

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


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## DECLARATION

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

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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 Wilson Mbogo and Lucy Muthanje. I appreciate the sacrifices you have made for me as well as your support. I'll always value your lessons and the impact you have had on me.

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## LIST OF ABBREVIATIONS

<b>AfDB</b>	- Africa Development Bank
<b>ANOVA</b>	- Analysis of Variance
<b>CIT</b>	- Corporate Income Tax
<b>DTA</b>	- Double Tax Agreement
<b>DTAA</b>	- Double Tax Avoidance Agreement
<b>EAC</b>	- East African Community
<b>EEA</b>	- European Economic Area
<b>EPZ</b>	- Export Processing Zones
<b>FDI</b>	- Foreign Direct Investment
<b>GDP</b>	- Gross Domestic Product
<b>ICT</b>	- Information Communication and Technology
<b>IMF</b>	- International Monetary Fund
<b>KNBS</b>	- Kenya National Bureau of Statistics
<b>KRA</b>	- Kenya Revenue Authority
<b>MNE</b>	- Multinational Enterprise
<b>MNC</b>	- Multinational Corporations
<b>OECD</b>	- Organisation for Economic Co-operation and Development
<b>OLI</b>	- Ownership, Location, and Internalization
<b>SEZ</b>	- Special Economic Zone
<b>TJNA</b>	- Tax Justice Network Africa
<b>UN</b>	- United Nations
<b>UNCTAD</b>	- United Nations Conference on Trade and Development
<b>VAT</b>	- Value Added Tax

## ABSTRACT

The motivation behind this project was to demonstrate the substantial impact of tax incentives on FDI inflows in Kenya. Specifically, the paper sought to lay out the impact of tax inducements (incentives) as the predictor variable together with interest rate, inflation rate, and economic growth as control variables on the FDI inflows as the outcome variable. Tax incentives were estimated using normal algorithm of yearly tax incentives given by the government. The interest rate was estimated by the CBK annual lending rate. Inflation rate was estimated by the annual inflation rate. Economic growth was estimated by yearly GDP. The FDI was estimated by yearly net inflows in Kenya. Utilizing the correlational research design, this paper gathered secondary data from different government and inter-governmental organizations official sources for 10 years (2012 – 2021) on annual basis. The paper adopted descriptive statistics (mean, median, and standard deviation) to describe the center and spread of the data and pattern plot (trend plot) examination to depict the presentation of the data across the investigation period. The study then conducted diagnostics analyses to ensure linear regression assumptions were met. Thereafter, the study conducted inferential statistics to illustrate the significant impact of tax incentives on FDI inflows in Kenya. With the aid of SPSS software version 23.0, the regression analysis provided R-Square of .588 and F-statistics of .269. The discoveries uncovered that though tax incentives predict nearly 59% of changes in FDI annual inflows, the F-Statistics indicate that model did not explain the substantial impact of tax incentives on FDI inflows in Kenya. This was also evident in the regression coefficients output where tax incentives, interest rate, inflation rate, and economic growth recorded significant values greater than .05. The study, therefore, concluded that there is no significant impact of tax incentives on FDI inflows in Kenya. The study recommends a need to review existing tax policies and laws of FDI and align them to the long-term economic stability of the country. At the same, there is a need for policymakers to ensure that tax incentives do not turn out to be costlier for the government. The limitation of this study is that it approached tax incentives in totality. Further research should attempt to establish impact of individual tax incentives on FDI inflows in Kenya.

## **CHAPTER ONE**

### **INTRODUCTION**

#### **1.1 Background of the Study**

Foreign direct investments (FDI) are investments made by organisations in a foreign concern, and it is important for companies to expand and develop an international presence and play a crucial role in a country's socioeconomic and technological expansion. The IMF further defines FDI as a cross boarder investment whereby the foreign investor has ownership equity that guarantees ten percent or more of the voting power and influence (Tee et al., 2017). FDI is beneficial to both the host country and businesses as the businesses can expand into new markets and the host country can enjoy increased revenue arising from an increase in the tax base, job creation, growth of industries, and adoption of modern technology that positively impact the socio-political and economic state of the country in the long term.

FDI is one of the biggest contributors to a country's capital inflow as well as a big catalyst to spur economic development especially in developing economies. Kenya has enjoyed being a regional country of choice for investors since independence and hosts many multinational corporations in East Africa. With the growth of technology and general urbanization across developing countries, the competition to FDI has been of the increase. Most governments have come up with ambitious infrastructure projects as well as implementation of various policies to either increase its FDI pool or retain the existing one. The policies range from tax incentives, signing DTAs as well as many others. FDI boost international trade by allowing businesses to move to other parts of the world that are more cost-effective and allowing revenue to flow to

other parts of the world (Marandu et al., 2019). FDI helps host countries increase their tax revenue primarily through increase of their tax base. The Kenya Vision 2030 is also anchored at being able to attract high levels of FDI.

### **1.1.1 Tax Incentives**

Tax incentives are the concessions in tax codes that are geared to encourage companies or individuals to invest in an economy. Common examples include free economic zones, tax holidays, investment allowances, reduced tax rates, and tax credits (Misati et al., 2022). Although the impact of tax inducements on FDI is not apparent in most countries, empirical studies show that FDI inflows directly impact tax in a given country, and that tax incentives are crucial in attracting FDI.

According to KRA, investors in Kenya get several incentives that include capital allowances, special economic zones incentives, EPZ incentives, tax holidays, VAT and Stamp duty exemptions, tax deductions, and DTAs, among others (2022). DTAs eliminate the double taxation of income in multiple tax jurisdictions, promote FDI, as well as encourage tax information exchange. DTA in Kenya has been implemented with countries such as the UK, Germany, Canada, India, France, South Africa, South Korea, UAE, Qatar, and the East African Community. Withholding tax rates in Kenya differ between countries with DTAA and those without DTAA. For example, the management fee for a non-resident with Kenyan PE for countries with DTAA is 5%, while that of a non-resident without PE is 20% (Deloitte, 2019). The Double Taxation Agreement is essential since it enhances economic cooperation and promotes FDI into a host country because companies are aware of the existing tax treaties and implement favorable taxes on foreign companies.

Although tax incentives are geared to improve some sectors of the economy, this is not always the case. According to AfDB, tax inducements, especially in the mining industry, are not effective in attracting FDI (Coulibaly & Camara, 2022). The IMF further argues that the usefulness of tax inducements in the mining industry is negligible and that it might harm economic progress as they deny nations of tax revenues that could supply the public with goods and services (Keen et al., 2014).

### **1.1.2 Foreign Direct Investments in Kenya**

Today, China is the leading foreign investor in Kenya and Africa, with the most investments in infrastructure and mining. In 2019 before COVID-19, the FDI flows in Kenya peaked at \$1 billion but declined to \$717 million the following year, primarily due to the pandemic (UNCTAD, 2021). In Kenya, the tax incentives that attract high FDI inflows include the ICT industry, transport industry, agriculture, and scientific research.

The net FDI inflows in Kenya as a percentage of GDP have been inconsistent over the years peaking at 3.1% in 2011. As of 2020, the percentage of FDI to GDP was 0.4% (KNBS, 2021). Between 2014 and 2020, the tax income to GDP averaged between 14% and 15%, with 2020 having the lowest tax income to GDP at 14.3% (KNBS, 2021). According to the Foreign Investment Survey 2020 report by the KNBS, the FDI inflows in the Nairobi Stock Exchange in 2019 were 112 billion shillings, while the outflows were 64 billion shillings. During the 2018-19 financial year, FDI accounted for the largest proportion of foreign investment liabilities at 52.9%, primarily through investment fund shares and equity (KNBS, 2021). Foreign investments are critical to a country's economic outlook.

### **1.1.3 Impact of Tax Incentives on FDI**

Efficient and attractive tax policies in the home country affects investments through providing efficient access to foreign markets, increasing net domestic income, and improving economies of scale. According to studies examining FDI inflows, a 1% increase in tax reduces FDI by 3.7% (OECD, 2008). Nevertheless, this varies depending depending on countries, industries, and periods. The sensitivity of FDI to changes with the difference in policies and economic situation of the host country and business mobility within the tax base.

Some tax policy considerations are important when planning for FDI because tax competition affects host countries' global investment decisions and tax policies. Another tax factor affecting FDI is business-friendly tax administration, whereby the predictable, reliable, timely, and consistent application of tax rules are key business considerations when considering FDI (Boly et al., 2019). Additionally, in the cases of outbound FDI, it is necessary to consider the rates that match those of inbound FDI for a more comparable tax burden. Tax neutrality is important for businesses to maximize pre-tax returns and increase the likelihood of businesses investing in FDI. Another way tax incentives affect FDI is through dividend credit systems that allow tax deferral of the home country until they have paid their foreign profits, as seen in most OECD countries (OECD, 2008). Although tax is an important factor in attracting FDI, it is not the main determinant of FDI. Governments have responded to pressures on lowering tax on FDI by reducing statutory CIT rates to improve tax efficiency. Other measures include tax relief on certain sectors and industries. Governments also seek to review the tax treatment of outbound FDI as it increases capital and business mobility (Kamau, 2020). Similarly, improving transparency and tax treatment of

organisations, especially foreign companies, makes it easier to improve business friendliness and attract more FDI.

According to World Bank, in 2018, Kenya had a tax-to-GDP ratio of 16%, which shows that the country relies heavily on taxes to raise its income (The World Bank Group, 2022). Therefore, Kenya is exposed to revenue loss with an increase in tax incentives to promote FDI inflows. A research conducted by the Tax Justice Network-Africa and Action Aid international revealed that Kenya foregoes more than Kes. 100 billion (\$1 billion) annually to tax incentives, and this is a sizeable part of its revenue (2012). The EPZs and SEZs are the most prominent sectors contributing to revenue loss through tax incentives.

## **1.2 Research Problem**

FDI plays a crucial role in growing economies around the world. Tax plays an important role in promoting FDI in many countries (Boly et al., 2019). Based on various empirical evidence, the contribution of tax motivations in attracting FDI has been contentious, hence lack of a clear consensus on the relationship. In Kenya, the number of studies carried out in this field is not sufficient as well as compared to other various demographics such as Europe and Asia. This study aims at filling that contextual research gap by establishing an understanding of the association between tax incentives and FDI inflows in Kenya.

Kenya has implemented many tax incentives, some that have attracted FDI inflows while others have led to revenue loss and unhealthy competition with other African countries. Case studies such as Nasibu (2022) show that tax incentives in Kenya do not contribute to the growth of FDI, instead, these incentives have led to the loss of

tax revenue for the government. This differs from other studies such as Gumo (2013) that show tax incentives lead to increased FDI inflows into the country. A methodological research gap does exist where some papers adopted non-OLS estimators and examined panel data sets. Some other papers utilized time series data and the OLS estimator to define the association (Nasibu, 2022). Some previous studies do not incorporate any control variables (Aslam, 2015). This creates a conceptual research gap.

Thus, the research sought to fill on these gaps and find out the impact of tax motivations on FDI in Kenya.

### **1.3 Objective of the Study**

This research aimed to determine the significance of tax incentives to the inflows of FDI in Kenya.

### **1.4 Value of the Study**

A 2006 research by IMF found that Kenya forgoes revenue of approximately one per cent (1%) of the annual GDP to tax incentives. This loss of revenue is significant because the resources could be used in other developmental programs that can promote economic growth. Therefore, this study is helpful as it may assist the Kenyan government to understand the efficiency of the tax policies as well as make comparisons between foregoing potential tax revenue and attracting additional FDI inflows. It is also important because it helps the government understand the specific tax incentives that are most beneficial and passing any amendments.



The study is important for trading blocs such as EAC because it helps member states understand the efficiency of tax incentives within the trading bloc as well as passing of necessary legislations.

The study may also help investors make informed decisions when settling international investments especially through existence of DTAs.

Lastly, this study may also be important to scholars because it enables them to build on the existing knowledge gaps and advance knowledge in the study.

## **CHAPTER TWO**

### **LITATURE REVIEW**

#### **2.1 Introduction**

This literature review chapter looks at some theories that are core to this study's theoretical framework. It also discusses other related topics and concepts in this study as part of the empirical study to understand the existing studies on the topic. This chapter further discusses other sections, such as the tax incentives in FDI in Kenya, the association between tax and FDI, and the determinants of FDI.

#### **2.2 Theoretical Framework**

This section of the chapter checks out different theories that offer alternative points of view on the connection between tax motivations and FDI. The theories selected to underpin the study included product life cycle, internationalization, and the OLI (electric) paradigm.

##### **2.2.1 The Product Life Cycle Theory**

The product life cycle theory, a relatively common hypothesis in economics was founded by Raymond Vernon and he later advanced it in 1966 (Mitchell & Clark, 2019). He used the theory to explain the various types of FDI for American firms in the post-war time. The theory uses comparative advantage theory and analyses the correlation between product life cycle and attraction of FDI inflows. According to the theory, the four phases of the cycle of production are innovation, product development, maturity products, and decline.

**Stage one:** Innovation is where local companies create a new product for the purposes of local consumption and exportation of surplus to foreign markets (Udokporo, 2021). In this early stage, there are no specifications on the cost and final specification.

**Stage two:** Growth products: This stage records an increase in volume demand, products become more standardized, and the local market attains saturation level (Musabeh, 2018). This growth leads the local firm to expand their operations in foreign locations where they can get lower production costs to give them a competitive advantage. In this stage, firms invest in FDI outflows in other host countries.

**Stage three:** Maturity products: at this stage, the characteristics of products become wholly standardized, and the price becomes a key factor in competition causing a rise in the number of foreign companies that expand to create value addition for their products (Musabeh, 2018). At this stage, the company's export position is threatened, pushing the firm to conduct its production processes in the host country using its foreign subsidiaries.

**Stage four:** Decline: This stage occurs when the market becomes saturated, and the goods are no longer sold in the domestic market (Musabeh, 2018). This stage occurs due to either competition from new and innovative products or a natural process of the business life cycle. Despite the decline, most organisations continue operations by offering services to their existing market. One of the modifications to the theory was the evolution of the second generation product life cycle theory that was transformed into two models that are the brand life-cycle (BLC), and organisational life-cycle (OLC) (Mitchell & Clark, 2019). This modification no longer considers life of an individual product, rather it focuses on the broad organisation and the various brands.

This hypothesis is useful in understanding FDI because it explains the rationale behind implementing operations in a foreign country especially in exporting countries. The theory applies to FDI because implementing this concept is only applicable in countries that are attractive to FDI because of the availability of factors such as good technology and technological capability and cheap manufacturing costs (Musabeh, 2018). As the product matures, the firm seeks cheaper production in foreign countries and market for export that sees them engage in FDI. The theory is essential because it helps investors to understand the timing and planning of investments depending on the product's life cycle. These four stages are important to investors in planning for expansion, redesigning, and when to enter or exit a particular market (Bajrami, 2019). Some factors that investors consider in the product life cycle when making foreign investments include consumer preferences, the rate of industry innovation, market maturity, market competitiveness, product shelf life, and market saturation.

Some criticisms that affect the theory include the lack of changes in the theory to reflect the current developments that have impacted marketing such as global competition and internet based search and purchase (Mitchell & Clark, 2019). Another criticism of the theory is that progress is driven by the organisation and not necessarily the customers or market demand. Further, the assumption that sales increase rapidly during the growth rate due to the customer acceptance of their products may be wrong because there may lack linear progression from one stage to the next, as well as lack of clear delineation of stages (Mitchell & Clark, 2019). Lastly, the theory assumes that price reduction attracts more customers which may not always be the case.

### **2.2.2 Internationalization Theory**

Buckley and Carson initiated the internalization theory in 1976 to expound on the growth of American multinational corporations following the end of World War II (Benito et al., 2019). The theory suggests that these MNCs internalize their resources that they later redistribute to different categories and other target markets. Buckley and Carson later modified the theory to expound why many firms participating in international business opt to export some of their products to particular markets while in other markets they choose to invest locally (Musabeh, 2018). In their modification, they argued that firms choose their mode of entry into the market by avoiding strategies that yield higher costs of doing business and lower profits. Using economic models by Hirsch (1976), firms ought to decide their location of operations, marketing, and the activities that should be internalized or externalized to cut costs. Internationalization requires an investment that has high fixed costs and low variable costs. Two main suppositions drive this theory. The first supposition is that economic activities are carried out within a firm only when they are more cost-effective and cost-efficient than when collaborating with partners. This assumption is true for domestic and foreign projects (Musabeh, 2018). Another assumption is that companies are only interested in participating in FDI if the returns are higher than those of their domestic market or if investing in FDI has a higher return on investment than licensing. The internalization theory seeks to define the behavior and strategy of organisations in international markets.

The theory is relevant in understanding FDI because it explains how MNEs exist and function by understanding the boundaries of the MNEs, their interaction with the external environment, and their internal organisation. The internalization theory

explains FDI as seen in international diversification opportunities whereby shareholders in MNEs use FDI to increase the firm's values and outsource intangible assets such as marketing and technology (Buckley & Casson, 2020). Internalization theory converges the interests between managers and shareholders in foreign expansion, and it is important because MNEs possess the ownership advantage in comparison to local firm's ownership. The foreign firms benefit from comparative advantage, and offers advantages when implementing their activities in the host countries when compared to leasing or buying from other companies mainly through saving on costs of production. One of the primary considerations in this theory that foreign investors look out for is the ownership structure of the business and the government policies on foreign investments (Benito et al., 2019). In cases where the regulations guiding business ownership in a host country do not favour foreign investors, it attracts less FDI inflow. Another factor that multinationals consider when making decisions on FDI is the ability of the company to produce in their host country, based on the competitive advantage they would derive from setting up in the host country.

Nevertheless, there are some criticisms to the theory include the theory does not factor in the impact of location advantages depending on the mode of entry. Secondly, the assumption that competition in the host country against an inferior company is not effective in market entry since competition is dynamic (Benito et al., 2019). Another criticism is that cost minimization limits the firm's operations, especially during market entry, since it does not utilize its full capabilities.

### 2.2.3 The O.L.I (Eclectic) Paradigm

This theory is an important theory when discussing FDI. In 1979, John Dunning developed the theory by extending the internalization theory (2015). This model combines three theories that focus on Ownership (O), Location (L), and Internalization (I), which are important considerations that firms consider while planning for FDI. OLI is the intersection of the microeconomic and macroeconomics of the firm, and it examines the relationships and interactions between the different components of a business to determine the most important factors for international business. The three critical factors of the eclectic paradigm include ownership advantages, whereby there are various ownership rights of a company participating in the FDI (Dunning, 2015). The *ownership* advantages are crucial for an organisation in FDI because they give the firm a competitive advantage, such as a reputation for reliability (Muindi, 2017). The variables of location advantage are secondary to ownership advantages. It is important for a firm to assess whether it gains any comparative advantage when performing specific functions within a particular nation for FDI consideration. The *location* advantage is important for comparison purposes to understand the availability and cost of resources between different locations. The *internalization* variable is the inherent flexibility of the organisation, market, and production capacity through its internal subsidiaries. This variable helps organisations understand when it is viable to produce in-house versus contracting with a third party (Muindi, 2017). Internalization can be an advantage to a firm in foreign investment because it enables the organisation to be more cost-effective when they operate in a different market but do the work in-house. In cases where the business prefers to outsource its production, it is better to negotiate partnerships with local firms to gain the advantage of first-hand experience of the local market, get cheaper and easier

access to raw materials and even acquire more skilled employees to make better products in the domestic market. The OLI paradigm advises firms to develop their home country ownership advantages and transfer these advantages to location-specific countries.

The OLI paradigm is relevant in explaining FDI because the three elements of the eclectic paradigm are critical for improving FDI. In the internalization element, legal systems play an important role in attracting FDI, whereby countries aligned to legal systems such as French or English are more likely to be inclined to foreign investors from countries with similar legal systems because of the better protection of investment rights, law enforcement, better intellectual property rights, and even language barriers. The three elements of the eclectic paradigm are important in attracting FDI primarily by governments avoiding excessive spending, investing in educating the labour force, and setting up a conducive legal environment for investors.

Some criticisms have emerged on the theory, such as the argument that bringing data together in the OLI paradigm is impossible without connecting links (Eden & Dai, 2010). Similarly, scientists have criticized that the variables, in theory, are too many, and their value is critical, and it would be much better if they stood as theories themselves rather than a single theory. Other criticisms include many firms internalize their activities to take advantage of market imperfections and do not necessarily engage in FDI.

## **2.3 Tax Incentives and its Impact on FDI in Kenya**

### **2.3.1 Government Policy on Tax Incentives**



The government of Kenya provides multiple tax incentives to encourage FDI inflows into the country. There are different incentives for different economic zones and industries. The most prominent industries to benefit from tax incentives is the EPZs that seek to transform Kenya into an export-based economy, and SEZs that seek to grow the country's economic base, create employment and reduce poverty. 61% of the EPZs in Kenya are foreign companies (Curtis et al., 2012, p.4). Some of the major tax incentives applied to the EPZs include a 10 – year tax break and a subsequent tax rate of 25% for the next ten years after the tax holiday ends, against the standard rate of 30%. There is a tax exemption of up to 10 years from all withholding taxes immunity from raw materials import duties, inputs, and machinery (Curtis et al., 2012, p.5). EPZs also receive an exemption of tax duty and raw materials VAT and other inputs. Another incentive that EPZs receive is Tax Remission for Exports Office (TREO) to motivate local manufacturers to export. Other incentives and exemptions are available to foreign investors, such as Wear and Tear Allowance which applies to goods such as tractors and motor vehicles as a capital allowance. Investment Deductions Allowance (IDA) is an allowance given to a firm's spending on building and machinery. Mining Deduction Allowance is given to mining companies that is equal to 40% of the expenditure in its initial year and a 10% rate for the next six years, and it covers the exploration, discovery, and testing of minerals (Curtis et al., 2012, p.5). Another tax exemption is Building Allowance, which allows businesses capital allowance when constructing industrial buildings. In Kenya, SEZs enjoy 100% investment deduction that is offered for the purchase or installation of machinery and other building materials that are used by businesses within the SEZ. There is the exemption of excise duty in the special economic zones. The SEZs are also exempted from Railway Development Levy (RDL) and Import Declaration Fee (IDF).

### **2.3.2 Revenue Losses from Tax Incentives**

There is a lack of transparency on how tax incentives affect Kenya's revenues in terms of FDI inflows. However, in terms of tax exemptions, there are significant revenue losses in Kenya, primarily due to tax holidays and exemptions. As of 2011, Kenya is said to have been losing over \$1.1 billion (Kes. 100 billion) from tax incentives and exemptions, mostly from VAT exemptions. The revenue losses amount to about 3.1% of the Kenyan GDP (Curtis et al., 2012, p.7). Another area that Kenya lost revenue from tax incentives is through import duty exemptions that grew consistently between 2005 and 2008. Kenya lost between 11% and 18% of its accrued revenue from import duty (EAC Trade Report 2008, 2010, p.51). The revenue losses from tax incentives do not seem to wield notable advantages in attracting FDI because in some years, such as 2007 and 2008, the country lost more revenue from tax incentives compared to earlier years, yet there were reduced FDI inflows as compared to earlier years. Tax holidays also result in perennial revenue loss for the country because the country does not gain any revenue from foreign companies through tax. The loss of FDI inflows in 2008 in Kenya can be pegged to political instability, and therefore, such cases show that tax incentives are not feasible in promoting FDI.

### **2.3.3 Problems with Kenya's Tax Incentives**

Tax incentives in Kenya have not been an effective determinant for FDIs because the disadvantages outweigh the possible advantages of the tax incentives. Some disadvantages include the loss of present and future tax revenue, mainly through import duty and VAT exemptions. Tax incentives lead to high administration costs used in establishing and implementing the incentives, mainly through research and auditing firms (Curtis et al., 2012, p.10). The application of different rules for

different companies complicates the process and increases the cost of tax administration. Similarly, tax holidays and tax exemptions attract rent-seeking from companies that are not profitable and can also be a platform for illegal activities. Tax incentives often lead to a lack of transparency because many companies may seek to establish or change their company models to fit in as foreign companies hence leading to revenue loss. According to an OECD report, tax incentives reduce government revenue by 1 to 2% of its GDP (Curtis et al., 2012, p.11). Tax holidays mostly favour transitory investments rather than sustainable investments. Therefore, the incentives may not yield positive results for the government in the long term; instead creates a loophole for tax avoidance. In Kenya, where there is poor governance, income tax exemptions attract little investment, mainly at the expense of domestic investments (Curtis et al., 2012, p.11). Tax incentives in Kenya have led to increased corruption because many domestic and foreign firms seek to abuse the tax policies to qualify for these incentives. Tax incentives in Kenya cause more revenue loss to the government; hence they are not a feasible determinant for attracting FDI.

KRA that is mandated with collecting tax revenue, has often missed out on its targets despite growth in tax expenditures. For example, in the 2018/19 financial year, there was a revenue shortage of 300 billion (TJNA, 2012). The primary cause of revenue shortfall in Kenya can be partly associated with tax incentives introduced by the government to support some of their projects, such as the Big Four Agenda and Vision 2030. Tax incentives, especially in CIT, tax holidays, and exemptions on VAT and stamp duty for foreign investors, have led to major revenue losses for the country primarily due to manipulation of the loopholes by MNEs (Nasibu, 2022). In return, there has been minimal growth in FDI inflows into the country, and therefore it can be argued that tax incentives do not replicate positive FDI inflows in Kenya.

## **2.4 The Relationship between Tax Incentives and FDIs**

Tax incentives are a positive attraction for FDIs, especially in developed countries. However, they play a secondary role in attraction of FDIs compared to other determinants such as exchange rates, interest rates, market size and growth, and inflation, among other factors (Appiah-Kubi et al., 2021). In Kenya, tax motivations and FDIs associations cannot be fully defined because of the absence of well-structured and lucrative tax motivations. Nevertheless, the government employs promotion strategies to attract FDI that seeks to boost economic growth and promote technology transfer and diversification of production. According to studies conducted by the AfDB and IMF in 2006, the effect of tax motivations in East Africa in attracting FDI was negligible (Curtis et al., 2012). Another report by the Tax Justice Network – Africa and Action Aid International showed that tax incentives by the Kenyan government led to tax competition with other African countries and eventual revenue loss (Curtis et al., 2012). Therefore, tax incentives have minimal power in attracting FDIs in Kenya.

According to UNCTAD World Investment Report (2011), Kenya had relatively more tax incentives than Tanzania and Uganda between 2006 and 2010, yet it had significantly lower FDI inflows. Estimates show that the government of Kenya lost about \$1.1 billion or Kes. 100 billion to tax incentives. In return, the government received just \$133 million in FDI inflows, which is relatively low when compared to neighboring countries such as Uganda that received \$848 million while Tanzania received \$700 million despite both countries investing far less as compared to Kenya. (Curtis et al., 2012). Kenya has more tax incentives than her neighbours Tanzania and Uganda but still attracts less FDI due to higher business costs and lack of natural

resources as some of the leading factors for loss of FDI. Therefore, the correlation between tax motivations in Kenya and the attraction of FDI inflows is weak. This relationship can further be emphasised by cases such as Egypt, which has a high inflow of FDIs despite its relatively higher taxes and lower tax incentives compared to many countries in the Sub-Saharan African region such as Kenya (Badr & Ayed, 2015). This leads us to the argument that tax incentives are not a primary factor in attraction for FDIs, especially in Sub-Saharan Africa.

## **2.5 Determinants of Foreign Direct Investments**

According to Gumo (2013), multinational companies engage in complex and strategic decision making when choosing to engage in FDI. The main motivator for MNCs to engage in FDI is driven by the need to improve business performance and profit margins that can be realized by venturing into newer markets as part of expansion while reducing costs of doing businesses such as labor and raw materials. The presence of favourable tax policies does play a huge role as well to expand to those markets.

According to Kadongo (2011), inflation rate is an important determinant in FDI because it represents the prevailing economic conditions in a given economy. A high inflation rate reflects high uncertainty levels, affecting the pricing of goods and services, with investors often choosing higher prices to offset inflationary risks. Inflation is normally linked to economic factors such as high debt obligation, which represents high risks to an economy, creating uncertainty. A high inflation rate affects profits and, therefore, negatively affects stability; hence it is an important consideration by foreign investors. The rate of inflation is important because it helps

foreign investors to measure instability at the macro level. A high rate of inflation negatively affects the rate of FDI inflows.

Exchange rate is another important macroeconomic factor that MNEs consider in determining FDI inflows because volatility in exchange rates negatively affects FDI inflows (Goldberg, 2009). When the value of a currency depreciates when exchanged against another currency, it leads to the reduction of a nation's wages and the costs of production comparative to the foreign currency, and this encourages FDI by giving the investors a locational advantage. Similarly, in the case of depreciation, which increases the salaries and production costs in the destination market, FDI is affected negatively. When there is a devaluation in the market of destination, currency increases the relative wealth of the agents in the source country and increases multinational acquisitions.

Interest rates are a crucial determinant of FDI because they show the market's potential. Economies with higher interest rates represent good economic performance and a stable economy that is good for investments (Siddiqui & Aumeboonsuke, 2014). Further, governments use interest rates to adjust inflation. Higher interest rates are important in attracting more foreign capital because they heighten the nation's exchange rates. Besides, low interest rates show economic instability and are less attractive for FDI.

## **2.6 Empirical Review**

Nduku (2017) found that tax motivations do not affect FDI inflows into a host nation. A regression analysis conducted on the same study found there was a negative FDI loss. The findings showed that farm works deduction had no statistical effect on FDI

inflows in Kenya. Similarly, industrial building allowances did not significantly affect FDI inflows in Kenya. Further, tax incentives such as wear and tear allowance and investment deductions showed no significant effects on FDI influses. The study found that other determinants are more influential in attracting FDI other than tax incentives, hence the relatively insignificant impact of FDI.

Ziegler (2013) explains that tax incentives have been implemented in many parts of the world to promote trade and FDI in a country or a trading bloc. Many countries, especially in Asia and Europe, have used tax incentives to promote economic development and trade by attracting FDI. For example, the European Economic Area (EEA) can be considered a large-scale plan to promote FDI in member states because they receive special benefits that include fiscal incentives such as tax incentives and non-fiscal incentives such as a single market, and this promotes FDI among the EEA member states. Some examples of tax incentives that member states receive include DTA whereby there is equal treatment of local and foreign companies and elimination of double taxation by payment of tax to the member state rather than their resident state. Tax incentives have proven effective when implemented over larger jurisdictions because they widen the scope of international trade.

Peters et al. (2015) investigated the impact of FDI in Nigeria and found that increase in tax incentives has a negative corresponding significance to FDI. The study sampled information from the the Central Bank of Nigeria and World Bank Development Indicators. The statistics were later analyzed using Error Correction Modelling (ECM) that was critical in determining the time series properties of the defined tax incentives. The findings showed that an increase in tax incentives did not positively impact FDI inflows in the country, as other external factors were more significant determinants of

FDI. Many foreign investors in the country locate Nigeria as an investment destination because of the natural resources rather than the financial incentives that are not a major determinant of their investment. The study recommends creating a stable political climate and stable economic reforms as they are key determinants that can positively influence FDI inflows in Nigeria.

Siregar and Patunru (2021) found that as the tax incentives increase, there is a significant decrease in FDI flows to Indonesia. The paper utilised data from 22 partner nations between 1999 and 2018 and analyzed the data using least square dummy variable examination to assess the effect of tax motivations on FDI alongside other determinants. The outcome revealed an inverse association between tax motivation and FDI because other variables are more significant in supporting FDI inflows into Indonesia, such as macroeconomic stability and high-quality institutions. The study advises that governments should stimulates and streamlines the quality of institutions and creates macroeconomic stability that are more significant determinants of FDI, and also because they would support tax incentives implementation more effectively.

## **2.7 Conceptual framework**

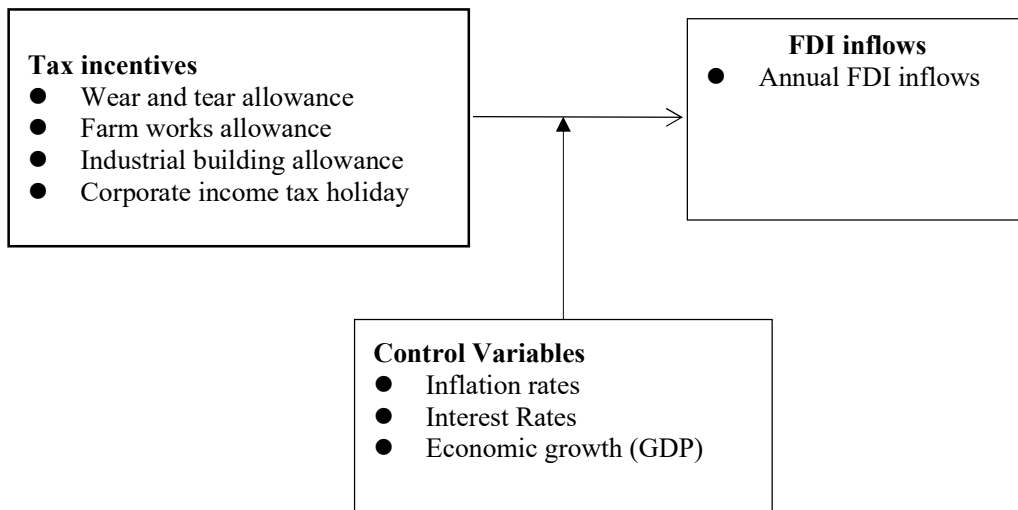
Tax incentives are essential in promotion strategies for FDI influxes (Boly et al., 2019). The conceptual framework developed in this research paper shows the expected relationships between the various study variables. It represents the relationship between different incentives and FDI inflows into the country. The independent variables are the tax incentives such as wear and tear allowances, corporate income tax holiday, VAT act, exemption from stamp duty & VAT, and farm works allowance. In the model, the FDI inflows are the dependent variable and it is measured through change in GDP annually. The model includes control variables



that are expected to influence FDI, and they include inflation rate, economic growth, and interest rates. Inflation rate affects the association between tax incentives and FDI because it affects the real value of investments in an economy and significantly impacts other determinants such as interest rates that are adjusted depending on inflation rates. Economic growth is another significant variable that affects the association between tax motivations and FDI because a growing economy is more attractive to investors and vice versa. Meanwhile, political stability is a key control variable in the relationship because it determines the suitability of investment in an economy.

**Figure 2.1**

*Conceptual Framework*



*Independent Variables*

*Dependent Variables*

**2.8 Summary of Literature Review**

The theoretical framework considers three useful theories in understanding FDI that are the product life cycle theory, internalization theory, and the O.L.I. (eclectic)

paradigm. The product life cycle theory is crucial because it seeks to explain the association between trade and FDI, and it analyzes the different stages of the production cycle and the impact on FDI inflows over time. The internalization theory is important in defining the behaviour and strategy of the organisation in international markets. It is important to understand why organisations choose to invest in other markets. The eclectic paradigm is significant in understanding FDI because it looks at international trade from a holistic viewpoint, combines ownership, location, and internalization models, and helps us understand how these components affect international trade.

Curtis et al. (2012) outlines the various tax incentives the Kenyan government provides to encourage FDI influxes. Nonetheless, the paper reveals that the government loses a significant portion of its taxable income to tax incentives, as seen with the loss of \$1.1 billion in 2011. Such losses highlight the negative connection between tax motivations and revenue losses. Further, the Tax Justice Network Africa (2012) reported that tax incentives negatively impact FDI because it leads to revenue loss from factors such as manipulating loopholes by foreign investments to evade taxes. Additionally, studies such as Appiah-Kubi et al. (2021) found that there are other FDI determinants such as financial infrastructure, interest, exchange, and inflation rates among other factors that made tax incentives less powerful in attracting FDI. In the same line of study, Nduku (2017) found that tax motivations do not affect domestic country's FDI influxes. Further, Peters et al. (2015) reported that tax motivations do not determine FDI inflows in Nigeria, while Siregar and Patunru (2021) recorded that tax motivations negatively affect FDI flows in Indonesia. These are various schools of thought discussed in the literature review, and they lack a consensus on the exact effect of tax motivations on FDI inflexus. This lack of

consensus calls for further research on the existing field of knowledge. This study provided additional data and information to improve the understanding of the impact of tax motivation on FDI influxes in Kenya.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter of the study highlights the strategy and methods the study relied on to establish the study objective. The chapter first provides the selected research design together with the population and data collection tool and procedures. The chapter then provides data analysis including diagnostic tests.

#### **3.2 Research Design**

Asper Creswell (2017), a research design is a framework that gives explicit plan of how the study was conducted. It is important in translating the phenomenon under investigation into relevant information for purposes of establishing research aims. The choice of research design was correlational research design because it attempts to illustrate the proposed relationship between study variables. The need to use statistical data to define the relationship between variables without having to manipulate the data was an important factor in selecting the research design. This research design is cost-effective and allowed the researcher to collect more data.

#### **3.3 Target Population and Sampling**

Rahi (2017) defines population as all people, items, or subjects that researchers seek to understand while conducting a research study. The population includes figures obtained from different sources such as the World Competitiveness Index Report, the Global Innovation Index, World Competitiveness Index Report, the Global Risk profile, and the World Bank Governance Indicators. There was no sampling

conducted during this examination. The exact population was the annual FDI inflows into the country and the GDP. The analysis covered a ten-year period (from 2012 to 2021).

### **3.4 Data Collection**

The research used secondary sources of data for a ten-year period (from 2012 to 2021). Most of the data used in the study were derived from government sources, including the KRA, KNBS, CBK, National Treasury and Export Processing Zones Authority, among other public records. Other sources were reputable international financial journal sources such as World Bank, IMF and UNCTAD collected from the last ten years. The data collected includes the FDI inflows into the country, the total revenue lost by the government during the period under consideration, inflation rates, changes in foreign exchange rates, interest rates, and economic growth.

### **3.5 Diagnostic testing**

This research study conducted diagnostic testing using four methods: heteroskedasticity, autocorrelation, multicollinearity, and normality test.

#### **3.5.1 Heteroskedasticity**

This is a condition where the difference between the number of measurements and the error term varies (Grégoire, 2014). This occurs when the predicted variable standard deviations, which are observed over various independent values similar to older time periods, are non-constant.

### **3.5.2 Autocorrelation**

This diagnostic testing occurs when the error term is correlated over time, thus seeking to develop a pattern over a time series (Grégoire, 2014). The findings can either be positive or negative, and this test is mainly conducted using the Durbin-Watson statistic and the Breush Godfrey test.

### **3.5.3 Multicollinearity**

This is a form of statistical diagnostic testing where several independent variables within a model are correlated (Grégoire, 2014). If the correlation coefficient between two variables is + or - 1.0, they are considered perfectly collinear.

### **3.5.4 Normality test**

The error term is distributed with zero mean, and the constant variance is denoted by  $\mu (0,1)$ , and it uses the assumptions of the classical linear regression model (Grégoire, 2014). The model excludes some variables not included in the model-dependent variable as error word because it assumes they have a slight random effect.

## **3.6 Data Analysis**

The research used a regression model to analyze the findings with the FDI inflows to Kenya as the outcome variable (Sarsted & Mooi, 2019). The predictor variables were tax incentives, economic growth rates, inflation rates, and interest rates. The research used version 23 of SPSS programming software to generate the analyzed statistics as it is user-friendly.

### 3.6.1 Analytical Model

The research used the data to conduct a regression analysis to illustrate the degree of the association between tax incentives and FDI influxes as shown in this model:

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

Where;

$Y =$  FDI inflows (outcome variables)

$\beta_0 =$  Y intercept of the regression equation

$\beta_1 + \beta_4 =$  are slope of the regression

$X_1 =$  Tax incentives (measured by natural logarithm)

$X_2 =$  Interest rate (measured by annual interest rate)

$X_3 =$  Inflation rate (measured by annual inflation rate)

$X_4 =$  economic growth (measured by annual GDP growth rate)

$\varepsilon =$  error term

### 3.6.2 Tests of Significance

A test of significance is a formal procedure used to compare observed data or hypotheses to assess the truth. These findings are expressed in the form of a probability that measures the extent to which the data and claim agree (Selvin, 2017).

The statistical test was conducted using the f-test to establish the significance of the general model, and it was obtained from ANOVA, while a t-test was conducted to report the significance of individual variables in the study.

## CHAPTER FOUR

### DATA ANALYSIS AND DISCUSSION

#### 4.1 Introduction

This chapter provides a comprehensive analysis and discussion of the findings. The chapter starts with a detailed summary of descriptive statistics followed by trend plot analyses of the study variables independently. The chapter then provides inferential statistics including correlation and regression examination to illustrate the significance of tax incentives on the FDI annual inflows in Kenya.

#### 4.2 Descriptive Statistics

The descriptive analysis results provided in Table 4.1 illustrates the observations of the study (N = 10 observations) with a mean and median to describe the center of the data. Specifically, the findings revealed that FDI annual inflows and tax incentives had a mean of 20.33 and 11.09 with a median of 20.35 and 11.31 respectively. The data appears to be slightly skewed to the left, which explains why the median is slightly higher than the mean. The findings further established that interest rate, inflation rate, and economic growth had equal mean and median of 15.00, 6.00, and 5.00 respectively. This suggests that the data appears to be symmetrical for interest rate, inflation rate, and economic growth, which explains why the data appears normal. Additionally, the standard deviation illustrated how data are spread out from the center. The results showed that FDI annual inflows, tax incentives, and interest rate had a standard deviation of .54, .95, and 2.79 respectively. Also, the inflation rate and economic growth recorded a standard deviation of 1.58 and 2.06 respectively. Generally, the descriptive findings suggested that FDI annual net inflows was the



most centered data with a higher median of 20.35 while interest rate was the most widely spread out data from the mean with a higher standard deviation of 2.79.

**Table 4.1**

*Descriptive Statistics*

	N	Minimum	Maximum	Mean	Median	Std. Deviation
FDI annual net inflows	10	19.41	21.05	20.33	20.35	.54
Tax incentives	10	8.68	12.27	11.09	11.31	.95
Interest rate	10	12	20	15.00	15.00	2.79
Inflation rate	10	5	10	6.50	6.00	1.58
Economic growth	10	0	8	5.00	5.00	2.06
Valid N (listwise)	10					

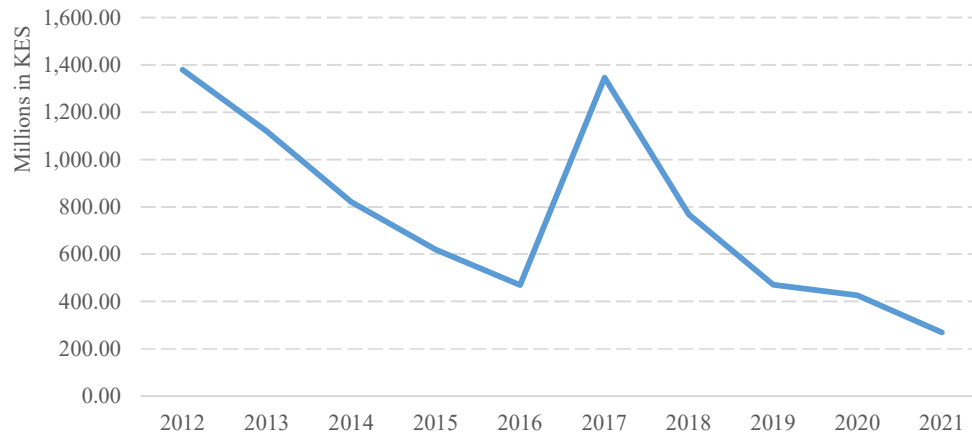
*Note:* A descriptive statistics table describing the center and spread of the data.

**4.3 FDI Annual Net Inflows**

The Trend plot analysis in Figure 4.1 demonstrated that FDI annual net inflows fell dramatically between 2012 and 2016. This represented a 66 percent drop to KES 469 million in 2016 from KES 1.4 billion in 2012. Besides, whereas there was a significant increase in FDI annual net inflows of KES 1.3 billion in 2017 from KES 469 million in 2016, approximately 187 percent growth, the FDI annual net inflows dramatically fell between 2017 and 2021. This represented approximately an 80 percent decrease in FDI annual net inflows to KES 268 million in 2021 from KES 1.3 billion in 2017. The results, thus, imply that the FDI annual net inflows in Kenya across the study period have been uneven, with a constant decline in growth from 2017 to 2021.

**Figure 4.1**

*FDI Annual Net Inflows*



*Note:* Trend plot analysis of FDI annual net inflows in Kenya between 2012 and 2021

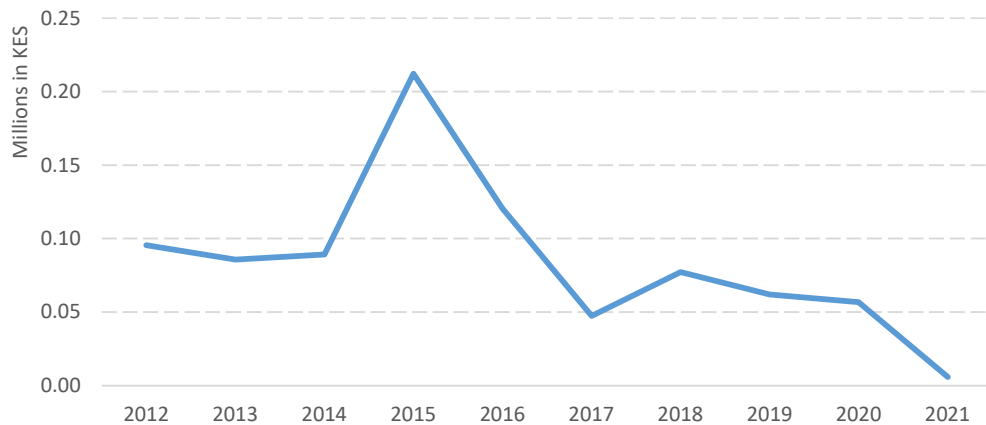
#### **4.4 Tax Incentives**

As shown in Figure 4.2 of the study, the results exhibited a slight decrease of 7 percent in tax incentives to KES 89 million in 2014 from KES 95 million in 2012. The results also showed that between the period of 2014 and 2015, the country (Kenya) witnessed a rapid growth of approximately 138 percent tax incentives from KES 89 million in 2014 to KES 212 million in 2015, the highest in the study period. However, this period was followed by a drastic decline in tax incentives to KES 47 million in 2017, approximately a 78 percent drop from KES 212 million in 2015. Moreover, the findings recorded that though there was a slight increase in tax incentives to KES 77 million in 2018 from KES 47 million in 2017, there has been a dramatic decline in tax incentives from 2020 to 2021. This represented a 90% decline in tax incentives from KES 56 million in 2020 to KES 5 million in 2021. Again, the result suggests that tax incentives for FDI in Kenya have not been consistent. The

highest tax incentives for FDI were recorded in 2015 at approximately KES 212 million.

**Figure 4.2**

*Tax Incentives*



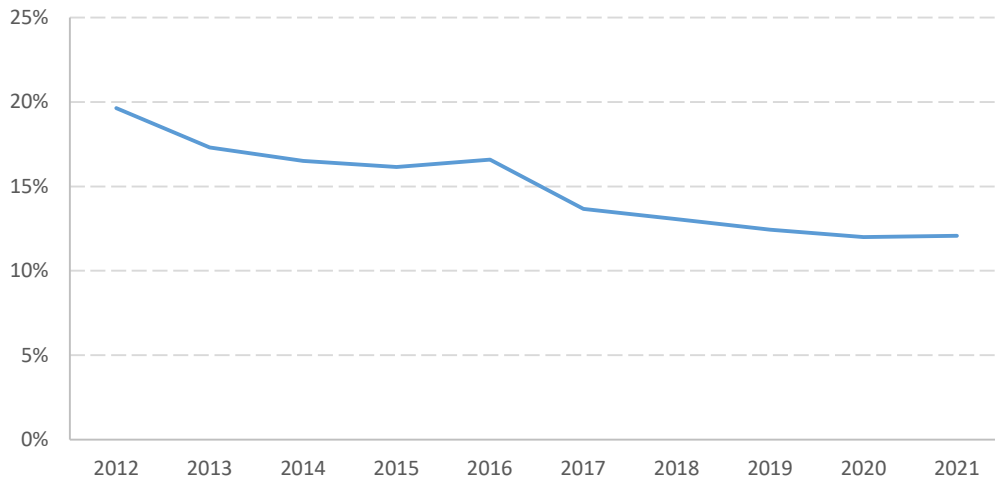
*Note:* Trend plot analysis of tax motivations for FDI in Kenya between 2012 and 2021

#### **4.5 Interest Rate**

In displaying the observations of interest rate across the study period, the trend plot analysis results in Figure 4.3 shows that the highest interest rate for FDI (19.65) was recorded in 2012 and the lowest interest rate (12.00) was recorded in 2020. The results also revealed that from 2012 to 2014, there has been a slight drop in the interest rate of 12 percent and 16 percent for 2013 and 2014 respectively since 2012. The country, nonetheless, recorded a slight increase of 3 percent interest rate from 16.16 in 2015 to 16.58 in 2016. Since then, the trend plot analysis outcome illustrates that there have been slight declines in interest rates from 13.67 in 2017 to 13.06 in 2018 and 12.44 in 2019, as well as 12.00 and 12.08 in 2020 and 2021 respectively.

**Figure 4.3**

*Interest Rate*



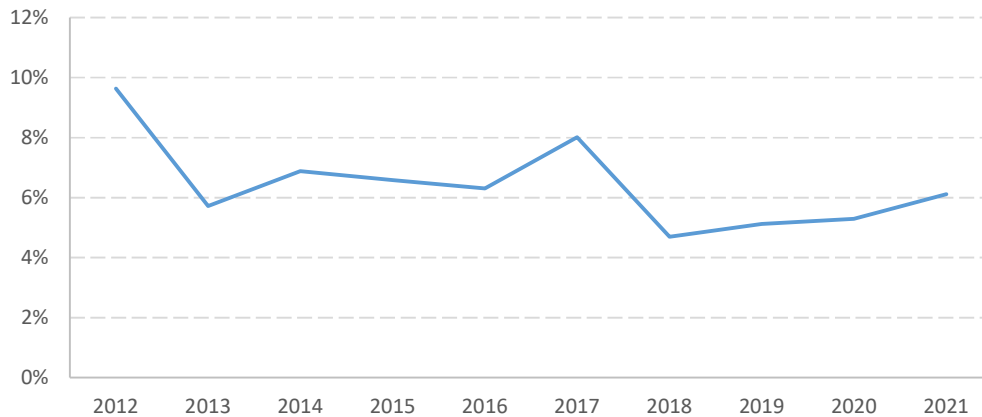
*Note:* Trend plot analysis of interest rate in Kenya between 2012 and 2021

**4.6 Inflation Rate**

As displayed in the trend plot analysis Figure 4.4, the outcome of this study confirms that there has been a simultaneous growth and drop in the inflation rate across the study period. In particular, the results revealed that the highest inflation rate (9.64) was recorded in 2012 and drastically declined to 5.72 in 2013, a 41 percent decline. There was an increase in the inflation rate (6.88) in 2014 and slowly declined in 2015 and 2016 at 6.58 and 6.3 respectively. Notably, the findings showed a growth in the inflation rate, a 27 percent increase from 6.3 in 2016 to 8.02 in 2017, which was followed by a dramatic decline of 41 percent inflation rate to 4.7 in 2018. The higher inflation rates in 2012, 2014, 2015, 2016, 2017, and 2021 may signify a bad economic environment with a lower purchasing power of consumers and increased costs for capital-intensive investments.

**Figure 4.4**

*Inflation Rate*



*Note:* Trend plot analysis of the inflation rate in Kenya between 2012 and 2021

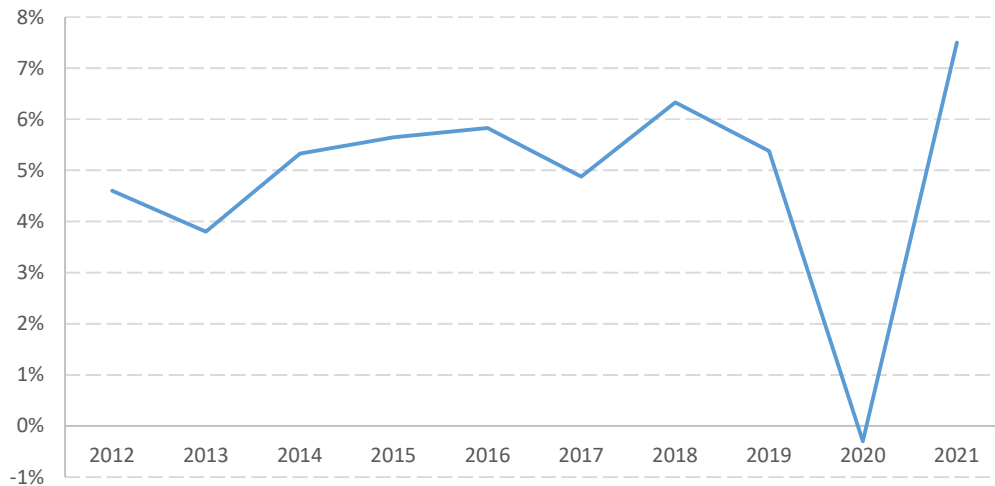
**4.7 Economic Growth**

Across the study period, the trend plot analysis outcome in Figure 4.5 displayed that Kenya's economic growth has not been positively constant for many years, with slight declines in some periods. For instance, there was a slight decline in economic growth from 4.6 in 2012 to 3.8 in 2013. This period was followed by a drastic positive economic growth of 5.83 in 2016 from 3.8 in 2013, representing a 53 percent growth. The economic growth, however, took a downturn (4.88) in 2017 and this could be attributed to the challenges of the 2017 general elections, which may have scared foreign investors. While the country attempted to gain stability in economic growth (6.33) in 2018, there was a slight decrease (5.38) in 2019 and a dramatic decline in economic growth (-0.3) in 2020. The negative economic growth recorded in 2020 could be attributed to COVID-19, which caused negative socio-economic impacts on

developing countries like Kenya. The country, however, responded well to the COVID-19 challenges by recording the highest economic growth of 7.5 in 2021.

**Figure 4.5**

*Economic growth*



*Note:* Trend plot analysis of economic growth in Kenya between 2012 and 2021

#### **4.8 Diagnostic Tests**

Before conducting inferential statistics, this study performed diagnostic tests to determine linear regression assumptions as discussed herein.

##### **4.8.1 Heteroskedasticity**

This study conducted heteroscedasticity to establish whether data was homogenous using the Breusch-Pagan test as well as a scatter plot. For the Breusch-Pagan test, the findings in Table 4.2 presented a Chi-square of 10.01 and a significance level of  $.35 > .05$ . The study, therefore, upheld the null hypothesis that data was homogenous for making study conclusions.

**Table 4.2**

*Breusch-Pagan Test for Heteroskedasticity*

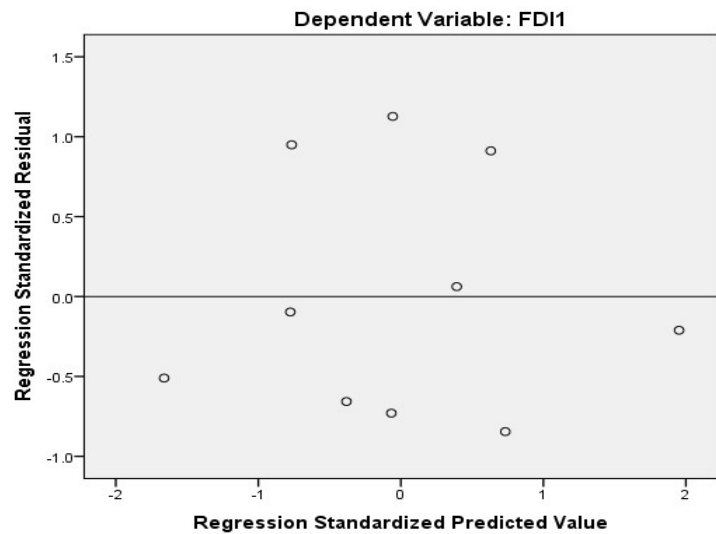
Breusch-Pagan test for Heteroscedasticity (CHI-SQUARE df=p)
10.01
Significance level of Chi-square df=p (HO: homoscedasticity)
.3505

*Note:* Testing whether the variance of error terms in a regression model varies

Similarly, the scatter plot in Figure 4.6 indicates no presence of any pattern. This confirms no presence of heteroscedasticity problems as revealed in the Breusch-pagan statistical test.

**Figure 4.6**

*Scatter Plot for Heteroscedasticity Test*



*Note:* Fitted heteroscedasticity graph of Residual Square against the predicted value of the dependent variable

### 4.8.2 Autocorrelation

Likewise, the study performed autocorrelation to measure the extent of closeness among same variables values between different points in time. Using the Durbin Watson (DW) test established from the overall linear regression model summary as shown in Table 4.3, the results exhibited a DW value of 1.58, which is positive and indicated no autocorrelation problems.

**Table 4.3**

*Durbin Watson Test for Autocorrelation*

Model	Std. Error of the Estimate	Durbin Watson
1	.46534	1.577

*Note:* The table confirms no presence of relationships between values of similar variables across different times.

- a. Predictors: (Constant), Tax incentives, interest rate, inflation rate, economic growth
- b. Dependent Variable: FDI annual net inflows

### 4.8.3 Multicollinearity

The multicollinearity test was determined to display whether there could be a correlation between the predictor variables of the study. The linear assumption is that a noble model or regression should not exhibit a association between predictor v factors. Using the Variance Inflation Factor (VIF), the results in Table 4.4 showed that all the predictor variables had VIF less than 4, thus, indicating no problems of multicollinearity between independent variables.



**Table 4.4***Variance Inflation Factor for Multicollinearity Test*

Model	Tolerance	VIF
1 (Constant)		
Tax incentives	.492	2.034
Interest rate	.263	3.806
Inflation rate	.389	2.571
Economic growth	.830	1.204

*Note:* The results in the table confirmed the absence of multicollinearity between predictor factors

a. Dependent Variable: FDI annual net inflows

**4.8.4 Normality Test**

Using the Shapiro-Wilk test and Kolmogorov-Smirnov tests, the findings in Table 4.5 indicated that the p-values of all the study variables were above .05. The study upheld the null hypothesis and concluded that data was normally distributed.

**Table 4.5***Shapiro-Wilk and Kolmogorov-Smirnov Tests of Normality*

	Kolmogorov-Smirnov <sup>a</sup>			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
FDI annual net inflows	.151	10	.200*	.950	10	.672
Tax incentives	.269	10	.309	.793	10	.102
Interest rate	.163	10	.200*	.887	10	.155
Inflation rate	.224	10	.168	.863	10	.083
Economic growth	.300	10	.101*	.821	10	.206

*Note:* The results in the table confirmed that the data was normally spread across for examination.

\*. This is a lower bound of the true significance

a. Lilliefors significance correction

#### **4.9 Correlation Analysis**

This study examined a bivariate correlation to illustrate the linear association between tax incentives, interest rate, inflation rate, and economic growth as predictor variables and FDI inflows as the predictor variable of the study.

Majorly, the outcomes presented in Table 4.6 of this study displayed a positive correlation between tax incentives and FDI inflows,  $r(5) = .49, p > .05$ . The result suggests that though tax incentives positively correlate to FDI influses, the correlation is not significant to warrant a linear positive changes on FDI inflows due to positive changes in tax incentives. Similarly, the findings reported a strong positive linear relationship between interest rate and FDI annual net inflows,  $r(5) = .62, p > .05$ . However, the result does not illustrate a noteworthy correlation between interest rate and FDI influses.

Results in Table 4.6 also showed a fairly strong significant positive linear association between inflation rate and FDI inflows,  $r(5) = .623, p < .05$ . The results suggest a linear growth in FDI annual net influses as a result of positive changes in inflation rate and vice versa. Finally, the correlation analysis results demonstrated that economic growth and FDI inflows have a negative linear relationship,  $r(5) = -.129, p > .05$ . This finding indicated that both economic growth and FDI influses do not a linear relationship.

**Table 4.6***Correlation Analysis*

		FDI net inflows	Tax incentives	Interest rate	Inflation rate	Economic growth
FDI net inflows	Pearson Correlation	1	.491	.623	.653*	-.129
	Sig. (2-tailed)		.150	.054	.041	.722
	N	10	10	10	10	10
Tax incentives	Pearson Correlation	.491	1	.559	.179	-.277
	Sig. (2-tailed)	.150		.093	.621	.438
	N	10	10	10	10	10
Interest rate	Pearson Correlation	.623	.559	1	.731*	.097
	Sig. (2-tailed)	.054	.093		.016	.790
	N	10	10	10	10	10
Inflation rate	Pearson Correlation	.653*	.179	.731*	1	.171
	Sig. (2-tailed)	.041	.621	.016		.637
	N	10	10	10	10	10
Economic growth	Pearson Correlation	-.129	-.277	.097	.171	1
	Sig. (2-tailed)	.722	.438	.790	.637	
	N	10	10	10	10	10

*Note:* The table illustrates correlation between study variables.

\*. Correlation is significant at the .05 level (2-tailed)

**4.10 Regression Analysis**

Comprehensively, this study conducted a regression examination to test the hypothesis of the study. However, the study first determined the model summary, which illustrated the extent of changes in FDI inflows due to changes in tax incentives, interest rate, inflation rate, and economic growth as outlined in Table 4.7.

The results revealed an R Square ( $R^2$ ) of .59, which suggest that tax incentives and (interest rate, inflation rate, and economic growth) predict 59 percent changes in FDI annual net inflows ( $R^2 = .59, F(4, 5) = 1.785, p > .05$ ) . The findings, nonetheless, demonstrates that there could be other predictors and tax incentive impact of FDI annual net inflows not covered in this current study.

**Table 4.7**

*Model Summary*

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.767 <sup>a</sup>	.588	.259	.46534

*Note:* The table illustrates the degree to which changes in tax incentives predict changes in FDI annual net inflows.

- a. Predictors: (Constant), Tax incentives, interest rate, inflation rate, economic growth
- b. Dependent Variable: FDI annual net inflows

Moreover, the regression analysis displayed the analysis of variance (ANOVA) output to test the model significance in explaining the main impact of tax motivations on FDI. The outcome in Table 4.8 demonstrated the model explained an insignificant positive main effect of tax incentives on FDI influxes  $F(4, 5) = 1.785, p > .05$ . The results suggest that the overall model did not explain the significant effect of the tax motivations on the FDI influxes in Kenya.

**Table 4.8***Analysis of Variance (ANOVA)*

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	1.546	4	.387	1.785	.269 <sup>b</sup>
Residual	1.083	5	.217		
Total	2.629	9			

*Note:* The table illustrates the model significance in explaining the effect of tax motivations on FDI

a. Dependent Variable: FDI annual net inflows

b. Predictors: (Constant), Tax incentives, interest rate, inflation rate, economic growth

Lastly, the regression analysis provided regression coefficients output to demonstrate the impact of tax incentives, interest rate, inflation rate, and economic growth on FDI inflows in Kenya. Specifically, the regression coefficients provided statistics for testing the main objective of the study as shown in Table 4.9. Altogether, the findings showed that none of the four predictor variables (tax incentives, interest rate, inflation rate, and economic growth) had a significant impact on FDI influxes in Kenya. Independently, the results confirmed that only tax incentives,  $\beta = 2.00, t(5) = .857, p > .05$ , and inflation rate,  $\beta = .21, t(5) = 1.36, p > .05$ , have positive coefficients (suggesting a positive association with FDI influxes). However, the association is insignificant to predict positive FDI inflows. Moreover, the findings showed that both interest rate,  $\beta = -.004, t(5) = -.033, p > .05$ , and economic growth,  $\beta = -.04, t(5) = -.44, p > .05$ , reported negative regression coefficients, suggesting both have an inverse relationship with FDI inflows.

**Table 4.9***Regression Coefficients*

Model	Unstandardized Coefficient		Standardized Coefficient	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	16.953	2.255		7.517	.001
Tax incentives	.200	.234	.351	.857	.431
Interest rate	-.004	.109	-.018	-.033	.975
Inflation rate	.214	.157	.627	1.363	.231
Economic growth	-.036	.083	-.138	-.437	.681

*Note:* Displaying regression coefficients to illustrate effect of tax motivations on FDI influxes

a. Dependent Variable: FDI annual net inflows

The study then tested the multiple linear regression model:  $(Y = 16.953 + 2.00 X1 - .004 X2 + .214 IX3 - .036 EX4)$ , to demonstrate the extent of the impact of tax incentives (X1), interest rate (X2), inflation rate (X3), and economic growth (X4) on FDI annual net inflows. The findings in Table 4.9 indicate that improved policies around tax incentives and inflation rate could increase FDI annual net inflations. However, these positive changes are insignificant to cause significant changes in FDI inflows in Kenya. Similarly, the results confirmed that declines in the interest rate and economic growth may harm FDI annual net inflows. The findings, thus, demonstrated a lack of significant effect of tax incentives on FDI in Kenya.

#### **4.11 Discussion of the Findings**

The study sought to estimate the research question: What is the significance of tax incentives to the FDI influxes in Kenya? From the analysis conducted herein,

especially the regression coefficient output, the results demonstrated insignificant impact of tax incentives on FDI influxes in Kenya. Whereas the study acknowledged the importance of various tax incentives, the results showed that a positive impact of both tax incentives and inflation rate are insignificant to cause major positive changes in FDI inflows. Also, the results confirmed that the negative impact of interest rate and economic growth are insignificant to cause significant changes in FDI.

The outcome of this study corroborates with some previous findings outlined in the empirical literature. The study agreed with Peters et al. (2015) that an increase in tax incentives does not have a significant positive impact on FDI. Similarly, the findings concurred with Siregar and Panturu (2021) whose study reported a lack of positive association between tax motivations and FDI inflows. In particular, the authors reported that tax motivations have inverse association with FDI. Besides, the findings confirmed Nduku's (2017) outcome that tax motivations have no significant effect on FDI influxes in Kenya.

Consequently, the outcome of this study disagreed with some previously examined studies in the area of tax incentives and FDI inflows. The results did not support earlier findings by Ziegler (2013) that tax incentives can promote economic development and trade by attracting FDI. Though the author was very categorical on how fiscal incentives like tax incentives and non-fiscal incentives like the single market can promote FDI in European Economic regions, these results were not statistically tested.

## CHAPTER FIVE

### SUMMARY, CONCLUSION, AND RECOMMENDATIONS

#### 5.1 Introduction

The preceding chapter, chapter four, of this study provided a comprehensive analysis, and discussion of the results. This chapter builds on chapter four to provide a summary of the results, conclusion, and recommendations.

#### 5.2 Summary of the Findings

The overriding objective of this study was to determine the significance of tax incentives on FDI inflows in Kenya. To accomplish this goal, it became necessary to particularly establish the impact of a) tax incentives, b) interest rate, c) inflation rate, and d) economic growth on FDI inflows. After conducting an extensive literature review on tax incentives, determinants of FDI, and possible effects of tax motivations on FDI inflows, the study adopted a correlational research design to determine the extent of the impact of the aforementioned predictor variables on FDI inflows in Kenya. Secondary data on tax incentives, FDI annual net inflows, interest rate, inflation rate, and economic growth were extracted from various sources including World Bank, IMF, UNCTAD, CBK, KNBS, and KRA for ten years (2012 – 2021).

From the regression analysis results, the study reported that the ANOVA outcome demonstrated that the model did not exclusively explain the significant positive impact of tax motivations on FDI inflows. The regression coefficients confirmed the findings by demonstrating that all the predictor variables had a p-value  $> .05$ . This suggested that though tax incentives and inflation rate had positive coefficients and



interest rate and economic growth had negative coefficients, all did not have significant impacts on FDI incentives. This demonstrated that there is no noteworthy effect of tax motivations on FDI influxes in Kenya.

The results were supported by trend plot analysis conducted for each study variable. For instance, the trend plot analysis extensively showed that even with increased economic growth in 2021, the FDI inflows for the same period declined to a record low. Thus, raises the question: Does an increase in economic growth increase FDI? The analysis shows no. This suggests that even with negative economic growth, FDI inflows can still be positive as in the case of negative economic growth in 2020 and positive FDI inflows in the same period.

### **5.3 Conclusions**

Tax incentives depict practices that a government through a recognized government tax institution like KRA uses to reduce taxes for businesses and entrepreneurs. The aim is to achieve some specific desirable actions or investment returns on their part. Tax incentives are seen as techniques to attract more investment activities that can result in improved economic growth in totality. Based on this theoretical understanding together with the practical findings presented in the results and analysis chapter, this study makes several conclusions.

Central to the general objective of this research was to illustrate the impact of tax incentives, interest rate, inflation rate, and economic growth on FDI inflows in Kenya. The findings confirmed that none of the predictor variables have significant positive impacts on FDI inflows. Independently, while both tax incentives and the inflation rate showed positive coefficients, the study concluded that none of the two predictor

variables have a noteworthy positive effect on FDI influxes. Tax incentives may be diverse and it is not clear in this study, as to what tax incentives may work or not. Thus, a general conclusion is that tax motivations lack noteworthy effects on FDI influxes.

Similarly, a higher inflation rate may suggest a worse economic environment and decreased purchasing power of consumers. The results, thus, concluded that though the inflation rate may be a critical determinant of FDI, it lacks noteworthy positive effect on FDI. Regarding interest rate and economic growth, the study highlighted that the two variables had negative regression coefficients. This means a negative impact on FDI. However, the results are not significant to cause a noteworthy impact on FDI influxes. In particular, economic growth regression and trend plot analysis results have provided mixed indications as to how best to describe the relationship with FDI inflows. Thus, the conclusion is that there is no noteworthy effect of tax motivations (as explained in this study) on FDI influxes in Kenya.

Notably, this study provides useful results that may be important in broadening theories related to internationalization and FDI activities. By showing that there could be different predictors of FDI, the study allows foreign investors and the Kenyan government to consider other factors like intangible assets and skills in determining FDI. The argument as effectively outlined in the internationalization theory, is that FDI is based on opportunities where MNE can capitalize on existing intangible resources (assets) to gain competitive advantage, thus, providing maximum FDI influxes to a particular nation. The study, thus, concludes that the findings provide useful results for improving the theoretical body of knowledge regarding the effect of tax motivations on FDI in Kenya.

The study concludes the results concurred with several past studies related to tax incentives and FDI. For instance, in one of the previous studies included in the literature focusing on FDI in Nigeria (Peters et al., 2015), the results concluded that tax incentives did not positively increase FDI. Rather, as the current study has shown, these studies highlight that FDI activities may be attracted by numerous reasons. Among them are exploitation of natural resources (opportunities) and existing technological skills. Thus, this study notes that there could be challenges like corruption that the government needs to address to understand possible causes of decline or growth in FDI inflows.

#### **5.4 Recommendations**

The outcome of this research revealed that tax motivations cannot overcome the fundamental challenges or opportunities of investments. Precisely, it was observed across different periods in the trend analysis of tax incentives that there are instances where tax incentive costs were higher or almost half the FDI net inflows. This raises questions as to why would tax incentives be extremely high yet there are no significant FDI inflows. This reveals existing policy gaps that this study makes recommendations on.

One, there is a need for the government of Kenya to review existing tax incentive policies and laws of foreign investments in Kenya. Rather than just making tax incentive policies to attract foreign investors, there is a need for the government to align the goal of tax motivations to the entire economic growth goals. This will ensure that tax incentives do not turn out to be costly on the government side and revenue to the foreign investors. Moreover, the government needs to critically evaluate the market and establish sectors that would experience higher investments even without

tax incentives. Among key considerations are technology sectors and manufacturing due to expanding digital skills (human capital) and available natural resources.

Taxation laws may be complicated to draft among some legislators, thus, a collective political approach to tax incentives rather than a well-thought economic approach. This may create a tax administration burden, which also means increased costs in the allocation of resources to achieve tax incentives. This study, therefore, recommends that policymakers should approach tax incentives from an economic perspective and try to tie the long-term impacts to economic growth. There should be a good working relationship between legislators and policymakers. This is to ensure that tax incentives are only applied to emerging sectors in the economy. The reason is that already developed sectors will automatically attract investments even without tax incentives.

While many developing countries may feel the need to do all they can to attract investments, many international organizations may also put pressure on developing countries to give them tax incentives. Countries that may enact tax incentives under such pressure may not realize the expected FDI growth in the long run. For these reasons, this study recommends the government to develop tax incentives that are not driven by external pressure but rather by economic stability. Even if foreign investors threaten to go to other countries, the government should ensure that tax incentives are not only done for the benefit of the investors but for the country's economic growth.

Finally, this study recommends the need to address major hindrances to investment opportunities in Kenya. A major concern is corruption, which has seen many foreign businesses leave Kenya for other countries. Corruption through the demand of kickbacks from some government representatives needs to be addressed to create a

conducive business environment. This can significantly contribute to a conducive business environment that promotes economic growth that can attract more FDI.

### **5.5 Limitations of the Research and Areas of Further Study**

Whereas this study has provided important findings, it encountered several limitations, which further research can be built on. One major limitation was access to different data about different tax incentives. The lack of this data made it difficult for the study to conclusively develop conclusions as to what or which tax incentives may work or not, and what impacts such tax incentives may have on FDI independently. For this reason, the study had to use general tax incentive data to make study conclusions. Further research, therefore, should consider accessing data on different tax motivations and attempt to model the impact of each tax incentive on FDI either focusing on Kenya or other emerging nations.

The second limitation of this study was the use of limited data for analysis. The study only collected secondary data for 10 years (2012 – 2021), which may have been not large enough to provide generalized results. As such, further investigation should be carried out on the study topic using large data, maybe for a period of 30 years to illustrate possible impacts of tax incentives on FDI. This may provide recommendations on the need to drop tax motivations if the impact has been effective or maintain it if the impact has been positive on FDI. Finally, this study only used secondary data, which though proved useful in determining the effect of tax motivations on FDI in previous years, there is a need for use of primary data to gauge legislators' and policymakers' perspectives on tax incentives and possible impact on FDI inflows in Kenya.

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## APPENDICES

### Appendix A: Secondary Data Collection Sheets

<b>Year</b>	<b>FDI Annual Net Inflows</b>
2012	1,380,173,661.94
2013	1,118,825,000.19
2014	820,937,598.36
2015	619,724,465.02
2016	469,533,310.68
2017	1,346,085,345.22
2018	767,761,506.73
2019	469,940,266.78
2020	426,305,189.43
2021	268,572,269.34

(Source: The World Bank Group, 2021)

<b>Year</b>	<b>Tax Incentives "Millions"</b>	<b>Interest Rates</b>	<b>Inflation Rates</b>	<b>Economic Growth</b>
2012	95,603.80	19.65	9.64	4.60
2013	85,809.44	17.31	5.72	3.80
2014	89,162.00	16.51	6.88	5.33
2015	212,197.00	16.16	6.58	5.65
2016	120,518.00	16.58	6.30	5.83
2017	47,559.80	13.67	8.02	4.88
2018	77,095.80	13.06	4.70	6.33
2019	61,980.80	12.44	5.12	5.38
2020	56,737.10	12.00	5.29	-0.30
2021	5,856.80	12.08	6.11	7.50

(Source: The National Treasury and Planning, 2021 & World Bank Group, 2021)