RELATIONSHIP BETWEEN FISCAL POLICY AND FOREIGN DIRECT INVESTMENT INFLOWS IN KENYA

BY

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DECLARATION

I, the undersigned, declare that this is my original work and has not been presented to any institution or university other than the University of Nairobi for examination.

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D61/79226/2015

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

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DEDICATION

I dedicate this project to my parents Daniel Towett and Alice Towett owing to their support while undertaking my studies. I will forever be indebted to them for the support. May God bless and increase their portions.

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LIST OF ABBREVIATIONS

ANOVA   Analysis of Variance

BOP   Balance of Payments

EU   European Union

FDI   Foreign Direct Investment

GDP   Gross Domestic Product

KES   Kenya Shillings

KNBS   Kenya National Bureau of Statistics

MNC   Multinational Corporation

OECD   Organization for Economic Corporation and Development

OLI   Ownership, Location and Internalization

UK   United Kingdom

UNCTAD   United Nations Conference on Trade and Development

USA   United States of America

USD   United States Dollar

ABSTRACT

Foreign direct investments' determinants have become a topic of importance for governments, policy makers and also for academic research purposes. Both theory and empirical literatures hold that a country's growth has a direct link with the economy, which is made of many variables such as the fiscal policy, FDI, interest rate, inflation, exchange rate, money supply, and many others. These variables are the backbone of any economy. Foreign direct investment inflows movements into a country are influenced by changes in many economic variables and these fundamentals' future prospects changes. Countries need to seek new ways of attracting FDI stock since motives of investors are varying over. The study aimed at determining the impact of fiscal policy on foreign direct investments inflows in Kenya. The independent variable was fiscal policy as characterized by government expenditure on a quarterly basis in natural logarithm form and balance of payment as measured by quarterly difference between exports and imports in natural logarithm form. The control variables were economic growth as measured by quarterly GDP and external debts as measured by quarterly external debt in natural logarithm form. FDI inflows in Kenya were the dependent variable which the study sought to explain and it was measured by FDI inflows in the country on a quarterly basis. Collection of secondary data was done for a period of 10 years (January 2008 to December 2017) on a quarterly basis. This study used a descriptive research design. A multiple linear regression model was employed for analyzing the association between the variables. SPSS version 21 was employed for data analysis purposes. The results of the study produced R-square value of 0.650 whose implication is that about 65 percent of the variation in FDI inflows in Kenya can be explained by the four selected independent variables while 35 percent in the variation was associated with other factors not covered in this research. The study also found that the independent variables were strongly correlated with FDI inflows (R=0.806). ANOVA results show that the F statistic was significant at 5% level with a p-value less than 0.005. Therefore the model was fit to explain FDI inflows in Kenya. The results further revealed that individually, only external government debt have a significant positive effect on foreign direct investment inflows while government expenditure, balance of payments and economic growth has an insignificant effect on foreign direct investment inflows in Kenya. This study recommends that there is need for policy makers to pay attention to the prevailing levels of external government debt prevailing in the country bearing in mind that they influence FDI inflows in the country.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

For a developing economy, foreign direct investment (FDI) is very crucial if it is able to absorb its spill- over effects in an effective manner (Adam &Tweneboah, 2009). FDI is a significant capital inflows' source that has positive impacts on the economy of the host nation which includes the transfer of technology, expansion in international trade, human capital that is specialized and a viable business environment (OECD, 2002). However, the fiscal policy environment in the home country must be favorable to attract foreign investors. As a result of the perceived benefits of attracting FDI, most governments have encouraged foreign owned companies to do investments in their respective sectors by introducing a number of different forms of investment incentives.

The study was guided by several theories such as the eclectic paradigm theory, product life cycle theory as well as the internalization theory that strive to explain the factors that determine the foreign direct investments in a given country. Internalization theory explains the growth of multinational corporations and their motivations. It demonstrates that multinational corporations organize their internal activities to achieve specific advantage and exploit them to enhance its competitiveness. Eclectic paradigm states that location-specific advantage is highly relevant in explaining both the direction and rationale of FDI (Dunning, 1993). By location specific advantage, Dunning refers to the benefits that accrue from the utilization of resources or possessions that are available to a specific foreign location and that a company finds important to merge with its own unique resources such as

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company's technical, marketing or administration potential (Charles, 2008). Product life cycle theory explains the stages a new product goes through before the producing firm goes international (Dunning, 1993).According to this theory, once a product or service reaches a certain stage in the development process, the producing firm enters new markets and this is a source of FDI.

In 2008, Kenya launched vision 2030 with the objective of among other things to achieve global competitiveness for FDI and gain economic prosperity. Since the 1970-1980 period, inconsistent FDI inflows have been experienced in Kenya. Kenya was chosen by the multinational companies as their regional hub due to good infrastructure, openness to FDI, market size and also there was a period when there was relatively closed regimes in other nations within the region that contributed to Kenya being chosen by multinational companies (MNCs) to be their regional hub. Net FDI were highly volatile and generally declining in the 1980s and 1990s besides the economic reforms and the advancements made in business environment (UNCTAD, 2015).

1.1.1 Fiscal Policy

Fiscal Policy involves influencing the economy by using taxation, the revenue collected by the government, and the government expenditure. Government expenditure and taxation are the main tools of fiscal policy. Fiscal policy is used by governments for influencing the aggregate demand level in the economy for them to realize economic objectives such as economic growth, full employment, and price stability. The Keynesian economics posit that increase in government expenditure and decrease in tax rates yield the best results in stimulating the aggregate demand and after the economic boom begins, increase in taxes and decrease in government

expenditure (Funke & Nsouli, 2003). In the past, fiscal policy has been viewed as a demand management instrument. The meaning of this is that the budget balance, the changes in government expenditure and indirect and direct taxation can all be utilized "counter-cyclically" for smoothing out some of national output's volatility especially during a time that the economy is in recession due to an external shock (Steven, 2003).

One of the two key fiscal policy's instruments is taxation. A decrease or an increase in taxes by the government leads to an increase or a decrease in the amount of money consumers have to spend and this has a significant effect in the overall economy's direction. Decrease in taxes often puts more money into the consumers' hands and this causes their spending to increase. When consumers increase their spending, businesses gain more revenues and they can therefore expand and employ more individuals. A common fiscal policy measure for encouraging economic growth is reducing taxes (Heyne et al., 2002).

The other key fiscal policy instrument is government spending. Government expenditure can encourage economic activity and lead to more job being created. An example of this is when a government provides funds for building a high speed train across the country. These funds could be used for hiring workers thus could lead to unemployment reduction and inject money to the economy. Government spending of higher levels tends to encourage economic growth and employment (Larch & Nogueira, 2009). Reducing taxes and increasing spending can both promote economic growth, but if the government spends more than it takes in through taxes it is operating on a deficit, meaning it is losing money over time. Operating on a deficit causes the government to accumulate debt (Heyne et al., 2002).

1.1.2 Foreign Direct Investment

Foreign direct investment can be described as an investment made in a corporation by an interested party from another nation for which the company is controlled by a foreign investor. This transaction brings about a long term association between the host and home country investors (Olson, 2008). According to Ismaila and Imoughele (2010), FDI represent long term commitments to the host country. It is a preferred form of investment because it has no obligations to the host country. UNCTAD (2002) describes three different types of FDI. These are: reinvested earnings, equity capital and other capital which mainly consist of intercompany loans. FDIs create new job opportunities as upon setting of the business, recruitment and training of the locals in the host country is undertaken transferring skills and technological know-how as well as providing jobs.

FDI is important in adopting new technologies, skills and managerial capabilities in the different sectors of the economy which are traditionally difficult to raise through use of domestic savings, and if not, there would be difficulty in importation of the technology from abroad. This would be compounded by the fact that transferring technology to firms with little experience is risky and they will find difficulty in the use of it and it comes at a great cost (Olson, 2008). FDI is responsible for many externalities that come in the form of benefits to the home country that are not responsible for generating incomes to the host country. FDI is important for developing countries as it avails resources necessary to optimize the level of economic development (Ismaila & Imoughele, 2010). The reason for this is that their economies face challenges such as low domestic savings, revenues, low levels of productivity and low foreign exchange earnings.

A country's appeal for FDI is affected by changes in restrictions that include removal of government barriers to trade as well as privatization of government agencies. The country's economic growth potential influences the appeal for the country for FDI since countries with higher economic growth potential make it easier for firms to take advantage of that growth by setting up business there. Tax rates and Exchange rates influence a country's appeal for FDI. Low tax rates on corporate profits encourage Foreign Direct Investment while firms prefer to direct FDI to countries where the local currency is expected to appreciate against their own currency (Mishkin & Eakins, 2009).

1.1.3 Fiscal Policy and Foreign Direct Investment

A country's appeal for FDI is affected by changes in restrictions that include removal of government barriers to trade as well as privatization of government agencies. A country's appeal for FDI is also attributed to by economic growth as states that have high potential for economic growth may enable the firms to be able to take advantage of that growth by setting up business there. Exchange rates together with tax rates also have impact on affect a country's appeal for FDI. Low-level tax rates on corporate profits are have a high probability of attracting Foreign straight Investment while organizations prefer to direct FDI to countries where the local currency is expected to appreciate against their own currency (Olson, 2008).

According to economic theory, public debt is good for a country's economic growth. However, this is only possible up to a certain level beyond which its effects are adverse to an economy. The theory of debt overhang as explained by Krugman (1988) clearly demonstrates how accumulation of high public debt leads to low FDI inflows translating into low economic growth of a country. According to Krugman (1988),

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debt overhang refers to a situation where the existing external debt is very large. The theory suggests that foreign investors will be discouraged from investing in a country that has a large external debt since part of their proceeds would be used to service the debt through high taxation. On the other hand, the theory postulates that reducing debt obligation results to a rise in both domestic and foreign direct investment thus minimizing the chances of debt default.

Many scholars have shown interest in studying the impact of external debt on the economic development of the developing economies. Those in support of external debt argue that governments that rely on external debts are capable of eradicating bottlenecks in their economies thus making full use of their resources. Maximum utilization of the resources has a direct link to economic growth. Those against external debt argue that such actions by developing countries' economies are likely to hamper economic growth through its negative effect on economic growth handles (Tchereni et al., 2013). Increased external debt service is also likely to lead to increased taxes which are an incentive for tax evasion. The increased taxes also discourage foreign direct investors since they are not guaranteed of good returns to their investments. Decrease in foreign direct investments and increased tax evasion are ingredients for retarded economic growth (Habimana, 2005).

The role of tax incentives in promoting foreign direct investments has been the subject of many studies, but their relative impact has not been clearly established (Voorpijl, 2011). A study by Easson and Zolt (2002) argues that tax incentives are both bad in theory in practice in growing nations since have a negative impact on the investment decisions. The study further states that the objectives of tax incentives are hardly attainable since they are perceived as corrupt. The study recommended that

governments need to regularly evaluate the effectiveness of their tax incentives and minimize chances of attracting corruption so as to improve their chances of success.

1.1.4 Fiscal Policy and Foreign Direct Investment in Kenya

Historically, the government of Kenya has had a mixed fortune in terms of fiscal performance. The Country has had budget deficits since independence which is mainly attributed to over expenditures due to dwindling resources brought about by poor macroeconomic performance, among other causes. This has contributed to the weak overall development performance, and high public debt and the associated high interest rates. The Government of Kenya like most developing countries has for the past several years been a perpetual victim of poor fiscal performance leading to budget deficit. However, over time, the government has adopted several strategies aimed at reducing the budget deficits so as to attain surplus. The strategies include measures to widen the tax base and various austerity measures to cut down on recurrent expenditures (Republic of Kenya, 2016).

There is a mix in fiscal policies applied in Kenyan government as more of the resources are directed towards infrastructural projects such as construction of roads, hospitals, education, electricity connectivity in rural areas and irrigation. In addition, there is increased taxation of luxurious items as well as reduced taxation on consumption expenditure. Furthermore, the Kenyan government has over the past few years implemented sound macroeconomic policies, resulting to massive macroeconomic fundamentals. Fiscal stance that is prudent has kept the budget deficit of the country at an average of 4.9 percent of GDP during the last 5 years, even though it performed below its East African neighbors. The budget deficit is forecasted to narrow down to below 4 percent in the short term, majorly due to continued fiscal

discipline as well as increased revenue collection from taxation as well as rationalization of recurrent expenditure. The country's tax to GDP ratio, estimated at 20.1 percent during 2013/14 period, remains high by regional standings, compared to Uganda's 13 percent and that of Tanzania at 18 percent (African Development Bank Group, 2016).

FDI in Kenya is covered in all the sectors, be it in the banking, automobile or telecommunications sector. Various multinational companies have set up operations in Kenya and they include Car and General, Coca-Cola as well as communication firms like Airtel. In every aspect of our lives, FDI is felt that is in the goods and services that we use. FDIs are not in isolation as they have provided jobs and with them, technical knowledge as they train their Kenyan employees to maintain the standards that are there in their other investments all over the world. They are the major source of foreign exchange to the country. In total, Kenya has more than 200 multinational companies across the sectors with Britain, USA, Germany, South Africa, Netherlands, Switzerland, China and India being the main traditional sources of FDI (Kinuthia, 2010).

Kenya serves as the East African business hub for many international businesses. This translates to a dependence of FDI for capital inflow that in turn reflects on provision of jobs and an economy that is helped to grow by these foreign investments. Kenya's FDI average percentage growth between 2007 and 2015 was forty percent (40%) with the inflows primarily channeled into retail and consumer products, technology, media, telecommunications, minerals, oil and natural gas sector mainly from the UK,USA and India (Ernest & Young,2015). This growth rate earned Kenya the status of a FDI hotspot joining other African Countries such as Ghana, Tanzania, Zambia, Uganda,

Nigeria, Mozambique, and Rwanda. In 2015, FDI inflows stood at USD 1076.9 million (KES 105.29 billion), up from USD 670 million (KES 65.51 billion) a year earlier which is a sixty per cent (60%) increase. This capital mainly went to oil, gas and the manufacturing industries (UNCTAD, 2015).

1.2 Research Problem

Foreign direct investments' determinants have become a topic of importance for governments, policy makers and also for academic research purposes (Mahiti, 2012). Both theory and empirical literatures hold that a country's growth has a direct link with the economy, which is made of many variables such as the fiscal policy, FDI, interest rate, inflation, exchange rate, money supply, and many others. These variables are the backbone of any economy (Mitullah, 2010). Foreign direct investment inflows movements into a country are influenced by changes in many economic variables and these fundamentals' future prospects changes. Countries need to seek new ways of attracting FDI stock since motives of investors are varying over. Research is therefore crucial for investment decision making and predictability of FDI inward stock is imperative.

Kenya has a mix in fiscal policies applied by the government as more of the resources are directed towards infrastructural projects such as construction of roads, hospitals, education, electricity connectivity in rural areas and irrigation. In addition, there is increased taxation of luxurious items as well as reduced taxation on consumption expenditure. This therefore involves both expansionary and contractionary fiscal policies which are geared towards stabilization of the economy. At the same time, the country has also seen multinational corporations that had well established operations in the country leaving in unclear circumstances and this has negatively affected FDI

inflows into the country. Sameer Africa bowed out in September 2016, decrying subsidized as well as cheap imports, in 2014, Eveready East Africa closed its Nakuru manufacturing plant and began importing batteries from its affiliate in Egypt due to stiff competition from imports that are cheap and illegal. After two weeks, Cadbury Kenya quitted Kenyan market. Other companies that have since quit the Kenyan market to move to other alternative markets are Colgate Palmolive, Bridgestone, Unilever, Procter and Gamble, Reckitt Benckiser and Johnson and Johnson. Experts have attributed these exits to fiscal policy and especially imports and this study will seek to investigate whether indeed fiscal policy influences FDI inflows.

Empirical evidence is largely inconsistent and quite varied on the influence of fiscal policy on foreign direct investments. The available studies have focused on individual components of fiscal policy and not the combined effect of the several components. Ahuja (2013) investigate the effect of government expenditure on FDI and found that increased government expenditure attracts FDI inflows. Ostadi and Ashja (2014) examined the relationship between external debt and FDI inflows and found that external debt negatively influence FDI inflows and a rise in foreign debt damages the vision of the investor and yields negative perceptions about the future economic situation which similarly reduces the country's investment. Kaur, Yadav and Gautam (2012) examined the relationship between current account deficit and foreign direct investment in India and found that current account deficit has an effect on FDI inflows that is significant while Ajudua and Davis (2015) sought to ascertain the effect of government expenditure on FDI inflows in Nigeria and found that capital expenditure did not have any significant effect on FDI inflows.

Locally, Kiragu (2005) found that economic openness is the main determinant of FDI in Kenya. Kinaro (2006) found that Kenya's FDI is influenced by human capital, economic openness, inflation, FDI in the previous periods and real exchange rate. Nyamwange (2009) established that Kenya's FDI is affected by level of human capital, stable macroeconomic policies, taxation, and market size. Imbayi (2013) conducted a study to determine the effect of taxation on foreign direct investments inflows in Kenya. The study concluded that taxation affect the level of inflow and the location of foreign direct investment. Most of the existing empirical evidence has expounded on the impact of different variables on foreign direct inflows to Kenya while those that have considered fiscal policy have only focused on individual components of fiscal policy without considering the combined effect. The current study leveraged on this gap by attempting to answer the research question; what is the relationship between fiscal policy and foreign direct investment inflows in Kenya?

1.3 Objective of the Study

This study's objective was to establish the relationship between fiscal policy and foreign direct investment inflows in Kenya.

1.4 Value of the Study

The findings are hoped to be of benefit to policy makers in developing investment strategy policies and developing the necessary institutional framework required to market Kenya as an ideal foreign investment destination. Also, it will help them in coming up with fiscal policies that are consistent with the objective of attracting foreign direct investments.

This study's findings will be used by other scholars, students and researchers in future to as a platform for executing further studies in the same field. The findings will also

be used by researchers and scholars in to identify further identify research areas on the related topics addressing the same matter through conducting a review of the existing literature so as to identify the research gaps.

The research findings will benefit international investors in making informed decisions in venturing into the Kenyan market. Investors with an interest in the Kenyan market will be able to make informed evaluation with regard to the influence of fiscal policy on foreign direct investments in the country.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The chapter reviews theories that form the foundation of this study. In addition, previous empirical studies that have been carried before on this research topic and related areas are also discussed. The other sections of this chapter include determinants of foreign direct investments, conceptual framework showing the relationship between study variables and a literature review summary.

2.2 Theoretical Framework

This presents review of the relevant theories which explain the relationship between fiscal policy and foreign direct investments. The theoretical reviews covered are; internalization theory, eclectic paradigm theory and the product life cycle theory.

2.2.1 Internalization Theory

The theory was advanced by Casson and Buckley in 1976. Further development of the theory was by Hennart (1982) and benefits from addition works by Casson (1983). The theory explains the growth of multinational corporations and their motivations. It demonstrates that multinational corporations organize their internal activities to achieve specific advantage and exploit them to enhance its competitiveness. According to Hymer (1976), FDI will occur only when the exploitation of firm specific advantage supersede the relative cost of investing abroad. In summary, he implies that FDI occur in imperfect markets and it's simply a strategy decision at firm level rather than a financial decision of the capital market.

Casson and Buckley (1976) argue that an FDI is only attractive if the Ownership, Location and Internalization (OLI) conditions are met. First, the multinational must have an ownership advantage compared to the local firm's ownership. This may be in form of the multinational's specific organizational or technological knowledge. The government policies' likely on the benefits of investing in a certain host country is also vital. In some cases the host government may pose regulations concerning the nature of foreign ownership. Such restrictions in effect reduce FDI inward inflows which will be accompanied by technology. Secondly, it must be advantageous for the multinational companies as well as other investors to produce in the host country if they can benefit from some comparative locational advantage. Finally, it should be suitable to execute the activities within the host countries, as opposed to leasing or buying them from other firms. This theory has relevance to the current study as it explains the factors considered by an MNC before making investment decisions in foreign countries and thus affect the amount of FDI inflows into a given country.

2.2.2 Eclectic Paradigm Theory

Dunning (1993) came up with this theory which is in itself a mix of three different but correlated theories. These theories are Ownership, Location and Internalization (OLI) which are used to describe how the factors therein contribute to changes in foreign direct investments. Ownership related advantages are those provided by intangible assets. This assets must however be considered as exclusive possessions held and owned by the company and are transferable to other firms at prices that would lead to reduction of costs to the company, or would lead to the company registering high rates of return. In his arguments, Dunning (2005) argues that when all other factors are held constant, a company with a higher level of competitive advantages, in

comparison with its competitors, has a higher chance in increasing its overall production and hence increasing its global presence.

Location benefits, as explained by Denisia (2010) are used to compare the different economies, as per their strengths and opportunity. The end result of this analysis is that the most suitable country is selected to be a host country for the activities of multinational firms. The correlation existing between location and ownership advantages is that when a multinational corporation is able to host itself in the most suitable economy, it is now able to engage in the exploitation of its ownership related abilities, and thus leading to the firm engaging in foreign direct investment.

Internalization establishes a need for the firm to be able to have an established business in each of the economies that the company sells its products or services. The firm must derive ways through which it can benefit further through foreign production as compared to the meager fees that are earned in international trade activities such as exporting and franchising. Dunning (2005) states that a corporation is more likely to get higher returns if, it engages in foreign production as opposed to the extension of its production rights to other countries. The eclectic paradigm is therefore in support of the establishment of production markets by a corporation through exploitation of its competitive advantages and the selection of suitable locations. In doing this, the corporations are not only engaging in foreign direct investments but also gaining much more than their competitors.

2.2.3 Product Life Cycle Theory

Vernon (1966), defines production life cycle as a process that consists of four phases of production which include innovation, growth, maturity and decline. A business entity would first come up with an idea regarding a service or a product. The idea or

the product then undergoes a growth stage and then eventually matures. It thereafter starts to decline. The product decline is mainly caused by competition in the market place as well as inability of the business to innovate. Firms that involve in foreign direct investment in a direct manner bring equipment of production to foreign nations for them to be near the target market and make sure that a market share that is sustainable is attained and maintained (Dunning, 1993).

The production life cycle described by Vernon is typically employed in countries that are engaged in manufacturing and exporting products. Sometimes, the countries may lose the market share to competitors who imitate the products and end up being the main exporters of the product. The theory explains that diffusion of technological innovations takes place at a much slower rate. As a result, differences are likely to occur in terms of the production technologies used by different countries. However, it is important to emphasize that the production life cycle described by Vernon is only applicable to certain kinds of products especially those targeting high income earners and products that have alternative labor and capital sources. Critiques have argued that Vernon's theory is silent on industrial innovation which is important in taking transitional advantages on innovations that require a significant amount of rent to develop (Dunning, 1993).

Vernon's evaluation of foreign direct investment solely focused on a product. The process's summary shows that a product is first invented in the home country. The home country which is the foreign investor's residence has advantages in relation to innovation and technology capabilities. The one who innovates produces local market product first which is later exported to foreign countries with little innovative capacity and technology to develop similar products. Consequently, the product becomes

standardized and eventually matures. At this stage of the product development, labor becomes and critical production input. Consequently, the investor must attract value input from local materials as well as people in the foreign countries. As a result, foreign direct investment is viewed as a critical stage in the product development life cycle (Chen, 1983).

2.3 Determinants of Foreign Direct Investments

FDI involves real assets and this ensures that an investor will be active in managing the assets he is acquiring. A number of issues exist which cause the attractiveness of amake one country to be more than the other and these factors can also vary from one period to another. These determinants have contributed to studies on why some given countries are more prosperous than others nations in attracting FDI. Quite many researches have been carried out on the determent factors of FDI but so far there is yet to be a definite consensus. The different approaches to the determinants of FDI do not cancel each other out but expound on various issues of a similar phenomenon (Kinuthia, 2010).

2.3.1 Fiscal Policy

Four components of fiscal policy and how they are expected to affect foreign direct investment are discussed here. The components are; government expenditure, taxation, balance of payment and government external borrowing. The main challenge of national governments worldwide is to continually increase the welfare of its people through the implementation of programs and economic policies that are appropriate (Keynes, 1953). Governments try to achieve this national objective by ensuring the provision of public goods for example road infrastructures as well as public services for example security, education, health and sanitation among others, hence forming

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the social and economic infrastructure. The adequacy of such infrastructures is a firm foundation for a country's economic growth which in return attracts FDI inflows (Barro, 1990).

The effect of taxes on growth of an economy can only remain positive if taxes levied create the right incentives (depending on economic activities) for the efficient allocation of resources in a given country. Additionally, in order to improve the welfare of its citizens, a given government should adopt fiscal policies with a tax structure that maximizes positive externalities while minimizing negative externalities, such as pollution and corrupt practices. Musgrave and Musgrave (1980) postulated a law of public expenditure growth in the United States of America, where, as national income per capita grew, so did government tax revenue when compared on percentage basis to the GNP. The implication of this is that as the U.S. registered economic growth, so did the country's tax effort. The authors' findings are in conformity with Ariyo (1997) and Hebel(1995) empirical findings in the discipline of development economics which indicates that as a country's economy grows, its tax base grows commensurately. However, growth rates of both the economy and tax capacity tend to differ among the countries for different periods of time, due to both short and long term causative factors, including internal and external economic shocks.

According to economic theory, government external debt is good for a country's economic growth which in effect affects the various sectors that make up the economy. However, this is only possible up to a certain level beyond which its effects are adverse to an economy. The theory of debt overhang as explained by Krugman (1988) clearly demonstrates how accumulation of high public debt leads to low FDI

inflows translating into low economic growth of a country. According to Krugman (1988), debt overhang refers to a situation where the existing external debt is very large. The theory suggests that foreign investors will be discouraged from investing in a country that has a large external debt since part of their proceeds would be used to service the debt through high taxation. On the other hand, the theory postulates that reducing debt obligation results to a rise in both domestic and foreign direct investment thus minimizing the chances of debt default.

The Balance of Payment (BOP) can be defined as trade balance between two nations. It is a reflection of all the payments and receipts for dividends, products and interests between the two nations. A country has a negative balance of payment in the current account when its imports are greater than what it is exporting. This is also referred to as a deficit and it shows that a nation needs more foreign currency than it acquires from the products that it's exporting. The balance of trade and earnings on foreign investment of a country are reflected by its current account which involves transactions such as its imports, exports and debt, among others. More expenditure of its currency by a country on imports than on exports causes a deficit in the current account. Soaring current account deficits are often an antecedent to difficulties in balance of payments (Higgins &Klitgaard, 1998). Theoretically, economies consuming more than they are generating through running large deficits, are unable to have enough funds for investing in the economy and thus foreign investors shy away from such a country. However, an increase in exports relative to imports may imply increase income for the locals which can end up attracting foreign direct investments.

2.3.2 Inflation

Inflation is very important in managing the macroeconomic environment and fiscal governance. It is usually measured by changes in the consumer price index which is essentially a weighted average price of goods and services consumed (Nwankwo, 2006). A high level of inflation is an indicator of tensions in the economic environment of a country and is a reflection of the government's reluctance to have a stable monetary policy. It can be argued that risk averse foreign investors coupled with high levels of inflation will lead to decreases in FDI in the host country since investors are not willing to risk the profits that they expect from their investments (Kadongo, 2011).

Given high uncertainty levels, investors are bound to demand high price levels in order to offset their exposure to inflationary risks which are bound to lower the volume of investment. Therefore as a move to encourage investments, inflation rate stability is important (Gastanaga et al., 1998). Nwankwo (2006) has stressed macroeconomic policy failures as deflecting FDI flows from Africa; he points that, poor monetary and fiscal policies cause unsustainable deficits in budgets and increase inflationary pressures thereby raising the production costs in the local country and thus creating instability in exchange rates and thereby the region becomes a risky destination for FDI (Onyeiwu&Shrestha, 2004).

2.3.3 Interest Rates

Agiomirgianakis (2003) defined FDI as capital inflow into a country due to investment from multinational business entities. The economic theory posits that financial resources have a tendency to flow to nations with a higher return on investment as compared to nations with lower rates of return (Pholphirul, 2002).

Consequently, investment is high in countries that offer better investment returns as well as security in the form of lower interest rates and a better business environment. Capital therefore tends to more from nations which have low rate return to nations which have a rate of return that is high.

Singhania (2011) argues that interest rates are normally adjusted to reflect changes in inflation. As a result, interest rates are critical determinants of foreign direct investment. Traditionally, investors tend to shop for credit sources that have lower interest rates or have a low cost and invest it in economies that are promising higher returns. According to Vesarach (2014), who conducted a study on the role of interest rates in attracting FDI in the Asian economies; the results showed that the determinants of FDI are interest rates, inflation, GDP, exchange rates, labor cost, money growth and political rights. The researcher concluded that countries should offer competitive interest rates to attract foreign direct investments in their country.

2.3.4 Exchange Rates

Exchange rate is an essential component affecting FDI. Asiedu (2002) stated that different currency areas were responsible for the generation of FDI. Dunning stated that greater fixed capital stakes of an investment showed the possibility of taking into account future movements in exchange rates (Dunning, 1993). Goldberg (2011) agrees that exchange rates volatility impact location decisions of MNCs. Other research indicates that exchange rate risk contributes significantly in explaining FDI (Gastanaga et al., 1998).

Exchange rate volatility may negatively affect and reduce direct investment. Gastanaga et al., (1998) based on an analysis of macroeconomic factors, institutional and legal frameworks and risk in determining FDI, proved that market size, fiscal

deficit, inflation and exchange regime and trade openness were all significant. According to earlier research, exchange rate movements have shown to be relevant and significant to FDI because exchange rate volatility contributes directly to uncertainty in the transaction plan from the countries investing (Behera, 2008).

2.3.5 Economic Growth

Many scholars have been attracted to the issue on the role played by economic development in attracting foreign direct investment. According to Charkrabarti (2001) better improved opportunities for gaining profits are attributed to bya rapidly growing economy as compared to those that are growing slowly or not increasing at all. Mishkin and Eakins (2009) find a high outcome of growth on FDI, while Gastanaga et al., (1998) gains a stiff support for the hypothesis in the time between 1983-1986, although only a link that is weak from 1975-1978.

Basing on the same guidelines, Aoki (2007) established that in less developed nations, there exists a weak positive association, and a negative relationship that is weak in the developed nations. Asiedu (2002) asserted that lagged growth for the full sample and non-Sub-Saharan African countries are affected positively, whereas there the Sub-Saharan Africa sample has an insignificant impact. Gastanaga et al., (1998) found significant positive effects of growth on FDI.

2.4 Empirical Review

Studies have been carried out both locally and internationally to support the relationship between fiscal policy and foreign direct investments, but these studies have focused on individual components of fiscal policy without establishing the combined effect.

2.4.1 Global Studies

Kaur, Yadav and Gautam (2012) examined the relationship between current account deficit and foreign direct investment in India. The researchers analyzed data for the period 1975- 2009 and applied the Toda- Yamamoto (T-Y) granger causality method. The findings of the research exhibited a blend between current account and FDI in the long run. A corroboration of unidirectional causality exists from current account to FDI. Additionally, an examination of key components of current account, exports and imports which are also a part of FDI and international Trade endorsed the findings.

Siddiqui, Ahmad and Asim (2013) examined the link between current account and FDI in an empirical investigation for Pakistan economy. Using the Granger causality test and also application of Johansen-Juseliuscointegration approach the research revealed that Foreign Direct Investment and Current Account are cointegrated and confirmed a relative long run connection. The Granger causality test results expressed uni-directional causality between FDI and CA. Nonetheless, no short run causality was observed to be existing from FDI to CA and contrariwise.

Ahuja (2013) conducted an analysis of the association between FDI levels, degrees of economic development and government expenditures in third world countries. The study applied a time series research design that was comparative in nature. He posited that overall demand can be increased by government expenditure and consequently enhance economic development which in the long run boost FDI levels. Ahuja further maintained that escalation in government development expenditures tag along with a multiplier effect on the national earning resulting to a more than proportionate increase in the national earning. The findings of his study also revealed that the variation in government expending not only secures a steady economy, but also

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precipitates and stimulates economic development and attract FDI. Nonetheless, surplus government spending in many developing nations have steered to soaring budget deficit and occurrences of debt difficulty.

Kaur and Sharma (2013) investigated the factors that determined foreign direct investment in India using OLS model. Their findings indicate that long term debt, country's openness, foreign reserves and country's GDP positively influence the FDI inflows. Inflation and exchange rate were found to negatively affect the FDI inflows. This study can be improved by investigating the effect of other variables on FDI inflows since those investigated are not the only ones.

According to Ajudua and Davis (2015), in their study which sought to ascertain the effect of government expenditure and FDI towards Nigeria's economic development vital macroeconomic variables; Foreign Direct Investment as well as government expenditure are strong drivers of economic development of a nation. This study was necessitated by the need to control government expenditure and monitoring the FDI in order to gain a steady economic growth. Multiple regression analysis was applied to examine the correlation between Foreign Direct Investment and government expenditure, that is capital and recurrent expenditure as the explanatory variables on GDP as the dependent variable. The findings of the study exhibited that the explanatory variables: capital and recurrent expenditures and FDI had a notable relation with economic growth. Although capital expenditures didn't conform with the expectation.

2.4.2 Local Studies

Kiragu (2005) who conducted a study on determinants of FDIs in Kenya based on the generalized least square model (GLS) revealed that economic openness is the most

significant determinant of FDI inflows in Kenya. Other variables that were significant determinant of FDI inflows included growth rate of GDP, credit availability, the exchange rate and internal rate of return. The rest of the remaining variables including tax incentives, inflation rate were statistically insignificant.

Nyamwange (2009) conducted a research study to find out foreign direct investment in Kenya. The research's objective was to establish factors which influence FDI decisions in the Kenyan context. He explored the correlation between FDI and economic development in Kenya. Findings evidenced that FDI in Kenya is affected by level of human capital, stable macroeconomic policies, taxation, and market size. Additionally, there was no statistically significant link between human capital and GDP which means that there is shortage of skilled employees in Kenya.

Kinuthia (2010) studied on the determinant factors of foreign direct investment based on the 2007 Kenyan foreign firms survey. Market size, bilateral trade agreements, political and economic stability and a favorable climate of marketing firms are the most important determinants as per the findings. According to the researcher, political instability, crime and insecurity, and institutional factors most notably corruption are three main impediments to foreign investment inflow to Kenya.

Imbayi (2013) investigated the effect of taxation on foreign direct investment in Kenya. The study employed 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, inflation, levels of GDP rate and openness being the moderating variables. 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
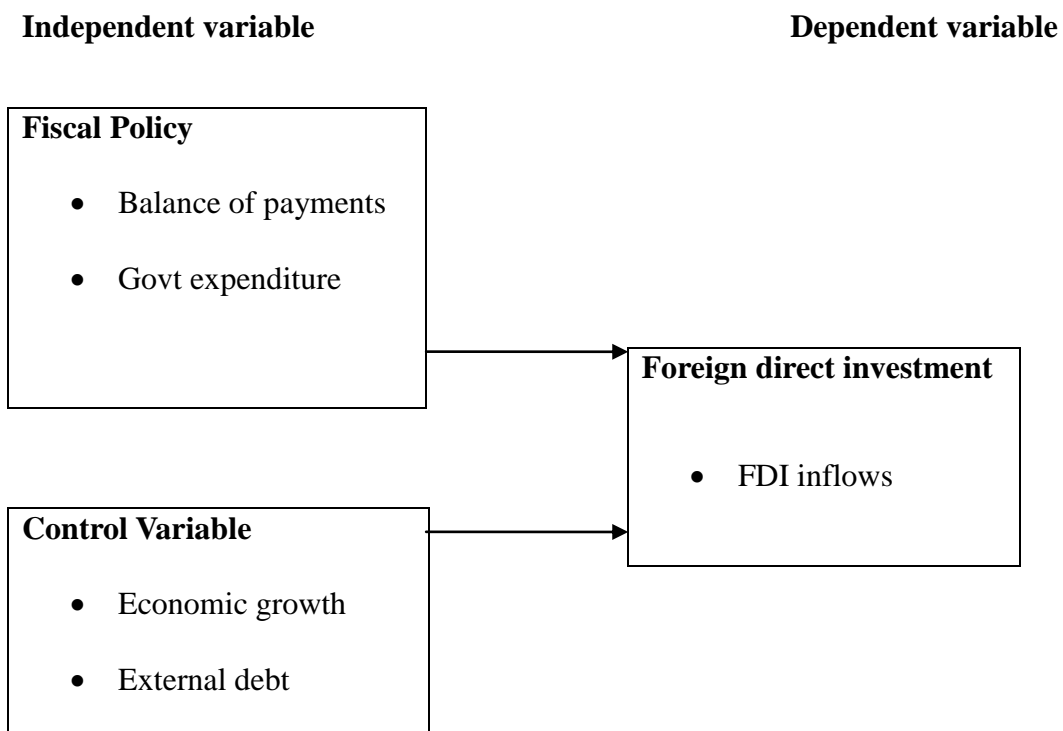
spanning 1992 to 2002. This study used regression analysis model in which the dependent variable was the percentage annual percentage change in FDI inflows to Kenyans. From the study findings and discussion, the study concludes that taxation affect the level of inflow and the location of foreign direct investment.

Wabwalaba (2017) sought to determine the effect of public debt on foreign direct investments inflows in Kenya. Secondary data was collected for a duration of 10 years (January 2007-December 2016) on a quarterly basis. The study used a descriptive research design as well as a multiple linear regression model was employed for analyzing the assoiation between the variables. The results of this study revealed that about 27.8 percent of the variation in FDI inflows in Kenya can be explained by the four selected independent variables while 72.2 percent in the variation was associated with other factors not covered in this research. The results further revealed that individually, public debt, economic growth, exchange rates and inflation rates are not significant determiners of FDI inflows in Kenya.

2.5 Conceptual Framework

The conceptual model developed below portrays this expected relationship between the study variables. The factors characterized here are fiscal policy and FDI inflows in Kenya. The independent variable are government expenditure as measured by percentage change in total government development expenditure on a given quarter, and balance of payments as measured by the percentage change in current account deficit on a quarterly basis. Foreign direct investments will be measured by quarterly FDI inflows. The control variable in this study will be economic growth as measured by GDP growth rate on a quarterly basis and external government debt as measured by percentage change in external government debt on a quarterly basis.

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Figure 2.1: The Conceptual Model

Independent variable   **Dependent variable**

```
┌─────────────────────────┐
│ Fiscal Policy           │
│                         │
│   • Balance of payments │
│                         │
│   • Govt expenditure    │──────────┐
│                         │          │      ┌──────────────────────────┐
│                         │          └─────▶│ Foreign direct investment │
└─────────────────────────┘                 │                          │
                                            │   • FDI inflows          │
┌─────────────────────────┐                 │                          │
│ Control Variable        │          ┌─────▶│                          │
│                         │          │      └──────────────────────────┘
│   • Economic growth     │──────────┘
│                         │
│   • External debt       │
│                         │
└─────────────────────────┘
```

Source: Researcher (2018)

2.6 Summary of the Literature Review

This chapter has focused on the theories that form the foundation for this study. The theories discussed here are namely; product life cycle theory, internalization theory and the eclectic paradigm theory. The chapter has also focused on some of the factors that are expected to determine foreign direct investments. There have been previous studies carried out either in this area and/or related areas and their findings have been discussed under empirical review. The lack of consensus among the various scholars on the effect of fiscal policy on FDI is reason enough to conduct further examination on the area of study.

Ostadi and Ashja (2014), external debts negatively influence FDIs and a rise in foreign debt damages the vision of the investor and yields negative perceptions about the future economic situation which similarly reduces the country's investment.

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Ayanwale and Bamire (2004) and Azam (2010) found positive relationships between GDP, exchange rates, inflation and openness and FDI, and negative relationship with taxation while Mwega and Ngugi (2007) established that FDI is determined by the economic growth rates, openness to trade, external debt ratio and the worth of institutions. In addition, most of the existing empirical evidence has examined the impact of different variables on foreign direct inflows in Kenya while still others have examined the effect of foreign direct investments on economic growth. However, there exist few studies on the relationship between fiscal policy and foreign direct investment in Kenya. Thus, this study intends to fill this research gap.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

In order to determine the relationship between fiscal policy and foreign direct investment, a research methodology was necessary to outline how the research was carried out. This chapter has four sections namely; research design, data collection, diagnostic tests and data analysis.

3.2 Research Design

A descriptive research design was employed in this study to investigate the relationship between fiscal policy and foreign direct investment inflows in Kenya. Descriptive design was utilized as the researcher was interested in finding out the state of affairs as they exist (Khan, 2008). This research design was appropriate for the study as the researcher is familiar with the phenomenon under investigation but want to know more in terms of the nature of relationships between the study variables. In addition, a descriptive research aims at providing a valid and accurate representation of the study variables and this helps in responding to the research question (Cooper & Schindler, 2008).

3.3 Data Collection

Time series data was collected exclusively from a secondary source. Quarterly data for 20 years (January 1998 to December 2017) was collected and analyzed. Data for the independent variables; balance of payments and public expenditure was gathered from the Kenya National Bureau of Statistics (KNBS) and World Bank database. Data for the dependent variable; foreign direct investments inflows on a quarterly basis will also be obtained from KNBS and World Bank database. Control variables data on

economic growth and external public debt was obtained from KNBS.

3.4 Diagnostic Tests

The linearity test was obtained through the scatterplot testing or F-statistic in ANOVA. Stationarity test is a process where the statistical properties such as mean, variance and autocorrelation structure do not change with time. Stationarity was obtained from the run sequence plot. Normality is a test for the assumption that the residual of the response variable are normally distributed around the mean. This was determined by Shapiro-walk test or Kolmogorov-Smirnov test. Autocorrelation is the measurement of the similarity between a certain time series and a lagged value of the same time series over successive time intervals. It was tested using Durbin-Watson statistic (Khan, 2008).

Multicollinearity is said to occur when there is a nearly exact or exact linear relation among two or more of the independent variables. This was tested by the determinant of the correlation matrices, which varies from zero to one. Orthogonal independent variable is an indication that the determinant is one while it is zero if there is a complete linear dependence between them and as it approaches to zero then the multicollinearity becomes more intense. Variance Inflation Factors (VIF) and tolerance levels were also carried out to show the degree of multicollinearity (Burns & Burns, 2008).

3.5 Data Analysis

The data collected from the different sources was organized in a manner that can help address the research objective. Statistical Package for Social Sciences (SPSS) version 22 was utilized for data analysis purposes. Both descriptive and regression analyses was carried out. In descriptive statistics, the minimum, maximum, mean, standard

deviation, skewness and kurtosis was computed for each variable. In inferential statistics, both regression and correlation analysis were carried out. Correlation analysis involved determining the extent of relationship between the study variables while regression analysis involved establishing the cause and effect between the independent and dependent variables. A multivariate regression analysis was employed to determine the association between the dependent variable (foreign direct investments) and independent variables: balance of payments, public expenditure, external public debt and economic growth.

3.5.1 Analytical Model

Using the collected data, the researcher conducted a regression analysis to establish the extent of the relationship between fiscal policy and foreign direct investments. The study applied the following regression model:

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

Where: Y = Foreign direct investments as measured by natural logarithm of FDI inflows on a quarterly basis

β_0 = y intercept of the regression equation.

$\beta_1, \beta_2, \beta_3$ and β_4 = are the slope of the regression

X_1 = Balance of payments as measured by the natural logarithm of current account deficit/surplus (exports minus imports) on a quarterly basis.

X_2 = Government expenditure as measured by natural logarithm of total government expenditure on a quarterly basis.

X_3 = External government debt as measured by natural logarithm of external government debt on a quarterly basis.

X_4 = Economic growth as measured by GDP growth rate on a quarterly basis

ε =error term

3.5.2 Tests of Significance

The researcher carried out parametric tests to establish the statistical significance of both the overall model and individual parameters. The F-test was used to determine the significance of the overall model and it was obtained from Analysis of Variance (ANOVA) while a t-test was used to establish statistical significance of individual variables.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND INTERPRETATION

4.1 Introduction

The chapter represents the results and findings of the study based on the research objective. The chapter dealt with the analysis of the collected data from CBK and KNBS to establish the effect of fiscal policy on foreign direct investments in Kenya. Using descriptive statistics, correlation analysis and regression analysis, the results of the study are presented in the form of tables for easy interpretation.

4.2 Diagnostic Tests

The researcher carried out diagnostic tests on the collected data. The research assumed a 95 percent confidence interval or 5 percent significance level (both leading to identical conclusions) for the data used. These values helped to verify the truth or the falsity of the data. Thus, the closer to 100 percent the confidence interval (and thus, the closer to 0 percent the significance level), the higher the accuracy of the data used and analyzed is assumed to be. To test for normality, the null hypothesis for the test was that the secondary data was not normal. If the p-value recorded was more than 0.05, the researcher would reject it. The test results are as shown below

Both Kolmogorov-Smirnova and Shapiro-Wilk tests recorded o-values greater than 0.05 which implies that the research data was normally distributed and therefore the null hypothesis was rejected. The data was therefore appropriate for use to conduct parametric tests such as Pearson's correlation, regression analysis and analysis of variance.

Table 4.1: Normality Test

FDI Inflows	Kolmogorov-Smirnov[a]			Shapiro-Wilk		
	Statistic	Df	Sig.	Statistic	Df	Sig.
Balance of payment	.173	40	.300	.918	40	.822
Government expenditure	.180	40	.300	.894	40	.790
Economic Growth	.176	40	.300	.892	40	.784
External debt	.181	40	.300	.896	40	.792
a. Lilliefors Significance Correction						

Source: Research Findings (2018)

A test of Multicollinearity was undertaken. Tolerance of the variable and the VIF value were used where values more than 0.2 for Tolerance and values less than 10 for VIF implies that there is no Multicollinearity. For multiple regressions to be applicable there should not be strong relationship among variables. From the findings, all the variables had a tolerance values >0.2 and VIF values <10 as shown in table 4.2 indicating that there is no Multicollinearity among the independent variables.

Table 4.2: Multicollinearity Test for Tolerance and VIF

Variable	Collinearity Statistics	
	Tolerance	VIF
Balance of payments	0.398	1.982
Government expenditure	0.360	1.382

Economic growth	0.392	1.463
Public debt	0.646	1.434

Source: Research Findings (2018)

In order to check for correlation of error terms across time periods, autocorrelation tests were run. Autocorrelation was tested using the Durbin Watson test. A durbin-watson statistic of 1.868 indicated that the variable residuals were not serially correlated since the value was within the acceptable range of between 1.5 and 2.5.

Table 4.3: Autocorrelation Test

Mode l	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.806[a]	.650	.610	22.634773	1.868

a. Predictors: (Constant), Economic growth, Government expenditure, Balance of payments, Government external debt

b. Dependent Variable: FDI inflows

Source: Research Findings (2018)

4.3 Descriptive Analysis

Descriptive statistics gives a presentation of the mean, maximum and minimum values of variables applied together with their standard deviations in this study. Table 4.4 below shows the descriptive statistics of the variables applied in the research. All the variables were analyzed by use of SPSS software over the ten year period (2008 to 2017) on a quarterly basis. FDI inflows had a mean of 49.695 with a standard deviation of 36.252. Government expenditure recorded a mean of 1.9394 with a standard deviation of 0.0553. Economic growth resulted to a mean of 6.215 with a

standard deviation of 3.488. External debt resulted to a mean of 28.622 with a standard deviation of 0.523 while balance of payments had a mean of 15.810 and standard deviation of 1.9545.

Table 4.4: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
FDI inflows	40	17.480	210.920	49.69500	36.251814
Balance of payments	40	13.653	20.213	15.80990	1.954510
Government expenditure	40	1.797	2.015	1.93938	.055269
External debt	40	4.030	16.830	8.55850	3.720589
Economic growth	40	.300	12.500	6.21500	3.487895
Valid N (listwise)	40				

Source: Research Findings (2018)

4.4 Correlation Analysis

Pearson correlation was employed to analyze the level of relationship between FDI inflows and the independent variables for this study (government expenditure, economic growth, external debt and balance of payments). From correlation analysis, the study showed the existence of a strong positive and significant correlation between government expenditure and FDI inflows into the country (p=.637, p=.000). This goes to show that the level of government expenditure in a country has a positive and significant association with FDI inflows into the country. The relationship between economic growth and FDI inflows was found to be weak positive but

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insignificant (p=.152, p>0.350). This implies that movement in economic growth is positively correlated to FDI inflows but not in a significant manner.

The study also revealed that external debt and FDI inflows were strongly and positively correlated (p=.798, p>.000). The implication of this is that external debts have a strong positive association with FDI inflows and the association is significant. Balance of payments was found to have a weak positive and insignificant relationship with FDI inflows as evidenced by a p value which is greater than 0.05.

Table 4.5: Correlation Analysis

		FDI inflows	Balance of payments	Government expenditure	Government external debt	Economic growth
FDI inflows	Pearson Correlation	1				
	Sig. (2-tailed)					
Balance of payments	Pearson Correlation	.053	1			
	Sig. (2-tailed)	.745				
Government expenditure	Pearson Correlation	.637**	.416**	1		
	Sig. (2-tailed)	.000	.008			
Government external debt	Pearson Correlation	.798**	.201	.640**	1	
	Sig. (2-tailed)	.000	.214	.000		
Economic growth	Pearson Correlation	.152	.367*	.056	.092	1
	Sig. (2-tailed)	.350	.020	.730	.571	

**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).
c. Listwise N=40

Source: Research Findings (2018)

4.5 Regression Analysis

FDI inflows were regressed against four predictor variables; government expenditure, economic growth, external debt and balance of payments. The study obtained the model summary statistics as depicted in table 4.6 below.

Table 4.6: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.806[a]	.650	.610	22.634773	1.868

a. Predictors: (Constant), Economic growth, Government expenditure, Balance of payments, Government external debt

b. Dependent Variable: FDI inflows

Source: Research Findings (2018)

According to the outcome in table 4.6 above, the R square value was 0.650, a discovery that 65 percent of the deviations in FDI inflows into the country is caused by changes in government expenditure, economic growth, external debt and balance of payments. Other variables not included in the model justify for 35 percent of the variations in FDI inflows to the country. Also, the results revealed that there's a strong association among the selected independent variables and FDI inflows as shown by the correlation coefficient (R) equal to .806. A durbin-watson statistic of 1.868 indicated that the variable residuals were not serially correlated because the value was more than 1.5.

Table 4.7: Analysis of Variance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	33321.913	4	8330.478	16.260	.000[b]
	Residual	17931.654	35	512.333		
	Total	51253.566	39			

a. Dependent Variable: FDI inflows

b. Predictors: (Constant), Economic growth, Government expenditure, Balance

of payments, Government external debt

Source: Research Findings (2018)

The significance value is 0.000 which is less than p=0.05. This implies that the model was statistically significant in the prediction of how government expenditure, economic growth, external debt and balance of payments affect FDI inflows in the country. Given 5% level of significance, critical value from the table is 2.324, table 4.7 above reveals computed F value as 16.260. This makes the confirmation that the multiple regression model is overly statistically significant since it's a prediction model that suitably explains how government expenditure, economic growth, external debt and balance of payments rates affects FDI inflows in the country.

Table 4.8: Model Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	30.964	238.249		.130	.897
	Balance of payments	1.689	2.263	.091	.746	.460
	Government expenditure	10.725	136.906	.016	.078	.938
	Government external debt	8.049	1.908	.826	4.220	.000
	Economic growth	.427	1.140	.041	.375	.710

a. Dependent Variable: FDI inflows

Source: Research Findings (2018)

This study applied t-test to determine the significance of individual variables applied in this study as predictors of FDI inflows in the country. The p-value under sig. column was used as an indicator of the significance of the association between the dependent and the independent variables. At 95 percent level of confidence, a p-value of less than 0.05 was interpreted as a measure of statistical significance. As such, a p-value above 0.05 shows a statistically insignificant association between the dependent and the independent variables. Results are as depicted in table 4.8

From the above results, it is evident that of the four selected independent variables only external government debt was found to be a significant determinant of FDI

inflows as it produced positive and statistically significant values for this study as shown by a low p value.

The following regression equation was estimated:

$Y = 30.964 + 8.049X_1$

Where,

Y = FDI Inflows

X_1 = External government debt

On the estimated regression model above, the constant 30.964 shows that if selected dependent variables (government expenditure, economic growth, external debt and balance of payments) were rated zero, FDI inflows would be 30.964. A unit increase in government external debt would cause FDI inflows in the country to increase by 8.049 while a unit increase in balance of payments, government expenditure and economic growth would not have a significant effect on FDI inflows as shown by high p values.

4.6 Discussion of Research Findings

This study aimed at determining the impact of fiscal policy on FDI inflows in the country. The independent variable was fiscal policy as characterized by government expenditure and balance of payments. The control variables were economic growth as measured by quarterly GDP growth rate and external debt as measured by quarterly external debt in natural logarithm form. FDI inflows were the dependent variable which the study sought to explain and it was measured by quarterly FDI inflows in Kenya. The effect of independent variables on the dependent variable was analyzed in terms of strength and direction.

The Pearson correlation coefficients between the variables revealed existence of a

strong positive and significant correlation between government expenditure and FDI inflows into the country. The relationship between economic growth and FDI inflows was found to be weak and positive. The study revealed the existence of a correlation that is strong and positive between external debts and FDI inflows. The results also revealed a correlation that is insignificant, positive and weak between balance of payments and FDI inflows in the country.

The model summary revealed that the independent variables: government expenditure, economic growth, external debt and balance of payment explains 65% of changes of the dependent variable as shown by the R^2 value which means that other factors not made part of this model which account for 35% of changes in FDI inflows in Kenya exist. The model was found to be fit at 95 percent confidence level because the F-value of 16.260 is higher than the critical value. This implies that the multiple regression model is statistically significant since it is a prediction model that suitably explains FDI inflows in Kenya.

These findings conform to those of Ajudua and Davis (2015) who in their study which sought to ascertain the effect of government expenditure and FDI towards Nigeria's economic development vital macroeconomic variables; Foreign Direct Investment as well as government expenditure are strong drivers of economic development of a nation. This study was necessitated by the need to control government expenditure and monitoring the FDI in order to gain a steady economic growth. Multiple regression analysis was applied to examine the correlation between Foreign Direct Investment and government expenditure that is capital and recurrent expenditure as the explanatory variables on GDP as the dependent variable. The findings of the study exhibited that the explanatory variables: capital and recurrent expenditures and FDI

had a notable relation with economic growth. Although capital expenditures didn't conform with the expectation.

This study is in contrast with Wabwalaba (2017) who sought to determine the effect of public debt on foreign direct investments inflows in Kenya. Secondary data was collected for duration of 10 years (January 2007-December 2016) on a quarterly basis. The study used a descriptive research design as well as a multiple linear regression model was employed for analyzing the association between the variables. The results of this study revealed that about 27.8 percent of the variation in FDI inflows in Kenya can be explained by the four selected independent variables while 72.2 percent in the variation was associated with other factors not covered in this research. The results further revealed that individually, public debt, economic growth, exchange rates and inflation rates are not significant determiners of FDI inflows in Kenya.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The chapter shows the summary of research findings, the conclusions from the results, and the recommendations for policy and practice. The chapter also discusses limitations encountered as well as suggestions for future research.

5.2 Summary of Findings

This study's aim was to investigate the effect of fiscal policy on FDI inflows in Kenya. The independent variables were government expenditure, external debts, economic growth and balance of payments. The study employed a descriptive research design. Secondary data was obtained from CBK as well as KNBS and was analyzed using SPSS software version 21. The study used quarterly data covering a period of ten years from January 2008 to December 2017.

The correlation analysis results showed that a strong positive and significant correlation exists between government expenditure and FDI inflows into the country. The relationship between economic growth and FDI inflows was established to be weak, positive and insignificant. This study also showed that external debt and FDI inflows were strongly, positively and significantly correlated. The results also revealed that balance of payments and FDI inflows in the country had a weak, negative and insignificant association.

The co-efficient of determination R-square value was 0.650 which implies that about 65 percent of the variation in FDI inflows in Kenya could be explained by the four selected independent variables while 35 percent in the variation of FDI inflows in

Kenya is associated with other factors not covered in this research. The study also found that the independent variables was strongly correlated with FDI inflows in Kenya (R=0.806). ANOVA results reveal that the F statistic was significant at 5% level with a p=16.260. Therefore the model was fit to explain the association between the selected variables.

The regression results show that when all the selected dependent variables (government expenditure, economic growth, external debt and balance of payments) are rated zero, FDI inflows in Kenya would be 30.964. A unit increase in government external debt would cause FDI inflows in the country to increase by 8.049 while a unit increase in balance of payments, government expenditure and economic growth would not have a significant effect on FDI inflows as shown by high p values.

5.3 Conclusion
As per the findings, the study makes the conclusion that FDI inflows in Kenya have a positive and significant association with government expenditure. The study therefore concludes that higher government expenditure lead to increased FDI inflows in the country and to a significant extent. This study found that balance of payment and external debts have a positive and significant correlation with FDI inflows in the nation and we can therefore conclude that higher external debt and balance of payment tend to encourage FDI inflows in Kenya. Economic growth was also found to have a positive relationship with FDI inflows in the country and therefore a rise in economic growth results to a rise in FDI inflows in Kenya.

The study concludes that independent variables selected for the study government expenditure, economic growth, external debt and balance of payment influence FDI inflows in the country to a significant extent as they account for 65 percent of the

changes in FDI inflows in the country. The fact that the four independent variables explain 65% of changes in FDI inflows in Kenya imply that the variables not included in the model explain 35% of changes in FDI inflows in the country. The overall model was found to be significant as explained by the F statistic. Thus it is adequate to make the conclusion that these variables affect FDI inflows in the country in a significant manner as depicted by the p-value in ANOVA summary.

This finding concurs with Ajudua and Davis (2015) who in their study which sought to ascertain the effect of government expenditure and FDI towards Nigeria's economic development vital macroeconomic variables; Foreign Direct Investment as well as government expenditure are strong drivers of economic development of a nation. This study was necessitated by the need to control government expenditure and monitoring the FDI in order to gain a steady economic growth. Multiple regression analysis was applied to examine the correlation between Foreign Direct Investment and government expenditure that is capital and recurrent expenditure as the explanatory variables on GDP as the dependent variable. The findings of the study exhibited that the explanatory variables: capital and recurrent expenditures and FDI had a notable relation with economic growth.

5.4 Recommendations

This study established that there is a positive influence of government capital expenditure on FDI inflows in the country which is statistically significant. This study recommends that there is need for policy makers to enhance government expenditure and specifically capital expenditure bearing in mind that an increase in government expenditure has a significant positive association with foreign direct investment inflows in the nation.

This study found that external debt has a positive influence on foreign direct investment inflows in the nation. This study recommends that policy makers should be motivated to fund projects using external debts as this will positively influence foreign direct investment inflows. However, high debt levels may also have some negative consequences in the economy and so policy makers should strike a balance between the benefits of external debt and the ills associated with unsustainable debt levels.

Balance of payment was found to have a positive and significant correlation with FDI inflows in the country. The study recommends that policy makers should pay attention to the prevailing level of exports and imports as they have an impact on foreign direct investment inflows in the country. Boosting exports will go a long way in encouraging foreign direct investments.

5.5 Limitations of the Study

The scope of this research was for ten years 2008-2017. It has not been determined if the results would hold for a longer study period. Furthermore it is uncertain whether similar findings would result beyond 2017. A longer study period is more reliable as it will take into account major economic conditions such as booms and recessions.

The quality of the data is a limitation of the study. It's hard to make a conclusion from this study if the findings portray the true facts regarding the situation. The data that has been used is only assumed to be accurate. The measures employed may continue changing from one year to another according to the conditions that prevail. This study used secondary data that had already been gotten and was in the public domain, contrary to primary data whereby data is obtained first-hand. This study also

considered selected determinants and not all factors affecting FDI inflows mainly due to limitation of data availability.

For data analysis purposes, the researcher applied a multiple linear regression model. Due to the shortcomings involved when using regression models such as erroneous and misleading results when the variable values change, the researcher cannot be able to generalize the findings with certainty. If more and more data is added to the functional regression model, the hypothesized relationship between two or more variables may not hold.

5.6 Suggestions for Further Research

This study's focus was on fiscal policy and foreign direct investment inflows in Kenya and relied on secondary data. A research study where collection of data depends on primary data, that is, in-depth questionnaires as well as interviews covering the different sectors that receive FDI is recommended so as to complement this research.

The study was not exhaustive of the independent variables affecting FDI inflows in Kenya and this study's recommendation is that further studies be carried out to incorporate other variables like money supply, exchange rates, inflation, cost of labour, technological advancement, education levels, political stability and other macroeconomic variables. Establishing the effect of each variable on FDI inflows will enable policy makers know what tool to use when controlling FDI inflows.

The study concentrated on the last ten years since it was the most recent data available. Future studies may use a range of many years e.g. from 1970 to date and this can be helpful to confirm or disapprove the findings of this study. The study limited itself by focusing in Kenya. The recommendations of this study are that further studies be conducted on other contexts such as other East Africa countries.

Finally, because of the regression models' shortcomings, other models such as the Vector Error Correction Model (VECM) can be employed in explaining the various associations between the variables.

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