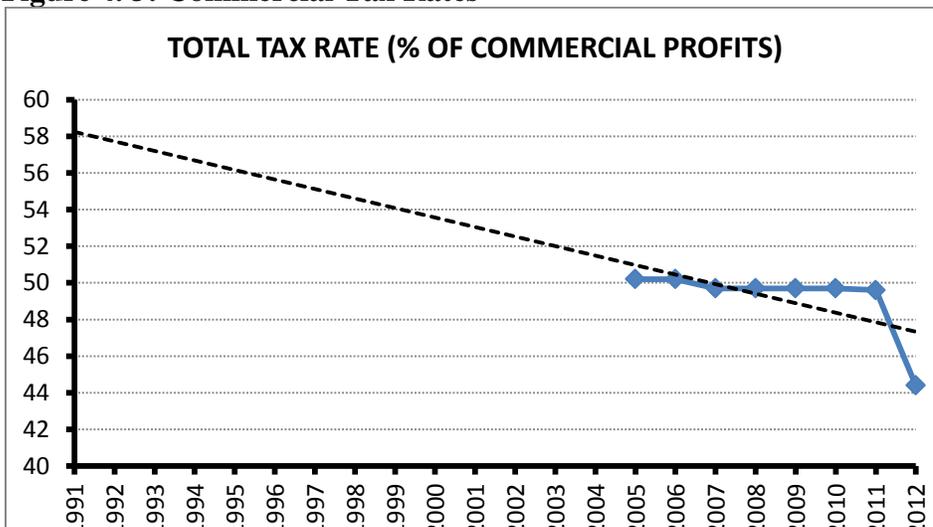


(Source: Prepared by Researcher with Data from IMF)

4.2.3 Commercial Tax Rates

Fig. 4-3 shows the various tax rates on commercial profits in Kenya from 2005 to 2012. The mean tax rate was 49.15%. The lowest tax rate was realized in 2012 at 44.40% which was a sharp drop from 49.60% the year before, while records show the highest level was realized in 2005 at 50.20%. The trend line, shown by the bold dotted line, shows that the taxation rates on commercial profits are reducing with time.

Figure 4. 3: Commercial Tax Rates

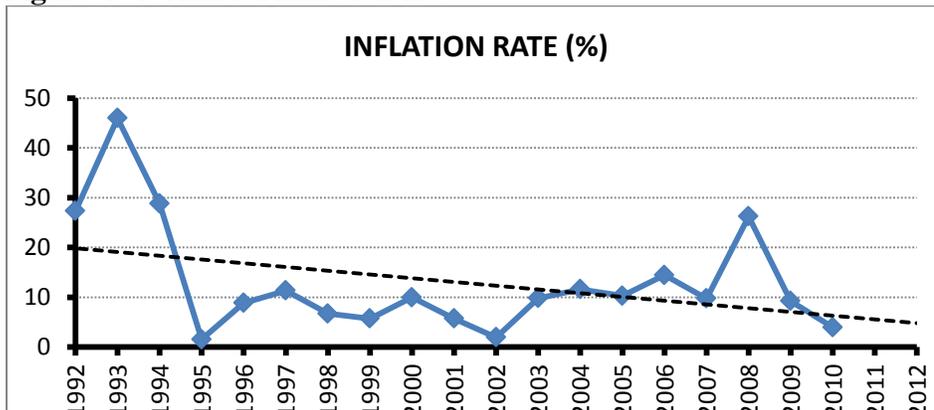


(Source: Prepared by Researcher with Data from IMF)

4.2.4 Inflation Rates

Fig 4-4 shows Kenya's annual inflation rates from 1991 to 2012. The highest levels of inflation were experienced in 1993 when the annual average hit 45.98%, in 1994 when it hit 28.81% and in 2008 when average inflation reached 26.24%. The mean inflation rate for the twenty years was 13.48%. However, as shown by the bold dotted trend line, the trend has been that the inflation rate reduced with passage of time.

Figure 4. 4: Annual Inflation Rates

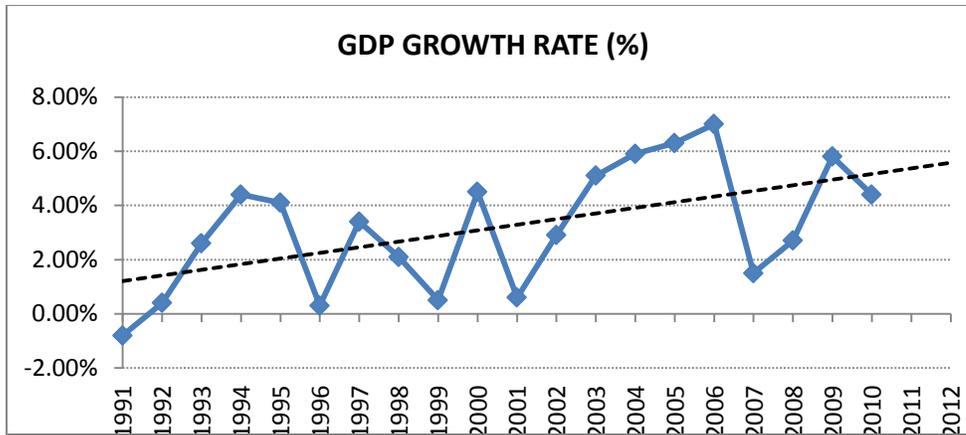


(Source: Prepared by Researcher with Data from KNBS)

4.2.5 GDP Growth Rates

Fig. 4-5 shows the annual rates of GDP growth in Kenya since 1991 to 2010. The average rate of growth for the 20 years was 3.19%. The highest level of economic growth was in 2006 when a rate of 7.00% was realized. The lowest rate for the period was -0.80% in 1991. The bold dotted trend line indicates that generally Kenya's GDP growth rate has been on the upward trend.

Figure 4. 5: GDP Growth Rates

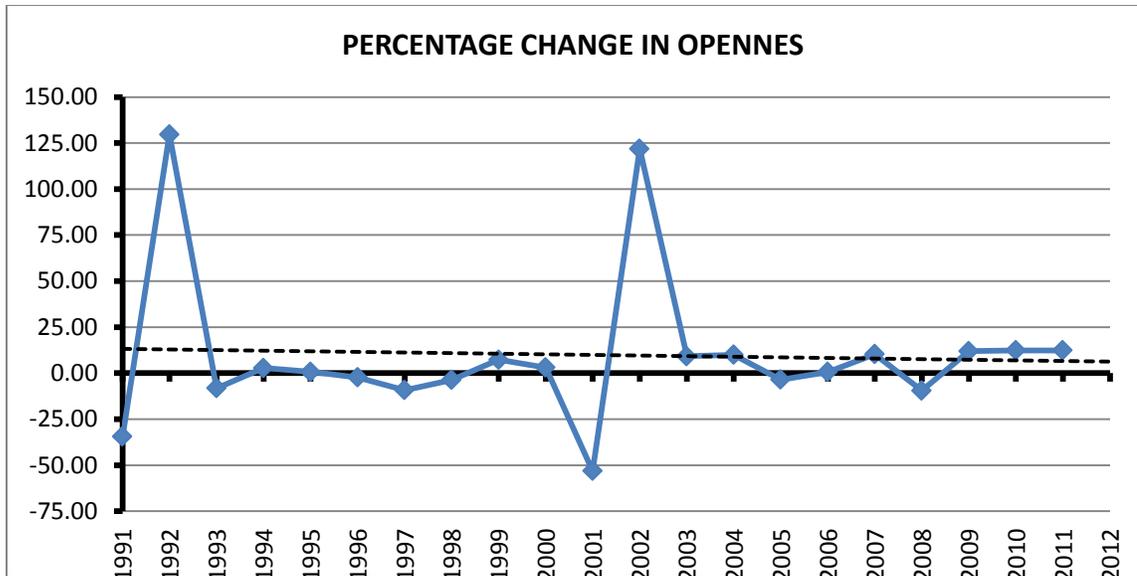


(Source: Prepared by Researcher with Data from KNBS)

4.2.6 Change in Openness

Fig 4-6 shows the changes in openness for the period 1991 to 2012. Openness was measured as the sum of exports and imports expressed as a percentage of GDP in the respective year. The percentage changes in the rates were used to prepare Fig. 4-6. The mean rate of opening up the economy was 9.92%. The highest rate of economic openness was achieved in 1992 when the Kenyan economy realized a 129.70% increase in openness. A high level of openness was also achieved in 2002 when openness hit 121.89%. The poorest rate of change in openness was recorded in 2001 when the rate fell to -53.10%. The trend line shows a gentle reduction in the rate at which the economy is being opened further.

Figure 4. 6: Change in Openness



(Source: Prepared by Researcher with Data from KNBS)

4.3 Correlation Analysis

Table 4-1 shows the correlations among the variables used for this study. There was a weak positive correlation between. FDI growth and rate of change in IMF exchange rates exchange, $r(20) = 0.09$, and between FDI growth and Openness, $r(20) = 0.24$. there was a strong positive correlation between FDI Growth and inflation, $r(20) = 0.65$ and between FDI growth and GDP growth, $r(20) = 0.53$. However, there was a weak negative correlation between FDI growth and Total tax, $r(20) = -0.05$.

The rate of change in IMF exchange rates were weakly negatively correlated to total tax rates on commercial profit, $r(20) = -0.14$, to inflation $r(20) = -0.06$ and to GDP growth, $r(20) = -0.01$. the IMF rate of change in exchange rates had a weak positive correlation with economic openness $r(20) = 0.20$.

Table 4. 1: Correlations Analysis

	FDI Growth	IMF Rates	Tax	Inflation	GDP Growth	Openness
FDI Growth	1.00					
IMF Rates	0.09	1.00				
Total Tax	-0.05	-0.14	1.00			
Inflation	0.43	-0.06	-0.43	1.00		
GDP Growth	0.17	-0.01	-0.02	0.53	1.00	
Openness	0.24	0.20	-0.16	0.15	-0.01	1.00

(p = 0.05, n = 20)

The correlation findings indicated that there was no problem of multicollinearity as $r < 0.5$ in all cases. Tax rates on commercial profit were positively correlated to inflation rate $r(20) = 0.43$, to GDP growth, $r(20) = 0.17$, and to economic openness, $r(20) = 0.24$. there was weak positive correlation between inflation rate and IMF growth rate, $r(20) = 0.09$, a weak positive correlation between inflation and economic openness, $r(20) = 0.15$. GDP growth rate had a weak negative correlation with economic openness, $r(20) = -0.01$.

4.4 Regression Analysis Results

Table 4. 2: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.905 ^a	.819	.793	.24895

The five independent variables that were studied, explain only 79.3% of the FDI in Kenya as represented by the adjusted R^2 . This therefore means that other factors not studied in this research contribute 21.7% of the FDI in Kenya. Therefore, further research should be conducted to investigate the other factors (21.7%) that affect FDI in Kenya.

Table 4. 3: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	9.831	5	1.966	12.691	0.001
	Residual	2.169	14	0.155		
	Total	12.000	19			

The significance value is 0.001 which is less than 0.05 thus the model is statistically significant in predicting how exchange rates, economic growth, Inflation, taxes and trade openness affect FDI in Kenya. The F calculated was also less than the F critical (2.958).

Table 4. 4: Regression Coefficients

	Coefficients	Standard Error	t Stat	P-value
Constant	-3264.10	3797.16	-0.86	0.040
IMF exchange Rates	60.12	75.81	0.79	0.044
Corporate Tax	-6705.75	4784.20	-1.40	0.018
Inflation	-19.31	6.95	-2.78	0.021
GDP Growth	2.66	2.71	0.98	0.034
Trade Openness	7.69	8.57	0.90	0.038

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (FDI in Kenya) that is explained by all the five independent variables.

As per the SPSS generated table above, the equation ($Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_5 + \varepsilon_i$) becomes:

$$Y = -3264.10 + 60.12(X_1) + 6705.75(X_2) + 19.31(X_3) + 2.66(X_4) + 7.69X_5$$

Table 4-2a presents the regression analysis result for the relationship between the dependent variable FDI growth and the independent variables. The intercept term was -3264.10 which was not significant, $t_{(14)} = -0.86, p > 0.05$. According to the model above, when the total tax, inflation, GDP growth and openness are held constant, a unit increase in IMF exchange Rates will increase the rate of FDI by 60.12. When other factors are held constant, a unit increase in taxation will decrease the FDI by -6705.75. The model also shows that inflation had a negative relationship with FDI such that a unit increases in inflation holding other factors constant will lead to a decrease in FDI of -19.31. The study also found that a unit increase in GDP growth will lead to a 2.66 increase in the rate of FDI flow while FDI would increase by 7.69 due to a unitary increase in trade openness.

4.5 Summary and Interpretation of Findings

The coefficient of the rate of change in the IMF exchange rates was 60.12 which was not significant, $t_{(14)} = 0.79, p > 0.05$. this shows that, though there was apposite relationship between FDI growth and rate of change in the IMF rates, the relationship was not significant. This Meant that changes in FDI inflows in Kenya were insensitive to changes in exchange rates. The finding are not in agreement with the findings of Goldberg and Klein (1998) who investigated the relationships among trade, foreign direct investment and the real exchange rate between a set of South East Asia and Latin American countries and both the United States and Japan and found that there was a

significant relationship between exchange rates and direct investment. The study, however, agrees with the findings of Osinubi and Amaghionyeodiwe (2009) which investigated the empirical evidence on the effect of exchange rate volatility on foreign direct investment (FDI) in Nigeria and found a significant positive relationship between real inward FDI and exchange rate.

The coefficient of Total tax on commercial profit was -6705.75 which was not significant, $t_{(14)} = 1.4, p > 0.05$. This indicated that there was no significant relationship between changes in FDI and Total tax on commercial profits from foreign firms. It indicated that FDI inflows in Kenya were not affected by the levels of taxation. These results are in contrast to those found by Agostini and Tulayasathien (2003) conducted a survey study in which they sought to find out The Impact of State Corporate Taxes on FD in the USA on the FDI from Australia, Canada, France, Germany, Japan, the Netherlands, Switzerland, and the United Kingdom. The results showed that corporate income tax rate that investors face affected FDI. The results support the findings of Slemrod (1990) who investigated the effect U.S. taxation on FDI in the United States and found that FDI did not show significance responsiveness to taxation.

The coefficient of inflation was -19.31 which was significant, $t_{(14)} = 2.78, p < 0.05$. the findings show that FDI inflows in Kenya were significantly and inversely sensitive to the rates of inflation. Higher rates of inflation resulted into greater the changes in the FDI inflows. The results are in agreement with the findings by Sayek (1999) who found a significant relationship between FDI and inflation in Canada and Turkey concerning FDI from the USA. However, the finding differ with the Sayek (1999) study because, whereas this study finds a positive relationship Sayek found a negative relationship. The findings

of this study agree with the findings of Gul, Sajid, Afzal, Khan and Mughal (2012) who conducted a study to establish the relationship between FDI and consumer price index in Pakistan for the period 1990-2008 and found that there was an insignificant relationship between inflation and FDI.

The coefficient of GDP growth was 2.66 which was not statistically significant $t_{(14)} = 0.98, p > 0.05$. These results indicate that economic growth was not a significant determinant of the FDI inflows into the country for the period of study. FDI inflows were not significantly sensitive to the economic growth rate of the country. These findings are in disagreement with those of Obadan (1992) in Nigeria who discovered a positive and statistically significant relationship between economic growth and FDI inflows for the period 1973-1990. The results also contrast with the findings of Campos and Kinoshita (2002) who studied the effects of FDI on growth for 25 Central and Eastern Europe and former Soviet Union transition economies covering the period 1990-1998 and found that FDI had a significant and positive relationship with economic the economic growth of each of the studied countries.

The coefficient of openness was 7.69 which was not significant, $t_{(14)} = 0.90, p > 0.05$. the results indicate that there was a positive relationship between changes in FDI and changes in the degree of openness of the country, though the relationship was not significant. This shows that the inflow of FDI was not significantly sensitive to the changes in the amounts of imports and exports for the period of this study. The findings of this study agree with the findings of Ghosh (2007) who conducted a similar study in developing countries for the period 1970-1997 and found that trade openness was positively correlated with FDI but trade openness did not have explanatory power for.

The findings seem not to agree with Liargovas and Skandalis (2011) who found that trade openness had a long term positive significant contribution to the inflow of FDI in developing economies.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter is organized into five parts; the summary of findings, conclusions of the study, recommendations for policy and practice and suggestions for further research.

5.2 Summary

Studies carried out in Kenya have shown the level of FDI to Kenya to be low, both in absolute and relative terms. Opinion is still divided over whether or not tax influences FDI, which requires further research. This study sought to investigate the effect of taxation on foreign direct investment in Kenya. This study adopted a descriptive research design. It was a time series correlation study with the values of FDI as the dependent variable while the independent variables was taxation with exchange rates, taxes, inflation, levels of GDP rate and openness being the moderating variables. The target population composed of Investment Promotion Centre and Chamber of Commerce and industry. Secondary data involved the collection and analysis of published material and information from other sources such as the Kenya National Bureau of Statistics. The sample data for this study was for the period spanning 1992 to 2002. This study used regression analysis model in which the dependent variable was the percentage annual percentage change in FDI inflows to Kenyans. From the study findings and discussion, the study concludes that taxation affect the level of inflow and the location of foreign direct investment. The study recommends that policy planners and implementers should put in place effective mechanisms to control inflation because inflation has a direct effect

on FDI inflows in Kenya. It should be established which behavioural factors affect FDI inflows into Kenya.

5.3 Conclusions

From the study findings and discussion, the study concludes that taxation affect the level of inflow and the location of foreign direct investment. On the study objective, the correlation analysis revealed a weak negative correlation between taxes and FDI growth in Kenya. Further, the negative relationship revealed by the regression analysis was not statistically significant. The conclusion is that taxes on commercial profit had a negative affect FDI inflow for the period of this study. However, there are many elements which affect foreign direct investment and the effect of corporate tax on foreign direct investment is not necessarily apparent. Consequently, the national and local governments wishing to attract corporations and people now find it more difficult than ever to impose a burden on income, which serves as an incentive to attract them.

5.4 Recommendations for Policy and Practice

Policy planners and implementers should put in place effective mechanisms to control inflation because inflation has a direct effect on FDI inflows in Kenya. The other factors like economic openness, taxes, economic growth and exchange rates can be improved since their improvement positively affects FDI inflows though they do not have a direct effect.

It should be established which behavioural factors affect FDI inflows into Kenya. These could be the factors that directly affect investment since investment is a behavioural issue. Combining the behavioural factors and the financial factor will provide excellent

input for planning the strategies to attract FDI for the support aimed at achieving the Kenyan vision 2030.

5.5 Limitations of the Study

The strength of this research lies in its time limit. The scope of this research was for the 20 years ending and including the year 2012. It is not known whether the results would hold if a longer period would have been researched upon. Further it is not possible to tell whether the same findings will hold for the period after 2012.

The findings of the research provide more concerning the effect of exchange rates, tax, inflation, economic growth and economic openness on FDI. This, however, does not provide enough evidence that can be used to make universal arguments concerning the effect of exchange rates, tax, inflation, economic growth and economic openness on FDI.

The quality of the data may be a weakness of this study. It is not possible to tell from this research whether the results are simply due to the nature and quality of data used or whether it is the true picture of the situation. Actually the use of the data from the various sources like the KNBS and UNDS is based on the assumption that the data are accurately captured.

5.6 Suggestions for Further Research

There is a need to answer the question of whether the findings of this research can be made universal across time in Kenya. Kenya has been receiving FDI since pre-independence times to date, yet the period of study is only a short 20 years. This may make the finding not to be assumed universal, but, a research can be done to determine

the nature of the effect of exchange rates, tax, inflation, economic growth and economic openness on FDI for longer periods of time.

There are very many countries in the world that receive FDI in different forms and quantity. This study has covered only one country. A research can be conducted to consolidate and reconcile all the findings on factors affecting FDI in the various markets of the world in order to tell what the situation is and come up with a universal result.

This study focused on the empirical historical data only. FDI is also affected by non empirical factors within the investors and the countries where the investment is to be done. There is need to complement the findings of this research using a qualitative approach to find out the current behavioural issues affecting FDI.

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APPENDICES

Appendix I: Annual Rates of Inflation

YEAR	AVERAGE INFLATION RATE
1991	20.08
1992	27.33
1993	45.98
1994	28.81
1995	1.55
1996	8.86
1997	11.36
1998	6.72
1999	5.74
2000	9.98
2001	5.74
2002	1.96
2003	9.82
2004	11.62
2005	10.31
2006	14.45
2007	9.76
2008	26.24
2009	9.23
2010	3.96

Appendix II: Trade Openness

YEA R	EXPORTS (MILLION US \$ CURRENT)	IMPORTS (MILLION US \$ CURRENT)	OPENNES (Exports + Imports) Million dollars	PERCENTAGE CHANGE IN OPENNES (%)
1991	1108	1935	3043	-34.38
1992	133	1841	1974	129.70
1993	1374	1774	3148	-8.18
1994	1587	2091	3678	2.78
1995	1878	2991	4869	0.68
1996	2067	2949	5016	-2.36
1997	2053	3279	5332	-9.22
1998	2008	3197	5205	-3.66
1999	1747	2832	4579	7.31
2000	1734	3105	4839	3.04
2001	1944	3192	5136	-53.10
2002	2116	324	2440	121.89
2003	2411	3725	6136	9.22
2004	2684	4553	7237	9.97
2005	3420	5846	9266	-3.53
2006	3502	7233	10735	0.60
2007	4081	8989	13070	10.32
2008	5001	11128	16129	-9.47
2009	4463	10202	14665	11.93
2010	5169	12093	17262	12.42
2011	5756	14782	20538	12.42
2012	6127	16290	22417	12.42

Appendix III: Percentage Changes in annual Exchange Averages

YEAR	IMF RATE	PERCENTAGE CHANGE IN IMF RATES
1991	27.5079	17.11836
1992	32.2168	80.03433
1993	58.0013	-3.3632
1994	56.0506	-8.24398
1995	51.4298	11.0541
1996	57.1149	2.83096
1997	58.7318	2.783671
1998	60.3667	16.49833
1999	70.3262	8.317384
2000	76.1755	3.134472
2001	78.5632	0.236625
2002	78.7491	-3.57274
2003	75.9356	4.264535
2004	79.1739	-4.57196
2005	75.5541	-4.57063
2006	72.1008	-6.63405
2007	67.3176	2.759605
2008	69.1753	11.82026
2009	77.352	2.431999
2010	79.2332	12.08786
2011	88.8108	

Appendix IV: Annual Economic Growth Rates

YEAR	GDP GROWTH RATE
1991	1.40%
1992	-0.80%
1993	0.40%
1994	2.60%
1995	4.40%
1996	4.10%
1997	0.30%
1998	3.40%
1999	2.10%
2000	0.50%
2001	4.50%
2002	0.60%
2003	2.90%
2004	5.10%
2005	5.90%
2006	6.30%
2007	7.00%
2008	1.50%
2009	2.70%
2010	5.80%
2011	4.40%

Appendix V: Foreign Direct Investment

YEAR	FDI (CURRENT US \$)	ANNUAL CHANGE RATE
1991	18,830,976.84	-66.2092
1992	6,363,133.14	2189.053
1993	145,655,517.11	-94.8973
1994	7,432,412.60	468.9841
1995	42,289,248.46	156.9753
1996	108,672,931.62	-42.859
1997	62,096,809.78	-57.247
1998	26,548,245.97	95.6945
1999	51,953,455.95	113.4691
2000	110,904,550.40	-95.2188
2001	5,302,622.94	420.845
2002	27,618,447.06	195.9552
2003	81,738,242.64	-43.6446
2004	46,063,931.45	-53.9516
2005	21,211,685.40	138.9
2006	50,674,725.18	1338.674
2007	729,044,146.04	-86.8889
2008	95,585,680.23	21.6266
2009	116,257,608.99	53.16383
2010	178,064,606.75	88.27429
2011	335,249,880.28	