# THE EFFECT OF FOREIGN DIRECT INVESTMENTS ON ECONOMIC GROWTH IN KENYA

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# DECLARATION

I declare that 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.

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## DEDICATION

This research project is dedicated to my parents, Stanley Kimotho and Esther Kimotho, who have unwaveringly supported me during the time I developed this paper and in my academic journey. I salute the efforts of my sibling Mary Ruth and John for their compassionate moral and material support in my entire journey in the course.

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# LIST OF ABBREVIATIONS

FDI        -            Foreign Direct Investment

GDP       -            Gross Domestic Product

ICT        -            Information Communication Technology

IMF       -            International Monetary Fund

KNBS -            Kenya National Bureau of Statistics

LDCs  -            Least Developed Countries

MDGs -            Millennium Development Goals

MNCs -            Multinational Companies

SPSS    -            Statistical Package for Social Sciences

UNCTAD-            United Nations Conference on Trade and Development

VAR    -            Vector Auto Regression

# ABSTRACT

The general benefits of foreign direct investment (FDI) for emerging economies are well documented. Given the appropriate host-country policies and a basic level of development, various studies show that FDI results in technology spillovers, enables human capital formation, improves international trade integration, helps create a more competitive business environment and improves enterprise development. All of these result in higher economic growth, which is a crucial tool for alleviating poverty in developing countries. This study explores the impact of foreign direct investment on the Kenyan economy using FDI and GDP inflow data series from 2005 to 2014. The Statistical Package for Social Sciences was used to analyse the data where descriptive analyses, frequencies and trend analysis, as well as inferential analyses involving Analysis of Variance (ANOVA) and Correlation analysis to establish relationships between the variables. Graphical trend analysis of FDI and GDP reveals a direct positive relationship between the two variables. The Pearson correlation was computed for GDP and FDI inflow data series resulting in a correlation coefficient of 0.937 at the 0.01 (2 tailed) significance level which indicates a strong positive correlation between the variables; this in turn means that there is a significant direct proportional relationship between foreign direct investment and economic growth in Kenya. These findings have led to the conclusion that the impact of foreign direct investment on the Kenyan economy is a positive one. As such, we can say that FDI promotes economic growth and suggest that the Kenyan government embrace policies that aim to attract more foreign direct investment while micro-managing the same to avoid the negative impacts of FDI on local firms such as crowding out. Policies such as opening up of the economy by engaging in more bilateral and multilateral trade agreements, improving the quality of infrastructure by way of channeling more resources to its development especially in marginalized regions of the country in the backdrop of the discovery of oil and water in Turkana, and demonstrating more political will in the fight against corruption so as to instill more confidence on foreign investors. These policies may enhance the attraction of FDI thereby increasing economic growth.

# CHAPTER ONE

# INTRODUCTION

## 1.1 Background of the Study

Many Less Developed Countries (LDCs) particularly in Africa, South America and part of Asia are now giving preference to the potential of Foreign Direct Investments (FDI) in their economies in a bid to pursue growth and development. In many countries, it is evident that FDI provides additional amount of external resources that can contribute to their economic performance. FDI is important in the sense that it contributes to capacity building through transfer of technology that is, external firms train local personnel on how to handle specific tasks regarding their operations. The foreign investments have an industrial effect of improving the general production levels and promoting competitiveness of host country products in the international market and they supposedly assist in transfer of cost effective technology. FDI is believed to close the technological gap which is high in the LDCs through direct and indirect technical transfer (World Development Report, 2013). Foreign direct investment has been argued to play a key role in accelerating growth in LDCs. Kenya intend to pursue growth in its ICT, manufacturing and energy sector through FDI.

In the LDCs, rising corporate profits and high commodity prices due to increased effective demand have helped boost inflows. Between years 2013and 2014, Kenya registered highest FDI. This is due to favourable macroeconomic policies adopted by Kenya and increased foreign investor confidence. In 2014, Kenya FDI was 97.8billion, a 95 percent increase from 49.9 billion in 2013. In 2014, total FDI inflows in East Africa stood at 672 billion an 11% increase Kenya attracting more inflows while Africa as a whole attracted total FDI inflow of at 5.3 Trillion a decrease in

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North Africa offset by an increase in FDI inflow in sub Saharan Africa (UNCTAD world investment report 2015).

In 2006, FDI to the LDCs amounted to US$281 billion, from US$235 billion in 2005, owing to reduced restriction on foreign ownership and privatization in the banking and telecommunication sectors. However, sub-Saharan Africa only absorbed 4 percent of global FDI. This is lower than it used to be in the 1970s and early 1980s, even though in the last three years. It has once more surpassed the regions share in global GDP and exports (Africa development indicators, 2006). The pace of technological change in the economy depends on the innovative and social capabilities of the host country together with absorptive capacity of other enterprises (Carkovic and Levine, 2002).

### 1.1.1 Foreign Direct Investments

Foreign direct investment are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor (World Bank, 2013). It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments.

Foreign direct investment (FDI) plays an important role in economic growth. The growth of international production is driven by economic and technological forces. It is also driven by the ongoing liberalization of foreign direct investments and trade policies. Globalization offers an unprecedented opportunity for developing countries to achieve faster economic growth through trade and investment. It is accomplished through opening up of the local economic sector as well as domestic capital for foreign investors to establish business, within the economy. Historically,

technological advancement led to the emergence of better means of transport and communication. These in turn led to the movement of investors beyond political boundaries, especially during the post-colonial period (Pritchard, 1996).

Even after nations acquired independence, globalization continued to influence trade between investors and foreign countries, whereby the less developed countries were supported by the developed nations to acquire materials and equipment to extract and utilize the available natural resources for economic development (Sacerdoti, 1997). However, the equipment needed the appropriate skills to ensure that less developed countries were able to utilize to their full potential. As economies expanded, trade grew and exchange of goods and services continued to advance. With the less developed economies possessing plenty of raw materials for industries abroad, foreign investment was inevitable, as industries from developed economies sought to establish in the less developed countries where raw materials were available (Sornarajah, 2004).

FDI is defined as a cross-border investment in which a resident in one economy (the direct investor) acquires a lasting interest in an enterprise in another economy (the direct investment enterprise). The lasting interest implies a long-term relationship between the direct investor and the direct investment enterprise and usually gives the direct investor an effective voice, or the potential for an effective voice, in the management of the direct investment enterprise. By convention, a direct investment is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad (Sacerdoti, 1997).

FDI is accounted as a form of direct investment that offers a unique form of capital inflow in that, unlike commercial lending, it has other spillover effect that includes

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transfer of technology and management skill, both of which can enhance productivity of the capital transferred. Direct investment also shares in both the risks and the rewards associated with the project financed hence FDI is the best form of financing in developing countries. (World Bank, 2011)

Once FDI is established incremental FDI (inflows) can take the form of injections of additional equity capital, reinvestment of earnings not distributed as dividends by subsidiaries or associated enterprises and undistributed branch profits, and various intercompany claims, such as the extension of suppliers' credits or loans, all of which represent FDI capital. These transactions cover only one aspect of financing available to direct investment enterprises that can also expand their operations by borrowing in local markets and in international capital markets, with or without the guarantee of direct investors (World Bank, 2002).

### 1.1.2 Economic Growth

Shearer (1961) defines Economic growth is an increase in the production and consumption of goods and services. Its measures entail increasing population and/or per capita consumption and an increasing gross domestic product (GDP). Economic growth literally refers to an economy that is expanding in size.

Economic growth leads to economic development, it is a process whereby an economy's real national income as well as per capita income increases over a long period of time. Here, the process implies the impact of certain forces which operate over a long period and embody changes in dynamic elements. It contains changes in resource supplies, in the rate of capital formation, in demographic composition, in technology, skills and efficiency, in institutional and organizational set-up. It also implies respective changes in the structure of demand for goods, in the level and

pattern of income distribution, in size and composition of population, in consumption habits and living standards, and in the pattern of social relationships and religious dogmas, ideas and institutions. Economic growth can be measured in nominal terms, which include inflation, or in real terms, which are adjusted for inflation.

### 1.1.3 Effect of Foreign Direct Investments on Economic Growth

The empirical literature finds mixed evidence on the existence of positive productivity externalities in the host country generated by foreign multinational companies. We propose a mechanism that emphasizes the role of local financial markets in enabling foreign direct investments (FDI) to promote growth through backward linkages, shedding light on this empirical ambiguity. In a small open economy, final goods production is carried out by foreign and domestic firms, which compete for skilled labor, unskilled labor, and intermediate products. To operate a firm in the intermediate goods sector, entrepreneurs must develop a new variety of intermediate good, a task that requires upfront capital investments. The more developed the local financial markets, the easier it is for credit constrained entrepreneurs to start their own firms (Alfaro, Laura, Areendam Chanda, 2010).

The increase in the number of varieties of intermediate goods leads to positive spillovers to the final goods sector. As a result financial markets allow the backward linkages between foreign and domestic firms to turn into FDI spillovers. Our calibration exercises indicate that a) holding the extent of foreign presence constant, financially well-developed economies experience growth rates that are almost twice those of economies with poor financial markets, b) increases in the share of FDI or the relative productivity of the foreign firm leads to higher additional growth in financially developed economies compared to those observed in financially under-

developed ones, and c) other local conditions such as market structure and human capital are also important to generate a positive effect of FDI on economic growth (Alfaro, Laura, Areendam Chanda,2010).

**1.1.4 Foreign Direct Investments and Economic Growth in Kenya**

East Africa has seen the level of FDI fall considerably over the recent years compared to North Africa. The region attracts the lowest FDI compared to other sub regions in Africa. In Kenya, a survey by Ngugi and Nyangoro (2008) cited market size and low economic growth as a major factor that would explain the entry of horizontal FDI in the market. Considering the GDP growth level and investments rates, Kenya has performed poorly in terms of GDP growth but its on recovery. The rate of GDP growth is higher in Uganda and Tanzania than Kenya. This would, therefore, act as a disincentive for market-seeking FDI in Kenya. Considering the population size, Kenya has a larger market and the GDP per capita indicates that the purchasing power is also higher in Kenya. In her attempt to accelerate growth and development, the country has encouraged foreign direct investments through the introduction of policy incentives and more openness of the economy. According to the 2002 Organization of Economic Commission for Development (OECD) report, foreign direct investments elicits technology spillovers, creates a more competitive business environment, enhances business development and contributes to international trade integration all of which contribute to economic growth.

Least developed countries have put in place competitive incentives for FDI attractions. Blomstrom and Kokko (2009) indicate the various incentives that can be put in place such as tax holidays, lower taxes and market monopolies. This is based on the perception that FDI not only provides capital for domestic investments, but

also creates employment opportunities, managerial skills and technology transfers, all of which contribute to economic growth and development.

## 1.2 Research Problem

Foreign direct investment has been argued to play a key role in accelerating growth in developing countries. Over the past two decades, world savings as a proportion of world income has fallen. As a result real interest rate has declined and inflation rate has risen in the world. It is against this background that foreign direct investment (FDI) has appeared increasingly attractive to developing countries facing declining domestic investment and higher costs of foreign borrowing. The government of Kenya therefore has been putting up incentives to ensure that foreign companies are attracted to the country in an attempt to increase the investments in the country and improve the level of economic growth in the country (Musau, 2011).

Kenya as a country is faced by challenges in developing its infant manufacturing sector has potential in developing its energy sector (geothermal power, wind energy) that is not fully taped and development of our infrastructure that includes roads, railway and airports. These challenges can be addressed by FDI to achieve the desired double digit economic growth. According to Gachino, (2009) A sound industrial policy is necessary for economic growth and development; such a policy should encompass FDI policies (promotion and entrenchment) targeted at sectors where MNC presence would be advantageous to the country's industrialization effort. The impact of FDI on economic growth and, therefore, poverty reduction is not clear in Africa. Indeed, even managers of African investment promotion agencies do not fully understand how and why foreign investors make the choices they do (Ikiara, 2003).

Empirical literature finds mixed evidence on the existence of positive spill-over effects of FDI for a host country. Yet, according to the mainstream economics positive direct and spill-over effects of FDI are taken as granted. Most studies on FDI have been concerned with how to attract FDI and not with the consequences of FDI. The benefits of FDI are considered to be confirmed by actual development which ignores inconclusive academic literature (Lipsey, 2006), positive externalities have remained to be publicized by international financial organizations, and FDI has stayed the pillar of the development strategies of most developing countries. Indeed, to attract FDI, developing countries have been willing to use various forms of subsidies: tax vacations, adaptations of the legal system, or even direct financial assistance to multinationals by which they have replaced contemptible sales of the assets in the period of speedy, often ideologically and politically inspired privatizations during which, the "family silver" in most of these countries was sold. In a decade, foreign ownership of productive assets has become major and in some sectors (financial services, telecommunications, retail trade) predominant or even exclusive type of ownership in developing countries.

To promote FDI, it is important to investigate its effects in Kenya's economic growth particularly in this global liberalization era. This paper, therefore, undertakes a study to establish the contribution of FDI on economic growth and possibly get information that can be used to reevaluate policies to promote foreign direct investment thus spearhead economic growth. What is likely to be more critical in the future is the distinctive combination of location advantages, especially the created assets that Kenya can offer potential investors (Nyamwange, 2009).

Previous Studies related to the effect of foreign direct investments and economic performance in general in Kenya include, Nyamwange (2009) who carried out a study on the foreign direct investment in Kenya, Voorpijl (2011), the gains and losses of foreign direct investment in Kenya, Musau (2011) the impact of foreign direct investments (FDIs) on economic growth and development in Kenya. These studies found that foreign direct investments affect the balance of payments of a country by injecting much needed capital in the economy. This shows that most of these studies focused on economic development of the country as whole. There is therefore a literature gap as far as the relationship between foreign direct investments and the balance of payments in Kenya is concerned hence the need for this particular study. This study therefore seeks to answer the following question: What is the effect of foreign direct investments on economic growth in Kenya?

## 1.3 Objective of the Study

To determine the effect of foreign direct investments on economic growth in Kenya.

## 1.4 Value of the Study

The value of this study is attributed to positive contribution of FDI to economic growth. Foreign direct investments do not only add capital or additional resources, it leads transfers of cost effective technology, encourages local innovation and invention and provides accessibility to foreign market. The study will show the relationship between FDI and economic growth and suggest the way forward. The transfer of technology shall be considered effective depending on available human capital, efficient macro the economic policies and free, open and competitive market.

Other studies consider FDI effects on economic growth to be very weak, for example, Alfaro et al. (2003) argued that FDI lead to economic growth in economies with developed financial markets only, that is, in first world countries. The essence of this study is to empirically determine effects of FDI and other control variables; openness to trade, human capital, government expenditure and private investments on economic growth of Kenya. To promote FDI the government should ensure there is macroeconomic stability.

**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 effects of foreign direct investments on the economic development of a country. Secondly, the empirical review of the studies that have been done on the effects of foreign direct investments on the economic development of a country is made. The research gap is then provided.

## 2.2 Theoretical Literature Review

This study will be guided by four main theories. These theories are Neoclassical Theory, Vernon Product Life Cycle Theory, Keynesian Theory of Economics and Industrial Organization and Internalization Theories. These are presented below

### 2.2.1 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 neoclassical theory, FDI influences income growth by increasing the amount of capital per person. It spurs long-run growth through such variables as research and development (R&D) and human capital. Through technology transfer to their affiliates and technological spillovers to unaffiliated firms in the host economy, MNCs can speed up the development of new intermediate product varieties, raise product quality, facilitate international collaboration on R&D, and introduce new forms of human capital (Ikiara, 2003).

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).

### 2.2.2 Vernon Product Life Cycle Theory

International Vernon's Product Cycle suggests that firms undertake FDI at particular stages in the life cycle of products they have innovated, Vernon (1966). theory of the product cycle puts less emphasis on the factor-proportion theory of comparative advantage and more on the timing of innovation, the effects of scale economies, and the roles of ignorance and uncertainty in influencing trade patterns, Vernon (1966) contends that a large gap exists between the knowledge of scientific principles and the application of these principles in the generation of new, marketable products. If all entrepreneurs, wherever located, were equally conscious of and equally responsive to all entrepreneurial opportunities, wherever they arose, the classical view of the dominant role of price in resource allocation might be highly relevant. There is good

reason to believe, however, that the entrepreneur's consciousness of and responsiveness to opportunity are a function of ease of communication, and further, that ease of communication is a function of geographical proximity. Accordingly, Vernon argues that we may have to abandon the notion that knowledge is a universal free good, and instead introduce it as an independent variable in the decision to trade or to invest. One immediate implication arises: producers in any market are more likely to be aware of the possibility of introducing new products in that market than producers located elsewhere would be.

The product cycle of Vernon represents the process of an advanced country developing and exporting a particular good, losing the export market share to other countries who imitate the innovation, and then ending up as a net importer of the product. The essence of the theory is the assumption that diffusion of new technology occurs slowly enough to generate temporary differences between countries in available production technology. Vernon's hypothesis is relevant only to innovation in certain kinds of products, namely to those associated with high income and those which substitute capital for labour. His hypothesis says nothing about industrial innovation in general. Indeed, a good deal of trade may arise because of transitory advantages resulting from innovation that would normally generate a substantial amount of rent.

The neo-mercantilists argue that trade policy can raise national income by securing for a country a larger share of the rent yielding industries at other countries' expense. For instance, certain high technology sectors may generate not only a large amount of rent but also large technological spillovers. In this case, the government intervention and promotion of these sectors may raise the national income.

In order to maximize production flexibility and to minimize uncertainty regarding the dimensions of the market in the early stages of a product's lifecycle, US firms develop innovations for and introduce them to the large high-income domestic market but eventually set up foreign production facilities in other advanced economies to defend their (real or imagined) monopolistic advantage, derived from the innovational lead, and finally, as the production techniques become standardized and products become more price sensitive, firms turn to the low-cost LDCs to maximize profits (and appease local governments). Therefore, the relation between outward FDI and trade is a function of the nature of the product and the development status of a divergent location and ownership advantages favoring FDI.

In summary Vernon (1971), analyzed FDI based on the product; initially a product is invented in the home country of a foreign investor with comparative advantage in technology and innovatory capabilities and produced for the home market in the home near to both its investors and markets. At a later stage of the product cycle, because of a favorable combination of innovation and product advantages offered by the home country, the product is exported to other countries most similar to the home country in demand capabilities. Gradually, as the product becomes standardized or mature and labour becomes a more important ingredient of production cost, the attraction of locating value activities in a foreign, rather than in a domestic location increases. FDI therefore is, regarded as a natural stage in the life cycle of the product.

### 2.2.3 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 (Bhagwadti and Eckaus, 1970).The economic motive was also in the 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-utilized 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).

## 2.2.4 Industrial Organization and Internalization Theories

These theories assume that foreign companies have oligopolistic power in the host countries (Cockcroft and Riddell, 1991; Meier, 1994). It holds micro and macroeconomic factors responsible for the real life deviations from the perfect market model. According to this approach, firms choose and investment location because of its comparative advantage.

Meier (1994) contributes to this theory by arguing that FDI may also be taken to gain control over inputs thus creating a barrier of entry to new competitors. According to internalization theory, firms keep operations internal through a hundred percent subsidiary because they want to control the risk and retain control and market share. Multinationals engage in FDI to secure internalization advantages. Compared with

external markets, the firm's linkages, integration, transfer pricing and economies of centralization allow costs to be reduced through FDI (Meier, 1994).

## 2.3 Determinant of Economic Growth

In Kenya studies have been done on FDI determinants. Kinaro (2009) using time series analysis finds that FDI in Kenya is determined by economic openness, human capital, real exchange rate, inflation, and FDI in the previous periods. 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 investments positively affect foreign direct investments inflows to Sub-Saharan Africa, while macroeconomic instability is a disincentive to foreign direct investments. Other variables such as government consumption, financial development, natural resources, wage and political rights are found to be insignificant. 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.

## 2.3.1 Foreign Direct Investments

Moosa (2002), Moosa and Çardak (2006) survey the theories of FDI, identifying the implied explanatory variables in the process, as well as variables that cannot be readily related to any of these theories which may be classified under "theories based on other factors" as shown in Appendix 1. These are market size (GDP or per capita GDP) as a market size hypothesis, wages as a location hypothesis, trade barriers as other factor, growth rate as a differential rates of return, trade deficit as other factor, exchange rate, currency areas hypothesis, tax as other factor, cost of capital as a location hypothesis etc… Moreover, UNCTAD (2002) classifies the determinants

variables of inward FDI, According to IMF (2003), investors underscore that the motivators for investing in EMCs and the determinants of investment locations differ among countries and across the economic sectors. They concur, however, that certain general factors consistently determine which countries attract the most FDI.

### 2.3.2 Government Expenditure

Economic growth must be sustained for a developing economy to break the circle of poverty. Countries usually pursue fiscal policy to achieve accelerated economic growth. Tanzi (1994) observes that fiscal policy applies to the use of fiscal instruments (taxation and spending) to influence the working of the economic system in order to maximize economic welfare with the overriding objective of promoting long-term growth of the economy.

According to Suleiman (2009) observes that the size of Government and its impact on economic growth has emerged as a major fiscal management issue facing economies in transition. He notes that previous research focused predominantly on size of Government in industrialized countries, but given the openness of most Developing Countries (DCs), trade dependency, the vulnerability to external shocks, and volatility of finances, the role and size of Government become germane to adjustment and stabilization programmes. Mitchell (2005) has argued that a large and growing government is not conducive to better economic performance.

### 2.4 Empirical Review

Empirical review covers the evidence from a few studies addressing the impact of FDI on economic growth in Kenya and internationally.

## 2.4.1 Global Evidence

Blomstrom et al. (1998) found that FDI exerts a positive effect on economic growth but there seems to be a threshold level of income above which FDI has extra effect on economic growth. The explanation to this was countries that have reached certain level of threshold income can absorb technologies and benefit from technology diffusion. In another study by, De Mello (1999) and Borensztein et al. (1998) they found that the interaction of FDI and human capital had important effect on economic growth; this explains differences in technological absorptive ability.

De Gregorio (2003) in his contribution on FDI, he noted that FDI may allow a country to bring technologies and knowledge that are not readily available to domestic investors hence increase productivity growth throughout the economy. FDI may also bring expertise that the country does not possess and foreign investors may have access to global markets. De Gregorio found out that increasing aggregate investments by 1 percent point of GDP increased economic growth of Latin America by 0.1 to 0.2 percent a year, but increasing FDI by same amount increased growth by approximately 0.6 percent a year.

Foreign direct investments has a significant positive impact on economic growth of developing countries but that the magnitude of the impact is also dependent on the conditions in and characteristics of the host country Bengoa and Sanchez-Robes (2003). In a similar study, Johnson (2005), using panel data found that foreign direct investments enhance economic growth in developing countries but not in developed countries.

Furthermore, Li and Liu (2005) examines whether FDI affects the economic growth of the host economy. The study utilize data from 84 countries over the period 1970 to 1999 and employ single as well as simultaneous equation techniques in order to test the relationship between FDI and economic growth. In order to achieve the desired result endogeneity is tested using the Durbin-Wu-Hausman (DWH) test, and result show for the sample as whole endogeneity is not significant but when the period is split, 1985 to 1999 show a significant relationship between FDI and Gross Domestic Product (GDP). Further, Phillips Perron (PP) was employed to test for stationary of the variables and the variables were found to be stationary. The study suggests a strong complimentary connection between FDI and economic growth.

In a survey by Ilhan (2007) of over 50 empirical investigations on the relationship between FDI and economic growth, 40 of such studies have showed a positive relationship with only 2 reporting negative and the rest demonstrating no effect. These empirical evidences point to the fact that most FDI's are associated to growth. Furthermore, Lumbila (2005) test a hypothesis whether FDI has an overall effect on economic growth and the results revealed a statistically significant difference that a 10 percent increase in FDI can bring about 0.34 percent growth. In another study, Feridun and Sissoko (2006) examines the relationship between FDI and economic growth for the period 1976 to 2002 in Singapore using Granger causality and vector auto regression (VAR). Their findings revealed a unidirectional causation running from FDI to economic growth.

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 investments positively affect foreign direct investments inflows to Sub-

Saharan Africa, while macroeconomic instability is a disincentive to foreign direct investments. Other variables such as government consumption, financial development, natural resources, wage and political rights are found to be insignificant.

Pradhan, (2009), study the relationship between foreign direct investment (FDI) and economic growth in the five ASEAN countries namely: Indonesia, Malaysia, Philippines, Singapore and Thailand results reports evidence of positive relationship between FDI and economic growth at both panel and individual level for the countries though with exemption of Indonesia, Malaysia and Philippines at individual level. However, when Granger causality test was done and results show evidence of bidirectional causality both at individual and panel level with exception of Malaysia.

Agrawal and Khan, (2011) investigated the impact of FDI on GDP Growth and report that "FDI promotes economic growth, and further provides an estimate that one dollar of FDI adds about 7 dollars to the GDP of each of the five countries". Similarly, Rabiei and Masoudi (2012) examine FDI growth nexus in D8 countries namely; Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan and Turkey. Results shows FDI have positive effect on growth in D8.

**2.4.2 Local Evidence**

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. Other variables such as government consumption, financial development, natural resources, wage and political rights are found to be insignificant. In his conclusions he states that FDI affects economic growth positively if there is a positive increase in the FDI inflows.

Gachino, (2008) after land resettlement between 1962 and 1964, the Kenyan government prevented foreign firms from purchasing more land and as a result foreign ownership in agriculture was greatly reduced. In commerce and industry by contrast, virtually all the expansion which took place, that is a 50 percent increase in output between 1964 and 1970 and 100 percent increase in the annual level of investments, was foreign owned. At first much of it involved capital transfer out of agriculture, especially following the introduction of exchange controls in 1965. But two years later after the initial period of uncertainty as to the government development strategy, a substantial inflow of foreign direct investments and its diversification to other sectors occurred.

Nyamwange (2009) did a study on foreign direct investments 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

Njeru (2013) did a study on the impact of foreign direct investment on economic growth in Kenya. The purpose of this study was to establish the relationship between Foreign Direct Investment and economic growth in Kenya. In his study he concludes that with constant and positive growth in FDI in Kenya between 1982 and 2012 there was a positive growth in economic growth in the country.

## 2.5 Summary of the Literature Review

The empirical review above has shown the relationship between foreign direct investment and economic development of a country. But these studies were done in different environments and hence the results may not be generalized to Kenya specifically. There is therefore a gap in literature as regards the foreign direct investment and the economic growth.

There is also a variety of theoretical models explaining FDI thus the criteria for judging the success of FDI by host governments from a confrontational approach and to a cooperative approach between host countries and foreign investors. More particularly emphasis in evaluating inbound Multinational Corporations have switched from the direct contribution of foreign affiliates in economic growth and development to a wider role of the upgrading of the competitiveness of host countries' indigenous capabilities and the promotion of their dynamic comparative advantage (Anyanwu, 1998; World Bank, 2012). In the final analysis, the empirical literature on determinants of FDI is still young enough that most hypotheses are still open for further study.

# CHAPTER THREE

# RESEARCH METHODOLOGY

## 3.1 Introduction

This chapter presents the methodology that will be used to conduct the study. It specifies the research design, how data will be collected and the methods of how data shall be analyzed. The study is based on the neoclassical new growth theory also known as endogenous growth theory.

## 3.2 Research Design

Research design is a plan and structure of investigation that is convinced to obtain answers to research questions (Robson, 2002). The method to be used in the research will be descriptive research. According to Mugenda and Mugenda (2003) descriptive research design is a scientific method which involves observing and describing the behavior of a subject without influencing it in any way. It addresses what are the characteristics of the population or situation being studied (Shields, Patricia and Rangarjan, 2013).

## 3.3 Population

Population is the set of all the individual of interest in a particular study (UN, 2009). This study is to determine the effect of FDI inflow on the Kenya's economic growth, GDP. The population shall be the entire economic performance data from 2005 to 2014. The population consists of the actual FDI inflow value, GDP, Government expenditure, BOP value and private investment. Changes in these variables is continuous, the population is too large. The study shall sample data from 2005 to 2014 a total of 10 years observations were made for each of the five variables.

The sampling technique employed in this study was a non-probabilistic sampling. This is because the study did not involve random selection. The researcher studied the variable under the study using the most recent data available from Kenya.

## 3.4 Data Collection

The method of data collection will be from secondary data. Secondary data will be collected and analysis done from published material. Data on gross domestic product shall be collected from Kenya National Bureau of Statistics, the other control variables; FDI, Government expenditure, Interest rate, Exchange rate shall be collected both from Kenya bureau of statics and world bank library. The period of study shall be from the year 2005 to 2014.

## 3.5 Data Analysis

The research shall analyzed econometrically using regression analysis. In trying to understand the relationship between the dependent and the independent variables regression analysis using ordinary least squares analysis (OLS) will be done. The research shall use the Statistical Package for the Social Sciences (SPSS 21.0). The data shall be tested for serial correlation, multicollinearity and heteroscedasticity.

A regression model shall be used in the study to analyze the effect of FDI on growth. The literature reviewed has shown linearity between the dependent and independent variables therefore linear model was chosen for this study. The basis of the research model is the Augmented Cobb-Douglas production function with FDI incorporated as one of the factor inputs; which takes the form:-

Log GDP Growth = $f$ (FDI, GE, OP, PI,)

Mathematically, the linear model showing the relationship between the dependent variable and the independent variables will be formulated as follows

$$\Delta \text{GDP} = \beta 0 + \beta_1 \text{FDIt} + \beta_2 \text{GE}_t + \beta_3 \text{OPt} + \beta_4 \text{PI}_t + e$$

GDP = Change in Gross Domestic Product in Kenya in a year

FDI = Change in Foreign Direct Investments inflow in Kenya in a year

GE =Change in Government expenditure in Kenya in a year

OP =Change in Balance Openness to trade in Kenya in a year.

PI = Change in private investments in Kenya in a year.

$\beta o$ = constant

$\beta_1$, $\beta_2$, $\beta_3$, $\beta_4$, $\beta_5$= coefficients of independent variables.

### 3.5.1 Operationalization of the variables

**Gross Domestic Product:** It shall be obtained as a gross output of all finished goods and services in the entire economy. GDP is normally used because it is a good measure of development in an economy. The data will be collected from Kenya National Bureau of Statistics, statistical quarterly abstracts for period 2005 to 2014.

**Government Expenditure:** It is expected to bear a direct relationship with economic growth. An increase in government expenditure translates to provision of more social capital hence encourage economic growth. Government spends money in development of infrastructure which reduces operating costs thereby promoting FDI (Wheeler and Moody 1992). Infrastructure increases the productivity of investments thereby enhancing economic growth. Further, Governments undertake critical human

development in such areas as education and training that are direct inputs to growth through the promotion of technology and skills development. This, in the long-run, encourages deepening of the value added content of production. The data will be collected from Kenya National Bureau of Statistics, statistical abstracts for period 2005 to 2014.

**Foreign Direct Investments:** It is expected to shows the net inflows of foreign investments in the country. If FDI is channeled into productive use it can lead to economic growth. The data will be collected from Kenya National Bureau of Statistics, statistical abstracts for period 2005 to 2014.

**Host nation Openness to trade:** This is the difference in countries exports against its imports. The variable measures the openness of the country to international trade. A low value of this variable may signal high tariff barriers or transportation costs, which would attract horizontal FDI; while a high value will indicate openness to trade, which the literature suggests should be attractive to foreign investors (Caves, 1996) because it is a sign of international competitiveness. The data will be collected from Kenya National Bureau of Statistics, statistical abstracts for period 2005 to 2014.

**Private Investments**

It shows the net amount of money invested by private businessmen in the country. It shows contribution of private sector in a country economic growth. An autonomous and developed private sector impacts positively to economic growth. The data will be collected from Kenya National Bureau of Statistics, statistical abstracts for period 2005 to 2014.

**3.5.2 Test of Significance**

The test of significance to be used in the proposal is the $R^2$ test. The coefficient of determination, denoted as $R^2$ will be used to indicate how well data fit into the statistical model. F-statistics (also known as fixation indices) will be used to test the expected level of heteroscedasticity in the target population. Analysis of variance (ANOVA) will be used in the analysis of experimental data to test the variables for statistical significance.

# CHAPTER FOUR

# DATA ANALYSIS, RESULTS AND DISCUSSION

## 4.1 Introduction

The Statistical Package for the Social Sciences (SPSS 21.0). Statistical Package for Social Sciences (SPSS) Version 0 computer package was used for data analysis. The raw data obtained from the World Bank's World Development Indicators and cross-checked with figures from the Kenya National Bureau of Statistics library on their Economic Surveys for the various years were entered into a data matrix with two dimensions. The number of years under consideration, 2005 – 2014, were entered in the columns and the number of variables entered into rows. The valid varied analyses, frequencies and correlations between the variables were then executed using the analyze option on the software to give an assortment of output which are presented in the subsequent subheadings below.

## 4.2 Data Presentation

Shows GDP – per capita (PPP) and FDI inflow data series from 2005 to 2014 as well as for the other variables: openness of host nation to trade, government expenditure and private investments.

## 4.2.1 Descriptive Statistics

This shows the statistically the mean, standard deviation, minimum and maximum of the dependent and the independent variables per quarter for over the 10 year period, as represented in table 4.1 below.

**Table 4.1: Summary Statistics**

| Descriptive Statistics | | | | | |
|---|---|---|---|---|---|
| | N | Mean | Std. Deviation | Minimum | Maximum |
| FDI | 40 | 87,048.05 | 11,735.37 | 69,333.63 | 105,384.31 |
| GDP | 40 | 3,694,933.80 | 3,175,748.22 | 466,120.00 | 8,874,250.00 |
| Government expenditure | 40 | 168,698.74 | 81,366.92 | 54,150.00 | 304,150.00 |
| Openness to trade- | 40 | 341,926.20 | 22,957.52 | 61,869.55 | 119,885.72 |
| Private investments | 40 | 190,031.53 | 26,851.03 | 71,755.20 | 341,703.00 |

**Table 4.2: Descriptive Statistics**

| | N | Mean | Std. Deviation | Minimum | Maximum |
|---|---|---|---|---|---|
| GDP - Millions of KSh | 40 | 3,694,933.80 | 3,175,748.22 | 466,120.00 | 8,874,250.00 |
| FDI – Millions of KSh | 40 | 87,048.05 | 11,735.37 | 69,333.63 | 105,384.31 |

**Source: Research Findings**

Table 4.2: Shows that GDP figures fluctuate between a high of KES 8,874,250 (million) in 2014 quarter 2 and a low of KES 466,120.00 (million) in 2006 quarter 4. On the other hand, FDI for the time span ranges between a maximum of KES 421,537 (million) to a minimum of KES 277,335 (million) with a mean of KES 105,384.31 (million) quarterly for the 10 years. The standard deviation for both GDP and FDI are

high at 3,175,748.22 and 11,735.37 respectively implying disbursements of FDI that fluctuate sporadically for the duration as observed from the data.

## 4.2.2 Inferential Statistics

Inferential statistics is concerned about making predictions or inferences about a population from observations and analyses of a sample. Correlation analyses were conducted on the data to establish relationships between the variables; analyses were done first between GDP and FDI then between GDP and all the other variables (FDI, private investments, government expenditure and openness to trade

### 4.2.2.1: Correlations

**Table 4.3: Correlation analyses between GDP and FDI**

| | | GDP – Millions of KSh | FDI - Millions of KSh |
|---|---|---|---|
| GDP | Pearson Correlation | 1 | .937$^{**}$ |
| | Sig. (2-tailed) | | .000 |
| | N | 10 | 10 |
| FDI | Pearson Correlation | .937$^{**}$ | 1 |
| | Sig. (2-tailed) | .000 | |
| | N | 40 | 40 |

**. Correlation is significant at the 0.01 level (2-tailed).

**Source: Research Findings**

The Pearson Correlation was computed for GDP and FDI inflow data series resulting in a correlation coefficient of 0.937 at the 0.01 (2-tailed) significance level which indicates a strong positive correlation between the variables this means that there is a

significant relationship between foreign direct investment and economic growth in Kenya.

**Table 4.4: Correlation Coefficients for the variables**

| | | GDP – Millions of KSh | FDI - Millions of KSh | Government expenditure- Millions of KSh | Openess to trade- Millions of KSh | Pivate investments -Millions of Ksh |
|---|---|---|---|---|---|---|
| GDP – Millions of KSh | Pearson Correlation | 1 | .937** | .965** | .898** | .950** |
| | Sig. (2-tailed) | | 0 | 0 | 0 | 0 |
| | N | 40 | 40 | 40 | 40 | 40 |
| FDI - Millions of KSh | Pearson Correlation | .937** | 1 | .932** | .975** | .931** |
| | Sig. (2-tailed) | 0 | | 0 | 0 | 0 |
| | N | 40 | 40 | 40 | 40 | 40 |
| Government expenditure- Millions of KSh | Pearson Correlation | .965** | .932** | 1 | .919** | .900** |
| | Sig. (2-tailed) | 0 | 0 | | 0 | 0 |
| | N | 40 | 40 | 40 | 40 | 40 |
| Openess to trade- Millions of KSh | Pearson Correlation | .898** | .975** | .919** | 1 | .852** |
| | Sig. (2-tailed) | 0 | 0 | 0 | | 0.002 |
| | N | 40 | 40 | 40 | 40 | 40 |
| Pivate investments - Millions of Ksh | Pearson Correlation | .950** | .931** | .900** | .852** | 1 |
| | Sig. (2-tailed) | 0 | 0 | 0 | 0.002 | |
| | N | 40 | 40 | 40 | 40 | 40 |

**. Correlation is significant at the 0.01 level (2-tailed).

**Source: Research Findings**

From the table 4.4 above, it's evident that GDP has a strong positive correlation with FDI, openness of host nation to trade, government expenditure, private investments

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and human capital. Likewise, FDI has a strong correlation with openness of host nation to trade, government expenditure and private investments. This implies that an increase in foreign direct investment impacts positively on economic growth, more indebtedness to private establishments. Using the results of the correlation analysis, the link between Economic Growth and FDI can then be described in linear form as:-

$$GDP_t = \alpha + 0.937FDI_t + 0.965\ \Delta GE_t + 0.898\ \Delta OP_t + 0.950\Delta PI_t + \varepsilon_t$$

### 4.2.2.2: Model summary

**Table 4.5: Model summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | Change Statistics | | | | |
|-------|-----|----------|-------------------|----------------------------|-------------------|----------|-----|-----|----------------|
| | | | | | R Square Change | F Change | df1 | df2 | Sig. F Change |
| 1 | .994[a] | 0.988 | 0.979 | 0.1857162 | 0.988 | 104.018 | 4 | 5 | 0 |

a. Predictors: (Constant),  Private investments,  Openness to trade,  Government expenditure, FDI

b. Dependent Variable: GDP

**Source: Research Findings**

In order to explain the percentage of variation in the dependent variable economic growth is explained by the independent variables. The researcher used coefficient of determination (R Square) that is obtained from the model summary above.

From the results of the analysis, the findings show that the independent variables (Foreign direct investment, openness to trade, private investment and Government expenditure.) contributed to 98.8% of the variation in economic growth as explained by adjusted $R^2$ of 97.9% while 1.2% is explained by other variables outside the model and the error term.

#### 4.2.2.3 Analysis of Variance

**Table 4.6: Anova**

ANOVA[a]

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 0.633 | 4 | 0.58 | 7.22018 | .000[b] |
| | Residual | 0.586 | 5 | 0.25 | | |
| | Total | 1.210 | 9 | | | |

a. Dependent Variable: GDP

b. Predictors: (Constant), Pivate investments, Openess to trade, Government expenditure, FDI

**Source: Research Findings**

From table 4.6 above, F value of 7.22 is significant at 95% confidence level. This is because the P value is less than 0.05. The result means that foreign direct investment, openness to trade, private investment and Government expenditure predict economic growth

#### 4.3 Interpretation of the Findings

This study explores the impact of foreign direct investment on the Kenyan economy using FDI and GDP inflow data series from 2005 to 2014. Descriptive statistics were tabulated to give a brief summary of the variables under consideration. The data was then subjected to various inferential analyses to establish relationships between the variables such as Analysis of Variance (ANOVA) and Correlation analysis. On the basis of our findings, empirical results reveal a positive and statistically significant

relationship between FDI and GDP Growth. Correlation analyses resulted in a correlation coefficient of 0.937 at the 0.01 (2- tailed) significance level. Thus, it can be stated that the impact of foreign direct investment on economic growth in Kenya is a strong positive one. Correlation analyses between FDI and the other variables such as private investments, government expenditure, and openness of host nation to trade also revealed a direct proportional relationship.

This result is also in agreement with the findings in earlier studies primarily on the direct positive relationship between FDI and GDP. In this regard, in a survey by Ilhan (2007) of over 50 empirical investigations on the relationship between FDI and economic growth, 40 of such studies have showed a positive relationship with only 2 reporting negative and the rest demonstrating no effect. These empirical evidences point to the fact that most FDIs are associated to growth. Furthermore, Lumbila (2005) test a hypothesis whether FDI has an overall effect on economic growth and the results revealed a statistically significant difference that a 10 percent increase in FDI can bring about 0.34 percent growth. In another study, Feridun and Sissoko (2006) examines the relationship between FDI and economic growth for the period 1976 to 2002 in Singapore using Granger causality and vector auto regression (VAR). Their findings revealed a unidirectional causation running from FDI to economic growth. It also concurs with the findings of Esso (2010) who reports in his investigation of ten sub-Saharan African countries on the relationship between FDI and economic growth, a positive and significant growth in Angola, Cote d'Ivoire, Kenya, Liberia, Senegal and South Africa.

Nonetheless, in contrast to our findings, Aitken and Harrison, and Carkovick and Levine argue that there is no significant positive relation between FDI and economic

growth. Even when the relation is positive, the effects tend to be weak. Rodrick for example argues that much of the correlation between FDI and economic growth is driven by reverse causation. Few studies such as Salz, find a negative relationship between FDI and economic growth. De Mello (1997) surveys the developments in the literature on impact of foreign direct investment (FDI) on growth in developing countries. He asserts that FDI is thought of as a composite bundle of capital stocks, know-how, and technology, and that its impact on growth is manifold and vary a great deal between technologically advanced and developing countries. He concluded that the ultimate impact of FDI on growth in recipient economy depends on the scope of efficiency spillovers to domestic firms. Lahiri and Ono (1998) in their investigation on foreign direct investment (FDI), local content requirement and profit taxation in developing countries posited that host countries must strike a balance between costs and benefits of FDI in formulating appropriate policies. The efficiency level of domestic firms must play a role and that a host country should make use of non-tax instruments such as specification on local content of inputs to enhance FDI benefits.

Moreover, further empirical evidence on the cons of FDI posits that foreign direct investment does not come devoid of some negative aspects. There is normally the tendency for over utilization of the available natural resources, as the companies strive to maximize profits in their venture (Colen et al. 2009). The 'tragedy of the commons' whereby many organizations compete to utilize a shared resource leads to degradation of natural resources as well as environmental pollution, which have largely been associated with the issue of climate change (Sindre, 2011). Importation of capital intensive and outdated technology, Exploitation of local labour, Increase in local wage cost through payment of high wages by MNC affiliates.

Contribution to economic leakage (and deterioration of balance of payments) through preference of imported inputs to local ones, Lack of linkages with local communities, that is, development of 'enclaves', Adverse effects on competition in the national market, Use of transfer prices to escape local taxes and to cheat local partners on returns, Encouragement of corruption, Pollution of the environment, especially in extractive and heavy industries, Social disruptions associated with accelerated commercialization and creation of tastes for expensive foreign consumer goods and Political dependency on FDI source countries and, therefore, loss of sovereignty.

Empirical results reveal a direct proportional relationship between foreign direct investment and economic growth. These findings imply that FDI promotes economic growth and suggest that the Kenyan government embrace policies that aim to attract more foreign direct investment while micro-managing the same to avoid the negative impacts of FDI on local firms such as crowding out, use of transfer prices to escape local taxes and contribution to economic leakage through preference of imported inputs to local ones. The results also emphasize the need for the government to weed out deep rooted vices such as corruption, reinforce security especially in the wake of terror attacks. We also need to channel investment into infrastructure and generally create an enabling environment to competitively garner more FDI funds to integral facets of our economy. Finally, recent developments in the mining sector notably titanium mining in the coast region and even more recently discovery of oil reserves in northern Kenya; projects which foreign affiliates are in the bidding for contracts, policies should be crafted to control the repatriation of profits from Kenya. Rather, a bulk of these funds should be reinvested in more needy sectors especially towards human development as growth in the GDP would be immaterial if the same doesn't reflect positively on the population.

# CHAPTER FIVE

## SUMMARY, CONCLUSION AND RECOMMENDATIONS

### 5.1 Summary

The first chapter explores the background of this study by elaborating on what FDI entails, its impacts both positive and negative and various definitions. The second chapter goes into the theories I place regarding FDI and economic growth. The chapter then elaborates on the findings by other researchers on the subject. Chapter three details the research method to be applied in this study. The next part explains the research design. Based on the research questions, the methodology uses a quantitative research design that helps to identify the numerical characteristics of the effects of FDI on economic growth in Kenya. The chapter also details how data analysis will be performed. The target population has been explained as well as the sampling procedure. The survey instruments have been explained as well as validation and reliability check for the findings. The next chapter offers a detailed report of the findings in the case study.

Findings of the study show that there is a strong and significant positive relationship between foreign direct investment and economic growth in Kenya. This positive relationship means that there is a direct proportionate relationship between foreign direct investment and economic growth. The results show that other factors also played a role; in particular, the relationship between FDI and human capital is positive indicating a direct proportional association between the two variables. This means that more foreign direct investment leads to higher levels of enrollment in tertiary institutions and thus a higher level of human capital.

Based on the above, we need to enhance more foreign direct investment in order to promote economic growth. Policy implications of these findings are that FDI is a prerequisite for economic growth in Kenya. The results also emphasize the need to invest in human development since growth in the GDP would be immaterial if the same doesn't reflect positively on the populace by translating to improved living standards which is in line with the vision 2030 that aims to transform Kenya into a newly industrializing, middle-income country providing a high quality of life to all its citizens by 2030 in a clean and secure environment.

**5.2 Conclusion**

Economic theories hold that FDI has the potential to be an important component of a nation's development strategy. FDI contributes to development in three major ways (Jacobs, 2001). First of all, capital inflows such as FDI enable countries to import more than they export, which enables them to invest more than they save and thus accumulate capital faster, boosting labor productivity and wages. FDI has the potential to absorb some of the surplus literate labor in the rural and urban informal sectors (Jacobs, 2001). Employment creation in industries with good productivity growth prospects is an important aspect of poverty alleviation strategies, which is good for local entrepreneurs (Watkins, 1998). Thirdly, FDI can transfer technology and expertise, stimulating the productivity of locally owned firms (Jacobs, 2001). This can occur through training, competition and emulation within industries where foreign firms are present, and through "forward and backward linkages" with other industries (for example, foreign firms providing domestic enterprises with both inputs and output markets under more favorable terms than imports and exports). In the backdrop of our finding a direct proportional relationship between FDI and economic growth, the government should strive to attract more FDI but exercise strict rules and

regulations regarding foreign investment and make every effort to micro-manage FDI, favoring it in some industries with targeted subsidies while forestalling it in other industries through legislation.

It's imperative that policies that promote economic growth be given adequate attention in order increase economic growth so as to attract FDI, this is because it is established in the literature that most factors that increase economic growth also attract FDI. It is also observed from the trend of FDI in the literature that some countries attract higher FDI than others. Kenya has comparatively low levels of FDI and as such needs to improve its business environment by ensuring that administrative procedure, legal and judiciary system are improved so as to ensure property right, fight corruption and respect rule of law and due processes. All of these will see higher levels of much needed FDI channeled into the country.

In a nutshell, foreign direct investment that is channeled into the country ought to be well utilized towards the projects for which it's targeted considering recent horror stories of the mismanagement of funds meant for free primary and secondary education. In this regard, relevant bodies and authorities should vigilantly prosecute those in positions of leadership who don't walk the talk.

## 5.3 Policy Recommendations

Going by the findings and conclusions drawn from this study, the following recommendations are suggested. Policies such as opening up of the economy by engaging in more bilateral and multilateral trade agreements, improving the quality of infrastructure by way of channeling more resources to its development especially in marginalized regions of the country in the backdrop of the discovery of oil and water in Turkana, and demonstrating more political will in the fight against corruption so as

to instill more confidence on foreign investors. These policies may enhance the attraction of FDI thereby increasing economic growth.

MNCs play a key role in foreign direct investment into the Kenyan market especially in the construction industry. One of the direct effects of this is the fear by locally owned businesses of losing control over the markets and industries to the expanding MNCs. To answer the question how national firms can survive and compete with MNCs, the government must revisit their policies concerning FDI and MNCs. In addition, due to the positive effects of

FDI investment on the Kenyan economy, the government should continue to keep its open door policy to FDI and MNCs in the future. However, feasible measures should be taken to limit the disadvantages on domestic businesses. The foreign investment policy should be considered as a supplemental part of the domestic development policy. The opening to FDI and MNC investment should be carried out simultaneously. Special treatment should not be given to MNCs. Rather the local firms should be given the same treatment and the administrative constraints on the domestic state owned enterprises should be gradually eliminated.

The government also needs to go a step further and actively seek to attract FDI by marketing our economy and eventually set up national investment promotion agencies (UNCTAD, 2001). In a nutshell, regarding investment promotion policies, Kenya should adopt a proactive approach towards FDI promotion, and explicitly look for ways to increase its benefits in terms of technology, skills and market access. Under these types of policies, foreign investors are targeted at the industry/firm level in order to meet Kenya's specific needs that fit in with its developmental priorities.

## 5.4 Limitations of the Study

Limitations are the boundaries that restrict the research scope and may cause difficulty in completing the research (Cooper & Schindler, 2002). Obtaining data for the study was problematic in the sense that the Central Bank of Kenya (CBK) Statistical Bulletin and Financial review for the various years was only available for a few of the years under study. The central bank website also seems to experience perennial problems that make it inaccessible most of the time. Nonetheless, the data available at the Kenya National Bureau of Statistics is not in soft form so a lot of time was utilized going through heaps of publications.

The research study was conducted for a sample of 10 years and as such may not be an exact representative of the situation on the ground since a lot has been happening in Kenya during the duration under consideration such as the SAPs of the 1980s, adoption of multiparty politics in the early 1990s, the post-election violence of 2007/2008 as well as the global financial crisis of 2009.This project was conducted whilst in full time employment. While this is has had the positive impact of having instilled in me a sense of discipline and responsibility, it has also meant higher levels of stress due to the inevitable need to put in extra hours to balance both tasks. Some bias in research occurs when the researcher fails to take into account all of the possible variables. The findings of this study may also be subject to the researcher's bias. For instance, the results of the research might be subject to design and sampling bias whereby the process of sampling introduces an inherent bias into the study.

## 5.5 Suggestions for Further Studies

The present Kenyan constitution having been promulgated during the last three years introduced a devolved system of government. With this in mind, further studies should focus on analyzing sector and county specific cases so as to allow for specific policy recommendations and employ more robust econometric models. As such the impact of FDI on the economy might be made that more successful.

The backbone of the Kenyan economy is Agriculture; although there is presently a huge of quantity of FDI funds channeled towards farming, much of it is through foreign affiliates who have established subsidiaries here. An example is Del Monte based in Thika. In this regard, studies should be conducted into the feasibility of channeling FDI towards the small scale agricultural industry and with an aim to counter poverty. In the wake of the recently vibrant mining sector wherein foreign affiliates with their superior knowhow and equipment being bound to lead exploration of natural resources in Turkana, studies should be conducted prior to breaking ground so that appropriate policies are put in place to hinder negative impacts on the local economy.

This study employs macroeconomic variables in investigating the impact of FDI on economic growth in Kenya. A study should be conducted on investor responses about the impact of various institutional variables to their businesses in that it would provide information on the other side of the coin; FDI viewed from the MNCs perspective.

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# Appendix I: Research Data Variable Per Quarter

| FDI MILLION OF KSH | | | | GDP –IN MILLION KSH | | | | Government expenditure- Millions of KSh | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 |
| 69,333.33 | 70,133.63 | 70,033.63 | 70,333.63 | 1,011,320.00 | 1,013,320.00 | 1,013,820.00 | 1,014,820.00 | 54,150.00 | 55,350.00 | 54,650.00 | 54,950.00 |
| 70,799.00 | 72,299.00 | 74,799.00 | 75,299.00 | 466,520.00 | 466,620.00 | 467,620.00 | 466,120.00 | 83,969.23 | 91,469.23 | 91,969.23 | 92,469.23 |
| 73,277.81 | 79,277.81 | 79,777.81 | 78,777.81 | 1,111,740.00 | 1,115,240.00 | 1,115,740.00 | 1,116,240.00 | 116,965.24 | 124,965.24 | 125,465.24 | 125,965.24 |
| 79,052.88 | 85,052.88 | 84,552.88 | 85,552.88 | 1,599,388.00 | 1,604,388.00 | 1,605,388.00 | 1,605,688.00 | 140,250.44 | 148,250.44 | 148,750.44 | 149,750.44 |
| 79,829.00 | 86,329.00 | 85,329.00 | 87,829.00 | 2,097,980.00 | 2,104,480.00 | 2,103,980.00 | 2,104,980.00 | 127,575.00 | 134,575.00 | 136,075.00 | 137,075.00 |
| 81,149.19 | 88,649.19 | 89,649.19 | 89,149.19 | 2,512,720.00 | 2,567,720.00 | 2,572,720.00 | 2,577,720.00 | 148,125.00 | 155,625.00 | 156,125.00 | 156,625.00 |
| 92,206.44 | 92,206.44 | 92,206.44 | 92,206.44 | 3,867,320.00 | 3,932,320.00 | 3,937,320.00 | 3,932,320.00 | 174,117.50 | 182,617.50 | 183,117.50 | 184,617.50 |
| 92,282.44 | 96,282.44 | 97,282.44 | 99,282.44 | 7,325,500.00 | 7,395,500.00 | 7,400,500.00 | 7,380,500.00 | 195,217.50 | 201,917.50 | 204,517.50 | 205,217.50 |
| 100,665.81 | 100,665.81 | 100,665.81 | 100,665.81 | 7,908,000.00 | 7,928,000.00 | 7,933,000.00 | 7,923,000.00 | 292,467.50 | 299,967.50 | 300,967.50 | 302,467.50 |
| 104,384.31 | 104,884.31 | 105,084.31 | 105,384.31 | 8,860,250.00 | 8,874,250.00 | 8,870,250.00 | 8,824,250.00 | 302,650.00 | 302,650.00 | 302,150.00 | 304,150.00 |

| Openess to trade-Millions of KSh | | | | Pivate investments -Millions of Ksh | | | |
|---|---|---|---|---|---|---|---|
| Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 |
| 61,896.60 | 64,696.60 | 66,196.60 | 65,996.60 | 71,755.20 | 71,755.20 | 72,255.20 | 73,255.20 |
| 57,369.55 | 62,369.55 | 63,369.55 | 64,369.55 | 72,010.30 | 80,010.30 | 79,010.30 | 81,010.30 |
| 72,639.14 | 76,639.14 | 77,839.14 | 79,439.14 | 75,087.70 | 81,587.70 | 81,087.70 | 80,587.70 |
| 72,688.58 | 76,888.58 | 75,688.58 | 77,488.58 | 84,527.10 | 88,527.10 | 90,027.10 | 91,027.10 |
| 71,488.58 | 75,688.58 | 77,688.58 | 77,888.58 | 147,841.00 | 152,841.00 | 152,841.00 | 152,841.00 |
| 66,251.54 | 70,251.54 | 71,251.54 | 69,251.54 | 224,437.00 | 229,937.00 | 231,937.00 | 231,437.00 |
| 80,822.54 | 84,822.54 | 86,322.54 | 87,322.54 | 254,055.00 | 260,055.00 | 262,555.00 | 263,555.00 |
| 109,669.19 | 115,169.19 | 116,669.19 | 115,169.19 | 277,022.00 | 285,022.00 | 284,022.00 | 288,022.00 |
| 116,385.72 | 118,385.72 | 118,885.72 | 119,885.72 | 310,877.00 | 317,877.00 | 318,877.00 | 321,877.00 |
| 119,469.19 | 119,569.19 | 118,569.19 | 117,569.19 | 333,703.00 | 339,203.00 | 340,203.00 | 341,703.00 |