THE MAIN IMPEDIMENTS TO THE GROWTH OF FOREIGN DIRECT INVESTMENT INFLOWS IN KENYA

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DECLARATION

This project is my original work and to the best of my knowledge has not been submitted for any award of any degree or any other academic qualification in this or any other learning institution in this world.

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DEDICATION

I dedicate this project to my children, Fred, Rita and Jeremy who gave me the motivation to keep going when things seemed difficult for me.

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There are a number of people without whom this project might not have been written, and to whom I am greatly indebted.

To God almighty, for his grace, gift of life and blessings without whom I wouldn't have had the strength to complete

To my family, who have always been an encouragement and inspiration to me throughout my life. For their financial and moral support, even when the road seemed too bumpy. A special thank you to them, for nurturing in me the appreciation of education and for the many ways.

I would like to acknowledge the advice and guidance of my supervisor, Mr. Ikiara. Your kindness and willingness to lead me has been profound. May God bless your future endeavors in leading and seeing many more go through your hands.

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LIST OF ABBREVIATIONS

BITS	Bilateral Investment Treaties
CET	Common External Tariff
COMESA	Common Markets for Eastern and Central Africa
EAC	East Africa Community
EPZs	Export Processing Zones
ERSWEC	Economic Recovery Strategy for Wealth Creation
KAM	Kenya Association of Manufacturers
KRA	Kenya Revenue Authority
MNCs	Multinational Corporations
RECs	Regional Economic Communities
SAPs	Structural Adjustment Programs
SSA	Sub Saharan Africa

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CHAPTER ONE

1.1 Overview of the study

This study aims at investigating the main impediments of foreign direct investments inflows into Kenya. The purpose of the study is to identify the main factors that have impeded the growth of foreign direct investment inflows into Kenya despite the government's efforts aimed at attracting foreign investors during the period 2007-2012. This chapter comprises of the introduction, the historical background of the problem, statement of the research problem which expounds the problem under study, main and specific objectives of the study, literature review, significance of the study, hypotheses, theoretical framework, limitations of the study and finally the research methodology.

1.2 Introduction

In the World Bank Report "Ease of Doing Business", it is argued that Kenya has dropped yet again 12 places to position 121 in the world's global list of economic competitiveness in the year 2013. In comparison with the other East African countries, Kenya's FDI trends are worrying as its inflows continue to decline every year. Kenya was ranked position 109 in 2012 and 106 in 2011 and furthermore, what is even disturbing is the fact that Kenya compares so unfavorably in relation to its neighbors Uganda and Rwanda who were placed 52 and 120 respectively in the same index.[1] This report highlights issues touching on the country's contract laws and non-tariff barriers like time taken to clear businesses in cross border trade and slow

[1] Ease of Doing Business ranks economies from 1 to 185, with first place being the best. A high ranking (low numerical rank) means that the regulatory environment is conducive to business operation. The index averages the country's percentile rankings on 10 topics covered in the World Bank's ease of Doing Business. The ranking on each topic is the simple average of the percentile rankings on its component indicators. The topics include: ease of starting business; dealing with construction permits; getting electricity; registering property; getting credit; protecting investors; paying taxes; trading across borders; enforcing contracts and resolving insolvency. Found at data.worldbank.org/… /IC.BUS.EASE.XQ… accessed at 8.16 on 4th June 2012.

processes of property registration. These issues and others have consequently added to the costs of doing business and robbed the country's regional and global ranking as an investment destination. The downward trend has with time been evidenced in Kenya's falling FDI inflows when compared to her neighboring countries as foreign investors now skip Kenya to more friendly and business conducive countries like Rwanda, Tanzania and Uganda. Unchecked therefore, these issues pose the danger of sending more investors packing and less coming in. Government officials, scholars and the private sector alike hence need to urgently identify and deal with these challenges that bedevil the economy.

Furthermore, the acceleration of the South-South trade and investment is one of the most significant features of recent developments in the global economy and as the global market place continues to be dominated with rapid changing notions of comparative advantage, much is at stake for Kenya as a country. With the emergence of South-South international commerce with China and India seen to take the lead, Kenya cannot afford to lag behind considering that growth enhancing opportunities for trade and investment with the North continue to become scarce. This study is therefore worth taking because it aims at identifying the main impediments towards FDI inflows into Kenya and giving recommendations on what needs to be done to improve the investment climate of the country.

1.3 Background of the Study

"The Republic of Kenya encompasses a landmass of about 586,650 kilometers with a population estimated at 43 million in 2012 and with an annual growth rate of 2.4

percent."[2] Nairobi which has a population of approximately 3.1 million is the capital city and is also Kenya's main centre of commercial activity. The performance of Kenya's overall economy has been unpredictable since 2003 with the growth momentum being at its peak in 2005 through to 2007. However this positive pace was interrupted in 2008 shortly after the severe political crisis resulting in violent events after the General elections in December 2007.

In addition, the country suffered from a severe drought and consequently the Gross Domestic Product (GDP) growth fell from a record high of 7 percent in 2007 to 1.5 percent in 2008.[3] Furthermore, the global economic crisis at that time weakened the country's economy and in countering the impact of these shocks, the government initiated and implemented several measures like the economic stimulus programme by funding public projects in education, health, infrastructure, services and agriculture. It also supported economic activity by facilitating the private sector's access to affordable credit. These macroeconomic measures coupled with a recovery in the international markets posited positive results with the GDP growing to 5.8 percent in 2010. However the GDP growth declined to 4.4 per cent in 2011 due to depreciation of the Kenyan shilling and high inflation and an increase in international oil and food prices.

It is evident from the literature available that after independence Kenya was a favorable foreign direct investment destination however over the years foreign direct investment levels have deteriorated or dropped significantly. Also, despite being

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[2]United Nations *(2012) Report on the Implementation of the Investment Policy Review KENYA* United Nations Conference on Trade and Development. pp.8

[3] Ibid pp.8

geopolitically and strategically located within East Africa, Kenya continues to be an underachiever rather than an overachiever as a host of foreign direct investment from the world's major source countries. A member of the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA) regional economic communities (RECs), Kenya is generally considered to be the finance, trade and transport hub of EAC which comprises of Uganda, Tanzania, Rwanda, Burundi and Kenya. Despite its economy being the largest among the EAC countries with 40 percent of the region's GDP and it's relatively advanced level of development Kenya has over the years performed poorly in terms of FDI attraction with inflows per capita being lower than in other EAC countries.

An increase in FDI is necessary for the attainment of sustained growth and development calling for an improvement and a review of economic policies needed to enhance macroeconomic performance and attainment of minimum growth rate required to meet the Millennium Development Goals as set by the United Nations. Also considering the unpredictability of aid flows,[4] low share in world trade and low savings rate and high debt from foreign aid the desired increase in investment has to be achieved through an increase in FDI inflows. Nevertheless, despite the government undertaking various macroeconomic and institutional reforms the country has not been able to attract sufficient FDI inflows hence the purpose of this study which seeks to identify the main impediments towards achieving the desired FDI inflows into the country and giving recommendations on reforms that need to be implemented to attract and retain quality FDI.

[4] Kenya has only received a quarter of the funds it expected in the 2012/13 financial year to help fix a growing budget deficit. By March, the treasury had received Kshs 53.7 billion against a sh.233.8 billion target representing 23 percent of the budgeted funds. This deficit is one of the biggest impediments to the country's growth. Griffins Omwenga "*Kenya Stares at Kshs 180bn cash shortfall from foreign donors*" Daily Nation Monday 27, 2013

1.4 Statement of the Research Problem

Kenya as a country has adopted and pursued various economic development strategies with emphasis on private investment as outlined in various development plans and sessional papers. Nevertheless, FDI inflows have remained low compared to other countries in Africa and even more worrying in East Africa. The various investment policies and incentives offered by the government have also not been successful in attracting sufficient levels of FDI. The challenge therefore is for the government and policy makers to redeem Kenya that has become relatively marginal to global investment flows so as to be able to attract and retain more feasible FDI by identifying what impedes the increase of FDI inflows. Previous studies conducted examining impediments of FDI inflows into Kenya date back to 2007 and most of the studies based their findings on secondary data hence the importance of this study which seeks to identify and understand the current main impediments to FDI flows into Kenya using both primary and secondary data. Findings of this study will then help the policy makers and the government to formulate and or review policies that can create the most conducive environment to attract and retain more foreign investors. Moreover, there is also need to change the country's attitude towards FDI from passive acceptance to active encouragement hence the desirability to identify the current impediments of FDI inflows into Kenya and offer policy recommendations on what needs to be done to reverse this trend.

1.5 Objectives

1.5.1 Main Objective

The main objective of the study was to identify the main impediments towards the growth of FDI inflows into Kenya.

1.5.2 Specific Objectives

1. To identify the political and governance factors that impede FDI flows into the country.

2. To identify the main institutional constraints that have contributed to the decline of FDI inflows into Kenya during the period under study.

3. To evaluate and assess the Kenyan policy framework on FDI and the various investment incentives undertaken by the government to attract FDI.

4. Give policy recommendations for a conducive business environment that can sufficiently attract and retain quality FDI.

1.6 Literature Review

1.6.1 Introduction

Foreign Direct Investment (FDI) is defined as long-term investment reflecting lasting interest and control, by a foreign investor (or parent enterprise), of an enterprise entity resident in an economy other than that of the foreign investor, IMF (1993). Mallampally and Sauvant (1999) concur. They define FDI as investment by multinational corporations in foreign countries in order to control assets and manage production activities in those countries. FDI can be divided into two components: portfolio investments, which refers to the buying of stocks and bonds purely for the purpose of obtaining a return on the funds invested; and direct investment, whereby investors are involved in the management of the firm besides receiving a return on their money.

1.6.2 Benefits of Foreign Direct Investment

FDI can contribute to the growth and development of a country by complementing its domestic investment, facilitating trade, and transfer of knowledge and technology

because multinationals deploying them are key players in the global economy besides it being a package of tangible and intangible assets.[5] On one hand, the pro-FDI arguments hold the view that FDI stimulates domestic investment, promotes economic growth and creates employment opportunities. On the same strength, Stiglitz (2006) argues that Multinational enterprises have played a significant role in advancing the benefits of globalization to the developing countries and improving the standards of living all over the world.[6] FDI has impacted positively on the economy by bringing in the much required expertise in terms of entrepreneurial, managerial and technical skills which in return may increase the productivity of workers and consequently that of exports thereby integrating the host into the global economic network.

Furthermore, these MNCs have enabled the goods being exported from the developing countries to reach the markets of the advanced industrial countries, created employment and brought about economic growth to the developing nations. They have also brought inexpensive goods of increasingly high quality to the developed countries, bringing down the costs of living and lowering both inflation and interest rates. FDI also helps the developing countries to fill in the foreign exchange, savings and revenue gaps. Ikiara (2002) argues that FDI is Africa's hope because it can contribute in significant ways to the breaking of the growth-poverty cycle. Africa depends on FDI to can make up for its domestic capital shortfalls; provide technical, management and marketing skills; facilitate access to foreign markets; and generate both technological and efficiency spillovers to local firms. By doing so, FDI is

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[5] H. Gorg and D. Greenaway, "*On Whether Domestic Firms Benefit from Foreign Domestic Investment*," The world Bank Research Observer, 19(2) 2004, pp.171

[6] Stiglitz J. (2006) "*Making Globalization Work"* pp. 188

expected to accelerate the integration of the continent into the global economy, boost growth and brings down the high levels of poverty in the Africa.[7]

On the other hand, anti-FDI arguments argue that the negative effects of FDI surpass the benefits realized from it. These demerits of FDI may include loss of political sovereignty, unfair competition to infant domestic industries which then stifle their growth and because of profit repatriation to their countries of origin and the importation of capital goods by the MNCs, the balance of payments of the host country may be adversely affected.[8]

1.6.3 Policies Promoting Foreign Direct Investment in Kenya.

Kenya's history in terms of efforts to attract FDI dates back to the 1980's during the economic liberalization period when the government adopted the World Bank imposed Structural Adjustment Program (SAPs) and its accession to the World Trade Organization (WTO). The implementation of the SAPs saw a reduction of tariffs and the removal of various protectionist measures that had been in effect with regard to the domestic agricultural and manufacturing sectors. Nonetheless, deregulation was also done in various sectors like the financial sector.[9]

In 1986, the government established the investment promotion center through an Act of parliament whose core mandate was to promote investments in Kenya by both local and foreign business enterprises by assisting and facilitating them in overcoming managerial, institutional and bureaucratic problems. This Act was later on repealed by

[7]Ikiara M. (2002) *Foreign Direct Investment (FDI), Technology Transfer, and Poverty Alleviation: Africa's Hopes andDilemma.* ATPS Special Paper Series No. 16 pp. 1

[8]"*The opportunities and Challenges of FDI in Kenya*" pp. 1 available at www.sgh.waw.pl/ …/tekst_zebranie.doc accessed at 10.44 am 27.05.2013

[9] A number of reform measures intended to enhance the effectiveness of monetary policy were put in place from 1986 although significant reform was the liberalization and complete decontrol of interest rates in July 1991 and the introduction of open market operations in the same month.

the Investment Promotion Act no. 6 of 2004 whose core business is to promote and facilitate investment by assisting investors obtain the licenses necessary to invest and by providing other assistance and incentives and for related purposes. World Bank efforts that led to the creation of the Export Processing Zones (EPZs) in 1990's and by the opening to foreign investment including the liberalization of foreign exchange, the removal of all restrictions on current accounts and domestic borrowings for foreign investors in 1993 further reinforced the government's efforts to attract FDI.

In addition, in 1994, Kenya accession to the WTO played a role in the intensification of its liberalization process. Furthermore Kenya is also a member of two RECs; EAC whose common external tariff (CET) entered into force in the year 2000 and of the COMESA which established a free-trade agreement amongst nine of its members[10] including Kenya in 2000. The privatization agenda of public services was also part of this liberalization menu with a sole aim of attracting foreign investments. Alongside these incentives, Kenya has also entered into three bilateral investment treaties (BITS) with Netherlands in 1970, with Germany in 1996 and with the United Kingdom in 1999 and signed over thirty bilateral trade agreements with an aim of improving investment and trade.

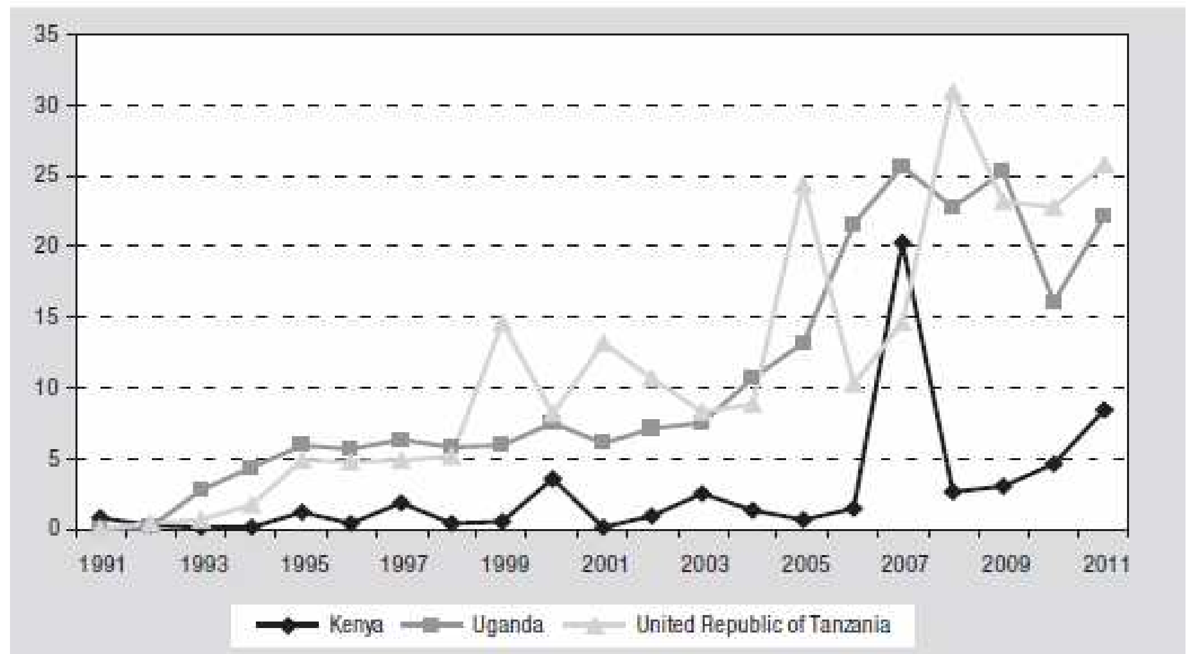
In 2003 when the National Alliance Rainbow Coalition (NARC) government took over, it introduced various initiatives to revamp the economy among them being the Economic Recovery Strategy for Wealth Employment and Creation (ERSWEC) 2003-2007 and a key element of the strategy was the promotion of investment and trade by ensuring that the public sector plays an important role in regulating and

[10] Original members include: Djibouti, Kenya, Madagascar, Malawi, Mauritius, Sudan, Zambia and Zimbabwe. Burundi and Rwanda joined the FTA on 1st January 2004 available at www.comesa.int accessed at 10.15 21.05.2013

facilitating private investment. After the expiry of the ERS in 2007, The Vision 2030 was launched in 2008 with the purpose of achieving global competitiveness and prosperity of the nation and there has been emphasis on attracting FDI which will contribute towards the industrialization process. The Vision 2030 alongside the new constitution adopted in 2010 were to provide a strong institutional and administrative framework in order to guide the country on the path to sustained economic growth and social development.

Over the past two decades, worldwide FDI has increased dramatically. The ratio of FDI to world GDP has grown twice as fast as the ration of world imports and exports to world GDP, implying that the increasing interdependence of the world economy is being driven, to a large extent, by the expansion of international production. (UNCTAD 1998) In as much as developed countries dominate global FDI, inflows into developing countries have risen steadily. Despite the fact that FDI accounts for a relatively small percentage of the total investment, it is believed to be a potential catalyst to economic growth hence the rationale why most developing countries in relation to their economic liberalization programs, have adopted policies designed to attract and retain FDI. That notwithstanding, the FDI inflows into Kenya have remained relatively low in comparison to its EAC neighbors as illustrated in the figure below.

Figure 1.1 FDI flows to Kenya and comparator economies, 1991-2011 (Dollars per capita)



Source: Source: UNCTAD, FDI/TNC database.

From figure 1.1, FDI inflows to Kenya over the period 1991 – 2011 is low as compared to other countries. The trend shows that however FDI inflows have been improving and increasing with huge variations. Kenya as a country received very low inflows as compared to Uganda and Tanzania where Tanzania reported high inflows in the year 2011, followed by Uganda and lastly Kenya. It should be noted that the period Kenya reported highest inflow was year 2007 but still did not reach inflows going into Uganda during that period.

Therefore, FDI has not played an important role in the Kenyan economy despite the reforms that have been undertaken and the many incentives provided to foreign investors. In light of the above statement, this debate brings to the fore the works of

various scholars on the subject matter of this study which seeks to explore the main impediments of FDI growth in Kenya. The literature review delves into diverse views and arguments on this topic on studies conducted in Africa, East Africa and Kenya.

1.6.4 Arguments on barriers towards the growth of FDI inflows to Kenya

Kenya's FDI inflows have been reducing over the years and this has been a concern to not only policy makers but to scholars as well. Phillips et al., (2001) argue that FDI flows to Kenya have not only been highly volatile, they generally declined in the 1980s and 1990s despite the economic reforms that took place and the progress made in improving the business environment. The investment wave felt in the 1980s faded away in the 1990s as the institutions that had protected the economy against arbitrary interventions were eroded. They also argue that Kenya's biggest task is reviving the institutions and infrastructure that facilitated its initial economic growth; the physical security of people and property, general law enforcement and judicial support for commercial contracts that has also deteriorated over the years.[11]

According to Mwega and Ngugi[12] Kenya's competitiveness in attracting FDI has declined with investors moving to its neighbors in the EAC (Uganda and Tanzania) due to low investor confidence resulting from factors like insecurity, poor infrastructure, high interest rates, high operational costs, and an unsupportive judicial system.

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11. Phillips, Lucie C., Marios Obwona, Margaret Mcmillan and Aloys B.Ayako (2000) *Foreign and Local Investment in East Africa, Interactions and Policy Implications: Case studies on Mauritius Uganda and Kenya*. Equity and Growth through Economic Research (EAGER), funded by USAID Bureau for Africa, office of sustainable Development Washington DC. pp.11

[12]Mwega F. & Ngugi R. (2006) "Foreign Direct Investment in Kenya" in Foreign Direct Investment in Sub-Saharan Africa: Origins, Targets, Impact and Potential by Ajayi S. 2006 African Economic Research Consortium pp. 119-143 : 120-121

According to Kipngetich (2008) the unpredictable political environment, a decline in assistance from development partners especially the International Monetary Fund (IMF), low economic growth, poor infrastructure, inefficient public services are some of the factors that have made Kenyan FDI inflows decline.

Nonetheless, Sunday Frankline argues that Kenya may lose investments worth billions of shillings if the current tax regime is not harmonized to ensure free intra-regional trade in the 47 counties. This is because each devolved unit of government is lacking in capacity to develop trade friendly policies setting precedence for a weak and bureaucratic economic policy regime in counties which would consequently result in an increase in the cost of doing business in the country.[13] In addition, Kenya has often scored poorly as a favorable investment destination due to high- energy costs, lengthy registration processes and corruption among other factors that have denied the country millions of dollars' worth of investment and thousands of jobs. The recent *World Bank Doing Business Report* found out that legislative requirements, weak enforcement of contracts and slow registration of property are major obstacles to businesses in urban centers especially in Nairobi.[14]

According to the USA Investment Climate statement on Kenya, it is argued that although there is no specific legislation preventing foreigners from owning land, the ability of foreigners to own or lease land classified as agricultural is restricted by the

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[13] Sunday F. "*Manufacturers raise concerns over double taxation*" The standard Newspaper Tuesday April 30, 2013 Business Beat pp.7
[14]Ibid pp.7

Land Control Act. Hence the Land Control Act serves as a barrier to any agro-processing investment that may require land.[15]

It has further been argued that despite efforts such as reforms aimed at macroeconomic stabilization, streamlining and simplifying business regulations, the share of FDI inflows into Kenya still remain low and the general assumption is that deterring factors of FDI inflows are: low level of effective demand as a result of limited purchasing power of the people, low level of infrastructure development, inefficient and ineffective legal system, excessive bureaucracy, slow process of privatization program and lack of skilled workforce. In addition, over time, the deteriorating business environment, poor governance, growing corruption and more recently crime has contributed substantially to low inflows of FDI.[16]

According to a study conducted by Voorpijl R. in 2007, it is argued that political instability and violence can impede the growth of FDI inflows. Before the election in 2007, Kenya was perceived as relatively stable. However after the elections, investors especially in the horticulture sector argue that there was a lot of tension between employees of certain tribes because of their tribal voting affiliations which resulted in forcibly sending home some of them and this consequently impacted negatively of the firms' productivity.[17] Another risk of investing in Kenya is the general presence of criminal networks or crimes committed against investors which can significantly add to the costs of doing business in Kenya. According to Larossi, (2007) these costs may

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[15] 2012 Investment Climate Statement –Kenya www.state.gov/e/eb/rls/.../191175.htm accessed on 17th April 2013 at 14.25

[16] *"The opportunities and Challenges of FDI in Kenya"* found at www.sgh.waw.pl/.../tekst_zebranie.doc pp.23 accessed on 11th June 2012 14.47

[17] Voorpilj R. (2011*) Foreign Direct Investment in Kenya: The Gains and Losses of Foreign Involvement.* M.A Thesis pp. 55 found at gpm.ruhosting.nl/ .../2011MASG44Voorp... accessed on 6th June 2013 22.15

be incurred directly from theft and indirectly from preventing measures like security protection costs.

Furthermore, in the study done by Voorpijl, most investors identified Kenya Revenue Authority (KRA) as the most corrupt and most unreliable institution. Investors argued that corruption is infiltrated in all levels of the governmental system with bureaucracy making procedures unnecessary hard. They argued further that with every permit or procedure the officials will complete one step before explaining the next and demand money for each step. An additional problem is the skills of the officials with most being hardly acquainted with the entire process and this uncertainty and lack of information makes it difficult to make a yearly budget.[18] This was reaffirmed by The Kenya Bribery Index (2008) which argues that "public servants and employees of the government are by far the most bribed accounting for 99 per cent of the bribery transactions and 97 per cent of the value.[19]

It is widely acknowledged that while Kenya was a prime source for foreign investors seeking to establish a presence in East Africa in the 1960s and 1970s, a combination of politically driven economic policies, government malfeasance, rampant corruption, substandard public services, and poor infrastructure has discouraged FDI since the 1980s. Over the past 25 years, Kenya has been a comparative underperformer in attracting FDI. Kenya lags behind neighboring Tanzania and Uganda in dollar terms despite their smaller economies and the UNCTAD 2008 *World Investment Report* describes Kenya as the East Africa region's least effective suitor in attracting FDI.[20]

[18] Ibid pp. 58
[19] Transparency International, (2008) The Kenya Bribery Index. pp. 7
[20] FDI inflows dropped sharply in 2008, coming in at only $ 96 million (0.3%0, and then increased to $116 million (0.4%) in 2009 and $ 186 million (0.6%) in 2010. These figures compare poorly to

Furthermore, the 2005 UNCTAD Investment Guide to Kenya argues that the significant disincentives for investment in Kenya include governmental over-regulation and inefficiency, expensive and irregular electricity and water supplies, an underdeveloped telecommunications sector, a poor infrastructure, and high costs associated with crime and general insecurity.

A survey conducted in 2007 by the Kenya Association of Manufacturers (KAM) also identified the following factors as making the Kenyan business climate hostile: unfair competition, which dumps counterfeit and pirated products; periodic unavailability of raw materials such as crude oil; labor laws that compel private companies, rather than government to provide their employees with a social safety net including paternity and maternity leave and health care, local government licenses and harassment over petty demands; and the failure of the KRA to process corporate tax and value added tax refunds expeditiously.

1.6.5 Arguments on factors impeding FDI inflows into Africa

The UNCTAD's World Investment Report (2004) reported that although Africa's prospects for FDI are promising, the anticipated increment is yet to be felt and furthermore, FDI is still concentrated in only a few countries for many reasons, ranging from negative image of the region, to poor infrastructure, corruption and foreign exchange shortages, an unfriendly macroeconomic policy environment, among others.

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neighboring Tanzania and Uganda, which have posted higher net inflows in dollar terms than Kenya each year since 2005 despite their smaller economies. In 2010 Tanzania reported $433 million in net FDI inflows and Uganda reported $817 million.2012 Investment Climate Statement –Kenya www.state.gov/e/eb/rls/.../191175.htm accessed on 28th April 2013 at 20.25

According to Ball D. et al (2008), despite the dramatic increases in international flows of FDI over the past two decades, the countries of Sub-Saharan Africa (SSA) still lag behind. Many of these nations have suffered from serious inadequacies of their regulatory and administrative practices with respect to the treatment of foreign investors and the protection of their investments, which sharply diminished the attractiveness of these nations for receiving incoming FDI.[21] Furthermore, they identify the following as impediments towards FDI in SSA. First, is that most countries in the region have fiscal regimes that lack international competitiveness in terms of FDI for export-oriented activities citing the fact that many processes for providing investment incentives are slow, arbitrary and lacking integration. Secondly, many countries lack good regulations with regard to the management of labour relations and dispute resolutions which is an essential factor in a nation's attractiveness for investment in labour-intensive export manufacturing sectors. Thirdly, they point out that many countries also lack updated systems for providing work and residence permits for expatriate personnel who are often critical resources for the foreign investor during the initial stages of an investment project due to the managerial and technical expertise they offer.

Moss T.et al (2004) argue that despite substantial changes in Africa towards attracting FDI, there remains a deeply rooted skepticism towards FDI owing to historical, ideological and politics of the post-independence period. These sentiments have manifested themselves through a range of barriers to foreign investment including nationalization of foreign firms, heavy state intervention in the economy, direct legal restrictions on foreign investments and a host of indirect barriers. At least part of the

[21] Ball D. et al (2008) *International Business The challenge of Global Competition* pp.50

negative attitude towards foreign investment is rooted in specific concerns that purported benefits of foreign investments are not being realized.[22] The indirect barriers typically include bureaucratic and other informal impediments to foreign investments such as ambiguous regulatory approval, delays in customs clearances, and permits for expatriates or weaknesses in the legal system. Political economists argue that excess bureaucracy, erratic economic policy and other problems associated with weak business environments have strong political logic and monopolistic positions by influential businessmen, political leaders or their families are frequently threatened by foreign competition. Tangri (1999) concludes that the political nature of the state and foreign business relations is an important reason why sub-Saharan Africa has failed to attract much FDI since independence[23]

Although most African countries have undertaken substantial economic reforms, Asiedu, E (2004) argues that as much as SSA improved its infrastructure, liberalized its investment framework and reformed its institutions, the degree of reform was mediocre compared with the reform implemented in other developing countries. As a consequence, relative to other regions, SSA has become less attractive to FDI over time.[24] In addition to that, Gordon (1993) and Van de Walle (2001) argue that Africa has been especially prone to "partial reform syndrome" where many reforms are only partially implemented or where only parts of a basket of policy changes are pursued hence not achieving the intended effect.

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[22] Moss T., Ramachandran V., and Shah M. (2004) *Is Africa's skepticism of foreign capital justified? Evidence fromEast African Firm Survey Data* Center for Global Development Working Paper No. 41 June 2004 pp. 2

[23]Tangri, R. (1999) The Politics of Patronage in Africa pp. 14

[24]Asiedu, E (2004) "*Policy Reform and Foreign Direct Investment to Africa: An Absolute Progress but Relative Decline,"* Mimeo, University of Kansas, Development Policy Review, Vol. 22, No. 1, pp.41-48 January 2004 pp. 47 available at people.ku.edu/-asiedu/Policy-Reform-DP…

1.7 Justification of the Study

The trends of FDI into Kenya in the last ten years evoke important issues concerning the factors that motivate or attract and those that impede these flows. An improvement in economic policies is essential to enhance macroeconomic performance and attain the growth rate required to actualize vision 2030 and to meet the Millennium Development Goals set by the United Nations. Therefore an increase in investment is crucial to the attainment of sustained growth and development in Kenya. This requires the concerted mobilization of both domestic and international financial resources. A better understanding of the factors and challenges that deter increased FDI inflows into Kenya will therefore enhance the capacity of the government and policy makers to formulate policies that allow for a conducive business environment aimed at attracting more and higher quality FDI with strong linkages to the domestic economy, advanced technology, export orientated and skill spillover effects. From the literature on FDI, it has been argued that FDI inflows are heavily influenced by the countries policies and institutions and very little by variables such as locational advantage, proximity to financial centers, total population and size of the country. In as much as initial country-inherent conditions play a certain role they can be overcome by sound policies and their thorough implementation. This research therefore seeks to identify the main impediments to FDI growth in Kenya with an aim of creating insights that will be helpful in the formulation and implementation of relevant and sustainable policy recommendations that will foster more FDI into Kenya as the country strives to achieve its tenets of vision 2030 of becoming industrialized. In addition, there is a lot of existing literature focusing on the determinants of FDI into Africa with case studies on Kenya with little focus on the impediments towards FDI growth peculiar or specific to Kenya as a country. This study therefore attempts to overcome this

limitation. Moreover, the studies that have so far been conducted were cross-country, usually employing comparative analysis using some of the African countries inclusive of Kenya. This study is country specific with emphasis that a country may have its peculiar problems with regard to challenges of FDI growth.

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

1.8 Hypotheses

1. Good governance and political stability have facilitated the increase of FDI inflows into Kenya.

2. Institutional constraints, delayed work permits and lengthy business registration processes have tended to discourage foreign investors in Kenya.

3. Macroeconomic instability, high cost of doing business and the taxation regime have acted as disincentives to FDI growth in Kenya.

1.9 Theoretical Framework

FDI has been viewed through several theoretical lenses with researchers taking diverse views of the phenomenon. The eclectic paradigm originally advanced by Dunning will serve as the basis of this research as it provides an ownership, location and internalization (OLI) advantages-based framework to analyze why and where Multinational enterprises would invest abroad. It also integrates host and home

country determinants of FDI, recognizing the impact of individual actors on investment decisions as well as the limitations of host country policymakers seeking to alter FDI flows.

The three basic types of ownership-specific advantages include knowledge or technology, economies of scale or scope, and monopolistic advantages associated with unique access to critical inputs or outputs. The advantage generates lower costs and/or higher revenues that will offset the added costs of operating at a distance within a foreign location. Location advantages of different countries are the key factors to determining who will become host countries for the activities of transnational corporations. The specific advantages of each country can be divided into three categories:

a) The economic benefits consist of quantitative and qualitative factors of production, cost of transport, telecommunications, market size etc.
b) Political advantages which may entail common and specific government policies that affect FDI inflows.
c) Social advantages which include distance between the host and home country, cultural diversity, attitude towards strangers etc.

The third characteristic of the OLI paradigm offers a framework for assessing different ways in which the company will exploit its power from the sale of goods and services to various agreements that may be signed between the companies. As cross border market internalization benefits is higher the more the firm will want to engage in foreign production rather than offering this right under license, franchise.

This eclectic paradigm infers generically that an MNE invests in the most advantageous location. Factors like political and economic instability, restrictive trade and investment policies, cultural distance and poor infrastructure are factors that account for differences in terms of choice of location.[25] MNEs investments initially flow to the region that provides the best mix of traditional FDI determinants: cost-reduction pressures; liberalized investment environment and institutional prerequisites for attracting FDI. With regard to institutional prerequisites for attracting FDI the role of governments in providing an environment that is conducive to FDI cannot be overemphasized. Most important they need to establish prerequisites such as a stable political and economic environment, the rule of law and sound infrastructure. An educated and technically skilled work force, low wages, an open economy and stable currency are also essential. (UNCTAD 1997) MNEs therefore ordinarily evaluate all prospective locations for their investments through the traditionally identified FDI determinants and opt for the location offering the best fit with their firm strategy. The eclectic paradigm therefore is best suited for this study as it shows that OLI parameters are different from company to company and depend on context and reflect the economic, political and social characteristics of the host country. Therefore the objectives and strategies of the firms, the magnitude and pattern of production will depend on the challenges and opportunities offered by different types of countries.

1.10 Research Methodology

This study largely depended on both qualitative and quantitative research methods. Main sources of data were primary and secondary.

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[25]Sethi D et al (2003) "*Trends in Foreign Direct Investment Flows: A theoretical and Empirical Analysis"* Journal of International Business studies, Vol. 34, No. 4 (JUL 2003), pp. 315-326:316-317 available at http://www.jstor/page/info/about/policies/terms.jsp accessed at 6.14 on 08/05/2013

Population

For purposes of gathering primary data, the target population encompassed foreign investors in the various sectors in the economy of the country, officials from various ministries: the ministries of trade, foreign affairs, labor, finance and immigration and employees of the Kenya Investment Authority will be targeted. This made an approximation population of 1400 employees in the ministries.

Sample Design

Due to the large number of investors and officials in the various ministries and institutions in the sectors where we intended to gather data for purposes of this research, probability sampling through random selection was used to arrive at an adequate sample population that is representative of all the elements of the larger population in every respective targeted population. Statistical formulae recommended for random sampling was used.

$$n = \frac{z^2pqN}{e^2(N-1) + z^2pq}$$

Where: N= Size of the population

n = Size of sample

p = Sample proportion estimated to have characteristics being measured. Assume a 95% confidence level of target population

q = 1-p

e = Tolerable error level (assume 0.05 since the estimate should be within 5% of the true curve)

z = the standard normal deviate at the required confidence level i.e. 1.96

The researcher assumed a 95% confidence level of target population and that the response achieved would be within ± 5% of the true state of the population target.

$$n = \frac{1.96^2 x\ 0.95\ x\ 0.05\ x\ 1400}{0.05^2(1400-1) + 1.96^2 x\ 0.95\ x\ 0.05}$$

n= 69 employees

Therefore the sample size is 69 employees

Questionnaires were distributed to the officials in the ministries under study randomly. Subordinate staffs did not form part of the respondents.

Data Collection

Questionnaires, interviews and observation were the main methods that were used to collect data. The questionnaires were dropped and picked from these companies to ensure a higher percentage of responses unlike would be the scenario when questionnaires were mailed. Interviews was also extensively used in conjunction with the observation method in as much as interviews sometimes elicit inaccurate data as respondents were unwilling to divulge information on sensitive issues for fear of being quoted or misquoted.

Data Analysis

Data was analyzed by the use of both descriptive and comparative statistics. After analysis the data was presented in percentages, graphs, representations, tables, pie charts, histograms etc.

Scope and Limitations

The study was limited to the analysis of the impediments towards FDI growth in Kenya during the period between 2007 and 2012. The role of FDI, its performance in Kenya since independence and the factors that impede the growth of FDI was documented, analyzed and conclusions on the macroeconomic and institutional recommendations that need to be implemented derived. The time frame within which this study was conducted was inadequate and due to financial constraints that incapacitated the researcher from hiring research assistants, insufficient data was gathered to facilitate a more comprehensive research. In addition to that, since this research entailed the use of field studies, financial costs posed a challenge to adequate data collection as this required extensive travelling within the region.

Finally, the aspect of confidentiality in research was a major limitation especially when using interviews or group discussion modes of data collection. Respondents in most cases held on to information or gave inaccurate information for fear of being reprimanded later on.

2.0 Chapter Outline

Chapter 2 will in detail expound on the general overview of FDI in Africa in the last five years with comparisons between Kenya and various African countries.

Chapter 3 will give an overview of FDI performance in Kenya since independence, the policy framework of FDI, the sectoral composition of FDI in the Kenyan economy and the various investment incentives that have been pursued by the government to attract FDI. It will also analyze the FDI determinants in Kenya with specific emphasis on governance and political stability, macroeconomic stability, cost of doing business

and the institutional constraints that have impeded the growth of FDI inflows into the country.

Chapter 4 will constitute the data findings, data analysis and discussion of the same.

Chapter 5 will give a summary of the findings highlighting the key issues that emerged from the study, conclusions and recommendations and possible areas for further research.

CHAPTER TWO: OVERVIEW OF FOREIGN DIRECT INVESTMENT IN AFRICA

2.1 Introduction

When most African countries attained independence in the 1960s they did not embrace the virtues of free trade and foreign direct investment. They imposed trade restrictions and capital controls as part of a policy of import-substitution with a protectionist view towards their domestic industries and the conservation of the scarce foreign exchange reserves during the 1970s and 1980s. Therefore, this inward-looking development strategy discouraged FDI and international trade and subsequently contributing to the negative economic growth of most countries in this continent.

In addition, until recently, FDI was not fully accepted by most African leaders as significant for growth and economic development because of the fear that it could lead to the loss of political sovereignty and encourage neo-colonialism, stagnate the growth of domestic firms because of competition from foreign firms, and accelerate the rate of environmental degradation if entry was dominant in the natural resource sector as was the case in most African countries.[26] Moss Ramachandran & Shah (2004) furthermore argue that the prevailing attitudes and concerns in relation to FDI in Africa are part to the fact that policymakers in the region are not convinced that the potential benefits of FDI could be fully realized within their economies in the region without the fear of being exploited by the foreign firms.

However, with the onset of globalization in the world economy, there has been a regime shift from inward-looking to outward-looking development strategies that had

[26]Dupasquier C. &Osakwe P. Foreign Direct Investment in Africa: Performance, Challenges and Responsibilities Pp. 11

resulted in a relative improvement in the economic performance in a number of African countries. Nevertheless, an increase in FDI is very important for the attainment of sustained economic growth and development in the region and also because most African countries need a substantial inflow of external resources in order to make up for the savings and foreign exchange gaps resultant from the rapid rate of capital accumulation in Africa. There is also need for growth to overcome widespread poverty as the continent remains the poorest in the world mired in debt according to Sachs (2004).

There are two main types of investments made by foreign investors in African countries: Greenfield investments which involve investments in a new establishment; and cross-border merger and acquisition of an existing local firm. Generally, these investors are motivated by the desire to make profits hence their choice of location is determined by factors such as the desire to: exploit natural resources like oil in Nigeria, Angola, Equatorial Guinea; take advantage of export opportunities created by certain investment locations as in Lesotho and Swaziland; reap the benefits of domestic investment incentives as in Mauritius and Seychelles; and respond to economic policy reforms, especially privatization as in Mozambique and Uganda.

Africa's FDI inflows are concentrated in the primary sector unlike in East Asia where a big volume of FDI goes into the secondary sector hence contributing to the diversification of the export base and to higher sustained growth exemplifying the fact that the sector in which a country receives FDI affects directly the extent to which it could realize its potential benefits. The challenge facing Africa therefore is how to

attract more FDI in dynamic products and various sectors especially the service sectors with high income elasticities of demand.

2.2 Recent Trends of Foreign Direct Investment in Africa

Africa's share as recipient in world FDI flows declined from 5.2 per cent during the 1970s to 1.9 per cent during the 1990s, before increasing to 3 per cent over the period 2005-2008.[27] Data from UNCTAD sources reveal that in 1970, the total amount of FDI inflows to Africa was US $ 1.26 billion and rose to US $ 55.04 billion in 2010.[28] The huge increase notwithstanding, it is important to put Africa's performance in relative perspective whereby whereas in the 1970s Africa's share in the global FDI inflows was 9.5 percent it dropped to 4.4 percent in 2010 and furthermore the share of Africa in developing countries FDI inflows was 32.8 percent in 1970 but dropped drastically to 9.6 percent in 2010.[29]

Table 2.1: Recent Trends of Foreign Direct Investment in Africa

Period	**Trends of Foreign Direct Investment in Africa (US $ 'billions')**
1970's	1.1
1980's	2.2
1990's	6.6
1997	11
2001	20
2005	38
2008	72
2010	81
2012	85

Source; UNCTAD, FDI/TNC (www.unctad.org/fdistatistics)

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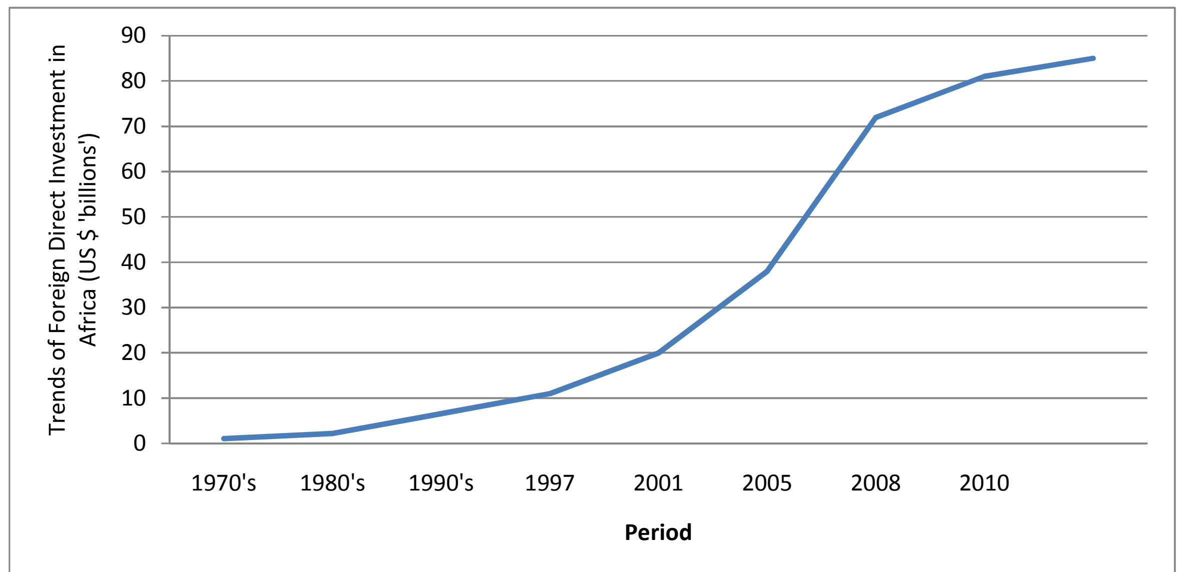
[27] Ibid pp. 130

[28] Mijiyawa A, "What Drives Foreign Direct Investment in Africa? An Empirical Investigation with Panel Data." Pp. 2

[29] Ibid pp. 2

Figure 2:1 Recent Trends of Foreign Direct Investment in Africa



Source: Compiled by researcher using data from Table 2.1

From table 2.1 and figure 2.1 it is evident that inspite of policy reform initiatives in a number of African countries and significant improvements in determinants governing FDI inflows including economic reforms, privatization, democratization, sustained peace and stability, FDI inflows to Africa still lag behind those of other regions of the world. The data above points to the very fact that Africa has continued to receive the lowest share of global FDI over time. During the 1970s, inflows to the continent averaged US $ 1.1 billion per year. The flows doubled to an average of US $ 2.2 billion in the 1980s and tripled to US $ 6.6 billion on average per year in the 1990's. From the 1990s the average flows shot to US $ 35.2 billion on average per year during the 2000-2008 periods. Record highs were recorded in 1997 (US $ 11 billion) and again in 2001 with US $ 20 billion. Since 2005, the momentum increased drastically from US $ 38 billion to a high of US $ 72 billion in 2008.[30] The year 2010 recorded inflows amounting to US $ 81 billion and most recently in 2012, US $ 85

[30] Loots E. & Mabundi A. (2012) Foreign Direct Investment to Africa: Trends, Dynamics and Challenges (p128-141): pp. 130

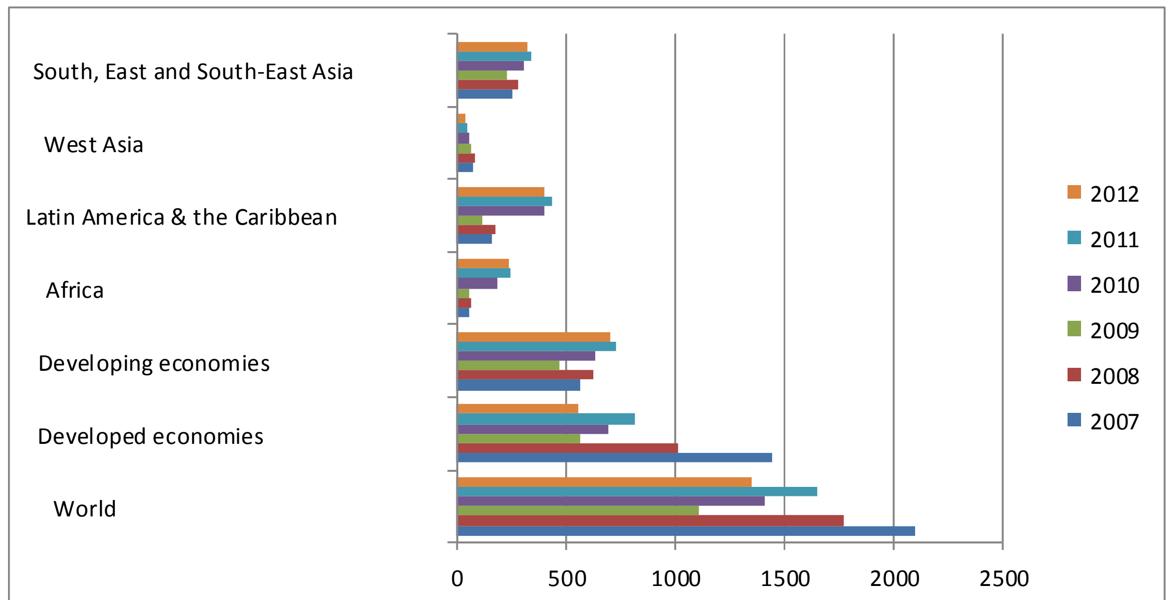
billion were achieved. This shows an upward trend as the figures keep increasing year after year, however as earlier mentioned the percentage of Africa's share in the World FDI inflows has continued to decrease.

Table 2.2: FDI inflows by Region (2007-2012)

Region	**(Billions of Dollars)**					
	2007	**2008**	**2009**	**2010**	**2011**	**2012**
World	2100	1771	1114	1409	1652	1351
Developed economies	1444	1018	566	696	820	561
Developing economies	565	630	478	637	735	703
Africa	63	72	59	44	48	50
Latin America & the Caribbean	164	183	117	190	249	244
West Asia	78	90	68	59	49	47
South, East and South-East Asia	259	282	233	342	387	360
	Percentage share in world FDI inflows					
Developed economies	68.8	57.5	50.8	49.4	49.7	41.5
Developing economies	26.9	35.6	42.9	45.2	44.5	52.0
Africa	3	4.1	5.3	3.1	2.9	3.7
Latin America & the Caribbean	7.8	10.3	10.5	13.5	15.1	18.1
West Asia	3.7	5.1	6.1	4.2	3.0	3.5
South, East and South-East South Asia	12.3	15.9	20.9	24.2	23.5	26.6

Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics)

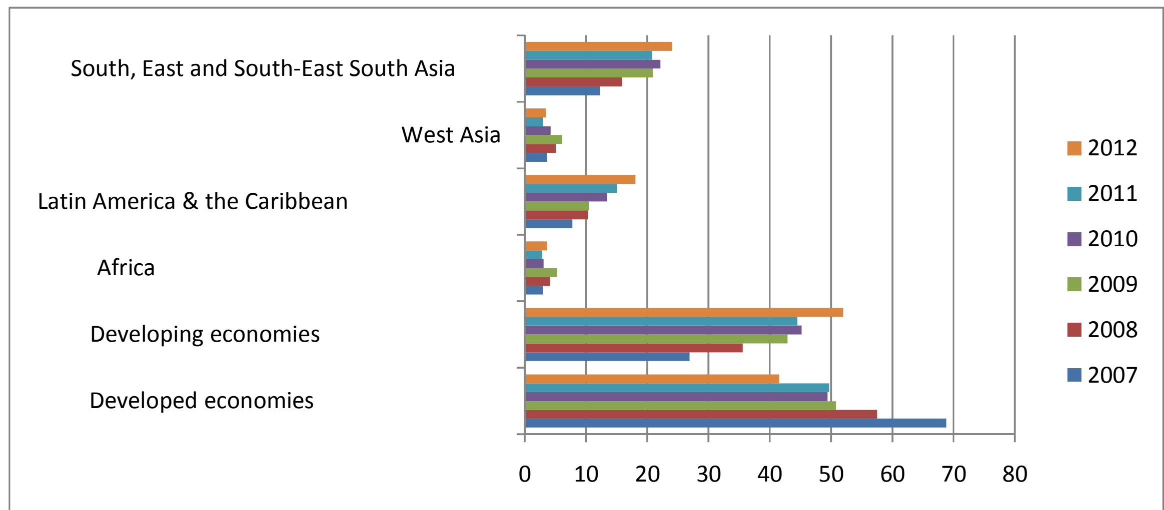
Figure 2.2 FDI inflows by Region (Billions of Dollars)



Source: Compiled by researcher using data from Table 2.2

From table 2.2 and figure 2.2 above, FDI inflows were high worldwide in the year 2007 where a total inflow of 2100 billion dollars was reported. The inflows declined in the year 2008 which reported figures of 1771 billion dollars, the year 2009 reported a further decline reporting an amount of 1114 billion dollars. In 2010, the downward trend reversed as the inflows increased to 1409 billion dollars, and a further increment in the 2011 to 1652 billion dollars. However in the year 2012, the global FDI inflows again decreased to a low of 1114 billion dollars. Africa recorded FDI inflows of 63 billion dollars in the year 2007 and the inflows increased in 2008 to 72 billion dollars. Thereafter, the trend reversed with the FDI inflows decreasing to a low of 59 billion dollars in the year 2009 and a further 44 billion dollars in 2010. The year 2011 and 2012 posited increments with the inflows rising to 48 and 50 billion dollars respectively.

Figure 2.3 Percentage share in world FDI inflows



Source: Compiled by researcher using data from Table 2.2

In figure 2.3, FDI inflows percentage share in the world over the years 2007 – 2012 are presented. Africa's percentage share of the world's FDI inflows remained the lowest in comparison to other regions. In Africa, the year 2007 reported FDI share to be 3%. The year 2008 had a share of 4.1%, 5.3% in the year 2009, 3.1% in the year 2010, 2.9% in the year 2011 and 3.7% in the year 2012. This showed a steady increase until the year 2009. In the year 2010 and 2011 the percentage declined before increasing again in the year 2012.

Despite a decline of FDI inflows to North Africa in the year 2011, due to the political instability in Egypt and Libya who previously were major recipients of FDI, inflows to SSA increased to US $ 37 billion in 2011 down from to US $ 29 billion in 2010.[31] This was as a result of a generally positive economic outlook for SSA, the steady rise in commodity prices and a rebound of FDI to South Africa. In addition the recent emergence of a middle class has encouraged the growth of FDI in the service sector in

[31] World Investment Report 2012 Overview (source UNCTAD) pp. 11

banking, retail and telecommunications thereby increasing the share of services FDI in 2011. The reduction of inflows from developed countries subsequently led to the developing countries to increase their share in inward FDI to the continent from 45 per cent in 2010 to 53 per cent in 2012 in Greenfield investment projects hence contributing to the overall increase in FDI inflows into Africa.

FDI inflows to Africa rose for the second year running in 2012 making it one of the few regions that registered year-on-year growth in 2012.[32] This was due to an increment of inflows resulting from investment in exploration and exploitation of natural resources and high inflows from China. The increase in investment in manufacturing and services was greatly influenced by the region's good economic performance with a GDP growth approximated at about 5 percent in 2012. The overall increase resulted from the increased inflows to North Africa, Central Africa and East Africa whereas South and West Africa experienced declines.

Table 2.3: Distribution of FDI Flows among economies, by range 2012

Range	Inflows
Above $ 3.1 billion	Nigeria, Mozambique, South Africa, Democratic
$ 3.0 billion	Republic of Congo and Ghana
$ 2.0 billion to	Morocco, Egypt, Congo, Sudan and Equatorial
$ 2.9 billion	Guinea
$ 1.0 billion to	Tunisia, Uganda, United Republic of Tanzania,

[32] Ibid pp. 12

$ 1.9 billion	Algeria, Liberia, Mauritania and Zambia.
$ 0.5 billion to	Ethiopia, Madagascar, Niger, Guinea, Sierra Leone
$ 0.9 billion	Gabon and Cameron
$ 0.1 billion to	Cote d' Ivoire, Zimbabwe, Mauritius, Namibia,
$ 0.4 billion	Senegal, Chad, Mali, Botswana, Kenya, Lesotho, Togo, Rwanda, Benin, Malawi, Seychelles, Somalia and Djibouti.
Below $ 0.1 billion	Swaziland, Gambia, Eritrea, Central Africa Republic, Verde, Sao Tome & Principe, Burkina Faso, Comoros, Guinea Bissau, Burundi and Angola.

Economies are listed according to the magnitude of their FDI inflows.

Source: World Investment Report 2013.

Flows to North Africa reversed their downward trend and Egypt saw a rebound in investment from European investors confirming that investor confidence seems to have returned North Africa as FDI inflows rose by 35 percent to 11.5 billion in 2012.[33] Growth of inflows to Egypt contributed largely to this upward trend same as in Morocco and Tunisia though inflows to Algeria and Sudan decreased. Recent discoveries of natural resources like gas and oil in Tanzania; Uganda and Kenya contributed to the rise in FDI inflows to East Africa, from $ 4.6 billion in 2011 to $ 6.3 billion in 2012. FDI inflows to SSA were driven majorly by investments in the extractive sector in countries such as the Democratic Republic of Congo, Mauritania, Mozambique and Uganda. Angola an important holder of FDI stock in Africa continued to post divestments in 2012.

[33]Ibid pp. 12.

In Contrast, a decline in inflows to Angola and South Africa to $ 6.9 billion and $ 4.6 billion respectively led to the drastic decline of FDI inflows to Southern Africa from $ 8.7 billion in 2011 to $ 5.4 billion in 2012. Nevertheless, Mozambique was however able to attract more investors to the tune of $ 5.2 billion during the same period.

Furthermore, FDI inflows to West Africa declined by 5 percent to 16.8 billion largely because of decreasing flows to Nigeria due to political insecurity and the weak global economy which saw the country's FDI inflows fall from $ 8.9 billion in 2011 to $ 7.0 billion in 2012. However, Mauritania and Liberia both experienced a surge in inward FDI flows as Mauritania doubled its inflows to $1.2 billion partly because of the expansion in mining operations of gold and copper[34]. Central Africa attracted $ 10 billion of FDI stock in 2012 a 23 per cent increment from 2011. Inward flows to Democratic Republic of Congo shot from $ 1.7 billion to $ 3.3 and this is partly attributed to the expansion of the copper cobalt mines.

The latest trend is that TNCs from developing countries continue to dominate in Africa in the recent years taking the highest share of FDI flows coming from emerging markets. Malaysia, South Africa, China and India are considered as the largest developing country sources of FDI in Africa. Malaysia with an FDI stock of $ 19 billion in Africa has investments spread across the continent in all sectors including substantive FDI in agribusiness and finance; South Africa and China with $ 18 billion and $ 16 billion respectively of FDI stock in Africa is also diversified across all sectors.

[34]Ibid pp. 14.

2.3 Determinants of FDI in Africa

A popular conceptualization of, and theoretical framework for, FDI determinants is the "eclectic paradigm" attributed to Dunning[35]. It provides a framework that groups micro and macro-level determinants in order to analyze why and where multinational companies invest abroad. The framework posits that firms invest abroad to look for three types of advantages: Ownership, Location, and Internalization advantages; hence it is called the OLI framework. The ownership-specific advantages, of property rights/patents, expertise and other intangible assets, allow a firm to compete with others in the markets it serves regardless of the disadvantages of being foreign because it is able to have access to, and exploit and export natural resources and resource-based products that are available to it[36]. These advantages may arise from the firm's ability to coordinate complementary activities such as manufacturing and distribution, and the ability to exploit differences between countries. The location advantages are those that make the chosen foreign country a more attractive site such as labor advantages, natural resources, trade barriers that restrict imports, gains in trade costs and strategic advantages through intangible assets for FDI than the others hence the reason for the FDI is to supply the domestic market of the recipient country through an affiliate[37].

The location advantages may arise from differences in country natural endowments, government regulations, transport costs, macroeconomic stability, and cultural factors.

[35]Dunning, J.H. (1977), Trade, location of economic activity and the MNE: a search for an eclectic approach in B. Ohlin and P.O. Hesselborn (eds.): The International Allocation of Economic Activity, London, Macmillan, 395-418.

[36]Sekkat, K. and Veganzones-Varoudakis, M-A. (2007), "Openness, Investment Climate, and FDI in Developing Countries", Review of Development Economics, 11(4), 607–620.

[37]Baniak, A., Cukrowski A. J. and Herczynski, J. (2005), "On the Determinants of Foreign Direct Investment in Transition Economies", Problems of Economic Transition, Vol. 48, No. 2, June 2005, 6–28.

Internalization advantages arise from exploiting imperfections in external markets, including reduction of uncertainty and transaction costs in order to generate knowledge more efficiently as well as the reduction of state-generated imperfections such as tariffs, foreign exchange controls, and subsidies. In this case, the delocalization of all or a portion of the production process (e.g. production of components/parts and/or different locations) leads to low costs benefits (vertical FDI)[38]. Following on these, Dunning[39] identified four categories of motives for FDI: resource seeking (to access raw materials, labor force, and physical infrastructure resources), market seeking (horizontal strategy to access the host-country domestic market), efficiency seeking (vertical strategy to take advantage of lower labor costs, especially in developing countries), and strategic-asset seeking (to access research and development, innovation, and advanced technology)[40].

The literature on the forces driving FDI has also identified both policy and non-policy factors as drivers of FDI[41]. Policy factors include openness, product-market regulation, labor market arrangements, corporate tax rates, direct FDI restrictions, trade barriers, and infrastructure. Non-policy factors include market size of the host country, distance/transport costs, factor proportions (or factor endowments) and political and economic stability[42]. The pull factors or domestic factors include economic, socio-political and structural conditions, including uncertainty, while the push factors relate to cyclical and structural conditions, irreversibility and herding.

[38]Kinda, T. (2010), "Investment Climate and FDI in Developing Countries: Firm-Level Evidence", WorldDevelopment, Vol. 38, No. 4, 498–513.
[39]Dunning, J.H. (1993), Multinational Enterprises and the Global Economy, Addison-Wesley
[40]Cleeve, E. (2008), "How Effective Are Fiscal Incentives to Attract FDI to Sub-Saharan Africa?", The Journal of Developing Areas, Volume 42, Number 1, Fall, 135-153.
[41]Fedderke J. W., and Romm A.T. (2006), "Growth impact and determinants of foreign direct investment into South Africa, 1956–2003", Economic Modeling, 23, 738–760.
[42]Mateev, M (2009), "Determinants of Foreign Direct Investment in Central and Southeastern Europe: New Empirical Tests", Oxford Journal, Fall, Vol. 8, N. 1, 133-149.

Gottschalk[43] presents a two-factor classification of the factors that influence FDI flows: as "push", those that are external to the recipients of FDI - relating to cyclical and structural conditions, irreversibility and herding, or "pull" factors, those internal to them such as economic, socio-political and structural conditions, including uncertainty. Other factors are those on the supply-side like skilled labor, research and development, and infrastructure, those on the demand-side like host country economic and social variables or pull factors, including interest rates, tax and tariff levels, market size and potential, wage rates, income distribution, human capital, cost differentials, exchange rates, fiscal policies, trade policies, physical and cultural distance, among others and institutional factors like culture, intellectual property rights, transaction costs, political risk, corruption, and bureaucracy.

Sekkat and Veganzones-Varoudakis[44] have grouped the factors determining the inward flow of FDI into three categories: basic economic factors, trade and the exchange market policies, and other aspects of the investment climate. The basic economic factors include the difference in the rate of return on capital across countries, portfolio diversification strategy of investors and market size of the host country. Trade and foreign exchange policy considerations relate to trade liberalization and exchange rate movements and their volatility[45]. Business climate factors relate to infrastructure, Wheeler and Mody[46], labor costs and availability of skilled labor/education, incentive factors, political risk, economic factors (per capita

[43]Gottschalk, R. (2001), "Lenders and Investors International Portfolio Allocation Decisions: What Do We Know?", Institute of Development Studies, Sussex.
[44]Sekkat, K. and Veganzones-Varoudakis, M-A. (2007), "Openness, Investment Climate, and FDI in Developing Countries", Review of Development Economics, 11(4), 607–620.
[45]Froot, K. A. and Stein, J. C. (1991), "Exchange Rates and Foreign Direct Investment and Imperfect Capital Market Approach", Quarterly Journal of Economics, Nov, p. 1191–1217.
[46]Wheeler, D. and Mody, A (1992), "International Investment Location Decision – the Case of United-States Firms", Journal of International Economics, Vol. 33(1-2), 1992.pp.57-76.

GDP, GDP growth rate, economic integration, importance of transport, commerce and communication), social factors (degree of urbanization), political stability (the number of constitutional changes in government leadership), the role of institutions (in terms of commitments to and enforcement of rules), the catalyzing effect of foreign aid, and the stability of basic macroeconomic policies[47].

[47]Baniak, A., Cukrowski A. J. and Herczynski, J. (2005), "On the Determinants of Foreign Direct Investment in Transition Economies", Problems of Economic Transition, Vol. 48, No. 2, June 2005, 6–28.

CHAPTER THREE: FOREIGN DIRECT INVESTMENT IN KENYA

3.1 Overview of FDI performance in Kenya

FDI has played a small (though increasingly important) role in the Kenyan economy. Net FDI inflows to Kenya have not only been highly volatile but also generally declined in the 1980s and 1990s, despite economic reforms and the progress made in improving the business environment.[48] The investment wave of the 1980s dwindled in the 1990s as the institutions that had protected both the economy and the body politic from arbitrary interventions were eroded.[49] In absolute terms, net FDI inflows declined from an average US$30.67 million in the 1980s to $17.7 million in the 1990s. The net FDI/GDP ratio declined from an average of 0.42 percent in the 1980s to 0.20 percent in 1990s. Share of net FDI in gross capital formation (GCF) declined from 2.02 percent in the 1980s to 1.13 percent in the 1990s. Foreign Direct Investment was therefore minuscule when compared with domestic investment. There was much concern among Kenyan policymakers over the falling off of FDI, which they attributed to low investor confidence resulting from insecurity, poor infrastructure, corruption, high real interest rates, high utility costs and patch service and limited legal recourse.[50]

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[48]Mwega, F.M. and R.W. Ngugi (2004) 'Foreign Direct Investment In Kenya'. Paper presented at the AERC Special Workshop on FDI in Sub-Saharan Africa, February 2005.

[49]Phillips, L.C., M. Obwona, M. McMillan and A.B. Ayako (2001) 'Foreign and Local Investment in East Africa, Interactions and Policy Implications: Case Studies on Mauritius, Uganda and Kenya'. Eager Project Paper.

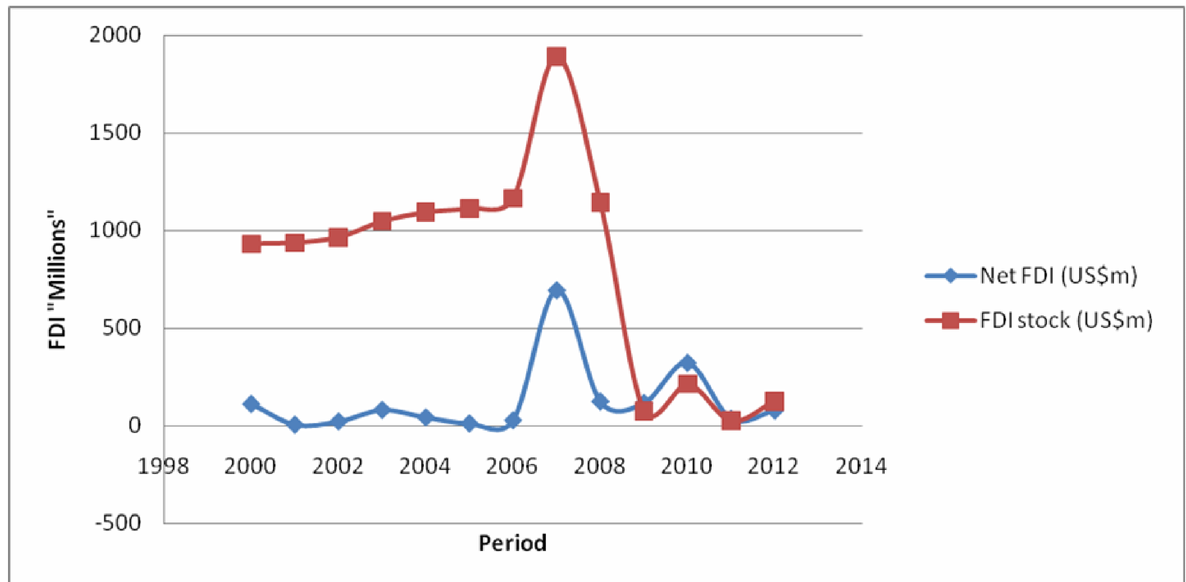
[50]Central Bureau of Statistics (2003).Statistical Abstract. Nairobi.

Table 3.1 Net FDI inflows to Kenya for the period 2000-2012

Period	Net FDI (US$m)	FDI stock (US$m)	Net FDI/GDP (%)	Net FDI/gross investment (%)	FDI stock/GDP (%)
2000	111	931	1.05	6.84	8.82
2001	5	937	0.04	0.31	8.34
2002	21	964	0.17	1.03	7.66
2003	80	1046	0.58	3.27	7.54
2004	42	1092	0.29	1.5	7.61
2005	11	1113	0.07	0.33	6.86
2006	27	1164	0.15	0.64	6.47
2007	692	1892	3.25	11.85	8.87
2008	123.6	1142.4	0.7	3.23	7.77
2009	115	74	0.65	2.33	8.56
2010	321	213	0.6	4.4	7.32
2011	35	23	0.4	10.12	7.34
2012	77	124	0.34	7.8	7.43
Average	127.74	824.26	0.64	4.13	7.74

Source: UNCTAD FDI database.

Figure 3.1: Net FDI and FDI stock Variation (2000-2012)



Source: UNCTAD FDI database.

The performance of FDI has improved recently and averaged US$127.74 million in 2000-2012. Net FDI increased to an average of 0.64% of GDP and to an average of 4.13% of gross investment in 2000-2012. The data shows, however, that this good performance was driven by a big jump of net FDI flows to the country in the year 2000 and the year 2007. The 2000 jump owed to new investments by mobile phone companies involving mergers and acquisition of $3 million and accelerated offshore borrowing by private companies to finance electricity generation activities, which became necessary as a result of the drought that prevailed the year. The 2007 upsurge in Foreign Direct Investment owed to the coming in of a new mobile telephone operator and the privatization of Telkom Kenya.

Probable causes of low FDI and variations in Kenya are varied but the economic crisis has been a major concern since 2007. Kenya's economy is highly dependent on the consumption, investment and financial aid pattern of the developed economies.

Therefore if these developed countries have economic problems Kenya is likely to suffer severe lash backs. The crisis is therefore likely to adversely affect the Kenyan FDI ratio by reducing the growth of the country's main trading partners (a 1% reduction in growth reduces the FDI ratio by 0.45%) as well as through a worsening of Kenya's terms of trade (a 1% worsening of the country's terms of trade reduces the ratio by 0.057%). However, given the miniscule FDI ratio (except in 2000 and 2007), these effects are likely to be minimal. They would be offset by the availability of grants and loans to finance the crisis and governance improvements which will require actions such as rebuilding institutions, reducing corruption and enhancing the rule of law and order with clear and transparent regulations uniformly enforced.[51]

According to the UN Conference on Trade and Development (UNCTAD)[52] Kenya has about 114 foreign affiliated firms located in the economy. Most of the big multinational organizations are in the tertiary sector which is composed mainly of transport, trade and telecommunications. Majority of these are from developed countries most from the United Kingdom and United States, and hence are likely to be affected by the global financial crisis.

Foreign firms in Kenya since the 1970s have invested in a wide range of sectors. Most notably they played a major role in horticulture and floriculture with close to 90% of flower firms being controlled by foreign investors. In the Manufacturing industry, FDI has concentrated on the consumer goods industry such as beverage industries and food. This has changed recently with the growth of the garment sector because of

[51]Phillips, L.C., M. Obwona, M. McMillan and A.B. Ayako (2001) 'Foreign and Local Investment in East Africa, Interactions and Policy Implications: Case Studies on Mauritius, Uganda and Kenya'. Eager Project Paper.

[52]UNCTAD (2005) Investment Policy Review, Kenya. United Nations: New York and Geneva

African Growth and Opportunities Act (AGOA). Of the 34 companies involved in AGOA, 28 are foreign and the majority concentrated in the Export Processing Zones (EPZs). FDI is also distributed to other industries including telecommunication and services. 55% of the foreign organizations are concentrated in Nairobi while Mombasa has about 23 percent. This means that Nairobi and Mombasa account for over 78% of FDI in the country. The main form of Foreign Direct Investment establishment has been through the form of green fields' establishments and Kenya's multinational corporations in total are more than 200. The main sources of FDI are US and Germany, Britain, South Africa, Switzerland, Netherlands, and of late India and China.[53]

3.2 Investment Policy Framework of FDI

Kenya's foreign policy framework aims at deepening and enhancing prosperity and social economic development. This has required a robust economic engagement to secure regional and wider economic objectives of Kenya. Foreign Policy has been a key tool for enhancing development via economic diplomacy which advances the employment and wealth for Kenyans in a prosperous region. The policy aims at achieving objectives of this economic diplomacy which are: Increase capital flows to Kenya by exploring alternative non-traditional sources of development assistance and foreign direct investment; Promote the country as a favorite destination for Direct Foreign investment, tourists and holiday makers; Expand access to traditional markets and explore new destinations for its products in emerging non-traditional markets; Enhance technological advancement by exploring new sources of affordable and appropriate technology; Accelerate economic integration at the regional and

[53] Ibid

continental levels; to serve as competitive blocs in the emerging global markets; Strengthen regional economic organizations and promote just and equitable rules and frameworks of international trade.

3.2.1 Entry and Establishment of FDI

For decades, Kenya is one of the most open regimes for FDI in Africa. The principal restrictions were contained in the Trade Licensing Act (1968, with subsequent amendments), even though the FDI related restrictions had not been enforced recently. Apart from this Act, the only formal limits on foreign ownership were in telecommunications and insurance (in which foreign ownership of a business is limited by policy to 70 per cent and 77 per cent respectively) and for companies listed on the Nairobi Stock Exchange, which are required to have at least 25 per cent national ownership. Moreover, FDI did not require screening for approval. A new FDI entry regime was introduced in late 2004, which overturned this approach. As a result, one of the most liberal entry regimes for FDI in sub-Saharan Africa has been replaced by one of the more restrictive ones. The Investment Promotion Act (2004), which the President ratified on 31 December 2004, introduces a mandatory investment threshold and restrictive screening procedure for all foreign investments. These are set to become a significant impediment to FDI inflows. The Act makes a formal distinction between domestic and foreign investors, and requires the latter to apply to the newly established Kenya Investment Authority (KIA) for an Investment Certificate by stating that "a foreign investor shall not invest in Kenya unless has been issued with an investment certificate".[54]

[54]Phillips, Lucie, Obwona, Marios, McMillan, Margaret and Ayako, Aloys (2000). Foreign and Local Investment in East Africa, Interactions and Policy Implications: Case Studies on Mauritius, Uganda and Kenya. EAGER Research Paper. Washington, DC.

The conditions under which KIA is allowed to issue an Investment Certificate to a foreign investor are restrictive which state that the amount invested must be at least $500,000 or the equivalent in another currency and the investment must be deemed by KIA to be to the benefit of Kenya, including at least as a result of creation of employment for Kenyans; the acquisition of new skills or technology by Kenyans and; the contribution to tax revenues or other government revenues.[55]

The legislature introduced mandatory Investment Certificates and minimum capital requirements for foreign investors for several main purposes: to maximize beneficial FDI and minimize its potential negative effects; to give priority to national private sector development and to protect small national businesses in certain sensitive areas, and; to ensure that the entitlement to work permits for foreigners granted as an incentive to holders of Investment Certificates is not abused to illegitimately bring in foreign workers.

3.2.2 Treatment and Protection of FDI

The principle of national treatment of FDI is not enshrined in law. In general, however, foreign investors receive the same treatment as domestic investors once established in Kenya. The main deviation from national treatment (aside from those related to trade licences described above) is in terms of access to agricultural land. The Land Control Act (1967, with subsequent amendments) specifically forbids non-citizens and private companies any of whose members is non-citizen to acquire or lease agricultural land. The Act nevertheless also allows the President to grant

[55]UNCTAD (2002).World Investment Report 2002, Transnational Corporations and Export Competitiveness.New York and Geneva.

exemptions to the restrictions mentioned above, without having to provide justification or impose conditions on the transaction. His discretionary power in this matter is thus total and not limited by law.[56]

Protection of private property, including for foreign investors, is enshrined in the Constitution. Private property may be compulsorily acquired by the Government only for reasons pertaining to public safety or public interest, and with prompt payment of full compensation. The owner of the property has a right of direct access to the High Court if he wishes to contest the legality of the expropriation or the amount of the compensation, or to enforce prompt payment of the compensation. The Constitution, offers stronger protection yet, as it would require prompt payment in full of just compensation before the property is expropriated. Foreign investors also have the option of recourse to the International Centre for Settlement of Investment Disputes (ICSID), as Kenya has been a member of the Convention since 1967. Recourse to ICSID for conciliation or arbitration requires the consent of both parties involved in the dispute, as specified by the ICSID Convention. The Investment Disputes Convention Act (1967) stipulates that awards granted by the ICSID Arbitration Tribunal are binding in Kenya and have the same validity as final decrees of the High Court. Kenya is also a member of the Multilateral Investment Guarantee Agency (MIGA), which allows foreign investors to seek cover for currency transfer risks, expropriation, breach of contract or war and civil disturbance.

3.2.3 Taxation

Kenya has signed eight double taxation treaties (DTTs), including with major source countries of FDI such as the United Kingdom, Germany and Canada, but including

[56]Central Bank of Kenya (2003).Annual Report 2003. Nairobi.

only one African country (Zambia). The treaties allow for the taxation of royalties, dividends, interest and management fees in both contracting States but set limits on the withholding rate allowed in the country where the income arises. These limits are typically higher than what Kenya applies in its general regime, except for management fees. All DTTs allow for tax credits for tax paid in the partner country.[57]

Negotiations for DTTs with Italy, the United Republic of Tanzania and Uganda were initiated over a decade ago, but have not been concluded. Investors based in Kenya and with subsidiaries or sources of income in the United Republic of Tanzania, Uganda or any other neighboring country thus face double taxation, which can raise the effective tax burden up to 51 per cent (e.g. 30 per cent corporate income tax rate in the United Republic of Tanzania or Uganda, and another 30 per cent in Kenya). Kenya does not offer unilateral foreign tax credits to companies with taxable income in countries with which it does not have DTTs. The absence of DTTs with neighboring countries thus constitutes a significant impediment to business expansion in the region. A trilateral tax treaty with the United Republic of Tanzania and Uganda to avoid double taxation was signed 1997, but it has not entered into force as it has been ratified by Kenya and the United Republic of Tanzania, but not Uganda. Additional negotiations are under way with South Africa, Nigeria, Mauritius and France.

Kenya's tax system is relatively straightforward and is not widely used to provide targeted sectoral incentives. The administration of the system is efficient and fair relative to other developing countries. Kenya compares favorably with other countries in the region and elsewhere in terms of revenue collection as a percentage of GDP, which averaged 21.2 per cent between 2000 and 2003. It relies relatively heavily on

[57]OECD (2001a).Corporate Tax Incentives for Foreign Direct Investment.Tax Policy Studies 4. Paris.

customs and excise duties, which represent close to 50 per cent of total revenue, although this is also the case among comparable countries. Investors' concerns about the tax regime are focused less on the structure of the system itself or the level of taxation, and more on what they perceive as a rather "aggressive" attitude of the Kenya Revenue Authorities (KRA) with respect to compliant tax payers, and the "punitive" levels of penalties in the event of delay in payments or minor mistakes in reporting. They often perceive KRA as expending too much effort on chasing existing taxpayers at the expense of its efforts to widen the tax base. They also raised concerns about delays in reimbursements of excess VAT payments and duty drawbacks, and the administration of customs. The overall efficiency and competence of the KRA must be commended however, as efficient tax collection is key to the functioning of the economy.

3.2.4 Foreign Exchange Arrangements

Kenya switched from a fixed exchange rate regime (1966-1982) to a crawling peg tied to a basket of major currencies (1983-1993) before floating the Shilling in October 1993. It fully liberalized capital account transactions in 1994 and signed up to the IMF's Article VIII, which ensures currency convertibility for current account transactions and bans multiple currency practices. The Exchange Control Act was repealed in 1995, and all foreign exchange transactions are free of any restriction. There are no multiple currency practices, and the exchange rate is freely determined in the inter-bank foreign exchange market. The Central Bank of Kenya reports very little in terms of intervention on the inter-bank market to stabilize the Shilling. Its intervention occurred mainly in the years following the floating of the Shilling, and it reports only three interventions in 1999, six in 2000 and only one other intervention

since then. The Shilling has nevertheless remained relatively stable against the dollar in recent years, as it depreciated from about Sh60/$1 in late 1998 to trade in a range of Sh73/$1 to Sh79/$1 between early 2000 and early 2005.[58]

3.2.5 Employment of Foreigners

Kenya follows a rather outdated approach to granting work permits that creates uncertainty for applicants. This was reflected in interviews with foreign investors, as some reported no difficulties in obtaining work permits, while in other instances investment was frustrated by such problems, particularly in the services sector. There are essentially two types of permits that can be granted under the Immigration Act (1967, with subsequent amendments), which consolidate work permits and entry permit into a single pass: Class A or D permits can be granted to an individual who is offered specific employment by a specific employer; Class F to J permits are essentially "investors permits" for individuals who propose to invest in different types of activities, from agriculture to manufacturing or professional services. The Immigration Act does not prescribe any minimum amount of investment for such permits, although it specifies that the individual must have "in his own right and at his full and free disposition sufficient capital and other resources for the purpose".[59]

Applications for work permits are examined on a case-by-case basis by a Committee chaired by the Department of Immigration, and which includes representatives from the Ministries of Foreign Affairs, Labour, Tourism, Trade and Industry and the Investment Promotion Centre. While the Immigration Act specifies that work permits

[58]Phillips, Lucie, Obwona, Marios, McMillan, Margaret and Ayako, Aloys (2000). Foreign and Local Investment in East Africa, Interactions and Policy Implications: Case Studies on Mauritius, Uganda and Kenya. EAGER Research Paper. Washington, DC.
[59]Beck, Thorsten and Fuchs, Michael (2004). Structural Issues in the Kenyan Financial System: Improving Competition and Access. World Bank Working Paper 3363. Washington DC.

can be granted to foreigners on condition that employment will be of benefit to the country. There are also no publicized guidelines as to how “benefit to Kenya” is to be understood. This increases the degree of discretion granted to the Committee and the level of uncertainty for investors. A single application is filed that justifies the merit of hiring an expatriate for the position and the merit of the individual proposed for the position. The petitioner must justify the steps that have been attempted to fill the position with a Kenyan citizen and why this has not been possible. This involves, in most cases, an extensive labour market test and requires advertising the position domestically, collecting curricula vitae and interviewing citizens. In some instances, for example high technologies, where local skills are in obvious shortage, this requirement may be by-passed.[60]

The new Investment Promotion Act entitles holders of Investment Certificates (whether foreign or domestic investors) to the class A (employee) permits for management or technical staff and the class H, I or J (investors) permits for owners, shareholders or partners. The permits are to be issued for an initial period of two years, and holders of certificates are entitled to have the permits renewed or transferred to another employee or investor if necessary, without time limit. Security, credentials and health checks on nominated individuals will obviously still be conducted following regular procedures.

3.2.6 Land

Access to land and the administration of land ownership titles raise serious concerns for foreign and domestic investors alike. As in other cases, the experience of foreign investors seems to be mixed, which is another reflection of the degree of discretionary

[60]DeloitteToucheTohmatsu (2004).Budget 2004, Kenya. Nairobi.

powers granted under the law to its administrators. Land classification falls under three categories: government land (20 per cent of the total), trust land (held by county councils, 60 per cent of the total) and private land (20 per cent of the total). There are also three main ownership titles: freehold, leasehold (generally, but not exclusively, 99 years) and customary tenure. Presidential exemption is thus the main channel through which foreign investors can acquire agricultural land. There are no procedures and publicized guidelines that investors can follow, however, as applications are considered on a case-by-case basis and on their own merit. Initial access to the Presidency is obviously the first hurdle to clear for foreign investors, as no clear procedure exists. The lack of guidelines in the granting of exemptions and the involvement of a number of Ministries also make the process lengthy and very unpredictable.[61]

Presidential exemption is thus the main channel through which foreign investors can acquire agricultural land. There are no procedures and publicized guidelines that investors can follow, however, as applications are considered on a case-by-case basis and on their own merit. Initial access to the Presidency is obviously the first hurdle to clear for foreign investors, as no clear procedure exists. The lack of guidelines in the granting of exemptions and the involvement of a number of Ministries (including the Ministries of Environment, Home Affairs and Land) also make the process very unpredictable and lengthy. The level of discretion and the uncertainty in administering transactions in agricultural land involving foreigners are characteristic of much of the investment environment in Kenya. As a result, investors' experiences have been very mixed. Some investors, mostly well-established already, reported no problem relating

[61]Commonwealth Secretariat (2004).Proposals for New Mining Policy and Legislation in Kenya. London.

to access to agricultural land, while others reported it as being a serious issue, with a least one case of an investment project being aborted for lack of access to the Presidency in petitioning for an exemption.[62]

Although the complexity and high level of discretion in allocating agricultural land to foreign investors do not seem to have prevented the development of horticulture and floriculture with large foreign involvement, the current system is clearly unsatisfactory and opaque. Further promoting the dynamic horticulture sector would require clear procedures and guidelines on the allocation of Presidential exemptions as a first step, and a complete overhaul of the law as a second step. Significant revisions to land laws are being considered and would be required in order to implement the draft Constitution, which is currently under discussion.

3.3 Sectoral Composition of FDI in the Kenyan Economy

Foreign firms in Kenya have invested in a wide range of sectors since independency. Most notably they played a major role in horticulture and floriculture, with close to 90% of flowers being controlled by foreign investors. However, FDI is now diversifying even into manufacturing and services.[63]In the Manufacturing sector FDI has concentrated on the local rather than the export market and consumer goods sector, such as food and beverage industries. FDI from Germany is going increasingly into manufacturing. This has changed in the recent years with the growth of the garment sector because of African Growth and Opportunities Act (AGOA). Of the 34 companies involved in AGOA 28 are foreign most of them concentrated in the Export

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[62]McCulloch, Neil and Ota, Masako (2002). Export Horticulture and Poverty in Kenya. IDS Working Paper 174, Sussex.

[63] Eglin, R. (2001). "Trade and Investment in the WTO", Background Note for the Panel Discussion, WTO Secretariat.

Processing Zones (EPZs).More than 60% of British FDI stock in Africa is in the manufacturing and services sectors.[64] A survey of MNCs in 2000 indicated that the sectors with the greatest potential to attract FDI in Kenya are tourism, natural resource industries, and industries for which the domestic market is important.[65]55 percent of the foreign firms are concentrated in Nairobi while Mombasa accounts for about 23 percent, thus Nairobi and Mombasa account for over 78 percent of FDI in Kenya.[66]

The main form of FDI establishment has been through the form of green fields establishments and Kenya has in total more than 200 multinational corporations. The main local sources of foreign investments are US, Britain, Germany, Netherlands, South Africa, Switzerland and of late India and China.[67] This gradual diversification is encouraging given that agriculture and labour-intensive manufacturing are two sectors that can make the greatest contribution to poverty reduction.[68]

3.4 Investment Incentives to Attract FDI

Investment incentives are Foreign Direct Investment policy tools which government may use to attract foreign investment. They include special tax allowances, financial incentives such as low interests on loans and tax exemptions and reductions. Investment guarantees such as the guarantee for capital and profit repatriation and foreign currencies provision may also be ways of attracting foreign investment.

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[64]UNCTAD (1999)."Foreign Direct Investment in Africa: Performance and Potential", United Nations, Geneva, UNCTAD/ITE/IIT/Misc.15.

[65]UNCTAD (2002a). Economic Development in Africa: From Adjustment to Poverty Reduction, What is New?.United Nations, Geneva, UNCTAD/GDS/AFRICA/2.

[66]UNCTAD (2005) Investment Policy Review, Kenya. United Nations: New York and Geneva.

[67] Ibid

[68]UNCTAD (2002a). Economic Development in Africa: From Adjustment to Poverty Reduction, What is New?.United Nations, Geneva, UNCTAD/GDS/AFRICA/2.

Governments may also attract Foreign Direct Investments by creating Investment Promotional Agencies (IPAs) which concentrate on activities of marketing the country as a preferred investment location and join the World Association of Investment Promotion Agencies which trains the Investment Promotion Agencies. Foreign Direct Investment promotion addresses a market failure on the imperfect information from the government side and the investors' and emphasizes on the attractiveness of the host country to the investors. Morriset[69]argues that greater investment promotion is associated with increase in cross-country Foreign Direct Investment inflows. Investment promotion will be more effective where there is good investment climate and there is a high level of development.

In Kenya, investment promotion is the responsibility of Kenya Investment Authority (KIA). The agency was created in 2004 through the Investment Promotion Act of 2004. This was meant to serve as the focal point between the indigenous and foreign investors in Kenya. The agency's functions are keeping close contact with all development finance institutions, arranging contacts between suitable local and foreign investors, gathering information from other countries on investment incentives, arranging promotional activities such as investment workshops overseas with the aim of attracting foreign investors, preparing investment guidance literature for foreign investors, advises the government on which policy changes are required and review of the investment laws so as to make the country more attractive to foreign investments and finally providing guidance and advice to investors on issues touching

[69]Morriset, J. (2003) "Does a Country Need a Promotional Agency to Attract Foreign Direct Investment? A Small Analytical Model of 58 Countries" World Bank Policy Working Research Paper, Nr 3028

on investments such as labor regulation, taxes, interest rates, credit access, infrastructure.

The government of Kenya offers several fiscal incentives such as reduced tax rates and tax holidays to foreign investors. Most of these incentives are normally directed to firms which are engaged in the Export Processing Zones (EPZ). The export processing zones were created under the Export Processing Zones Act (1990). There are three types of activities that firms may engage in while in the EPZs, these are namely, manufacturing, commercial and services. Firms involved in the EPZs have more incentives than other firms in other sectors. According to UNCTAD[70] these firms will amongst other things get an exemption from the VAT Act, be exempted from paying stamp duties, will not be required to pay withholding tax on dividends for both domestic and foreign investors for a period of the first 10 years of operation, after which they are expected to pay a 25% flat rate for the next 10 years after that. Other incentives include exemption from payment of customs and excise taxes, and less procedural requirements when establishing the business.

3.5 Determinants of FDI in Kenya

Foreign Direct Investments mostly comes as a bundle of endowments such as organizational and managerial skills, production technology, marketing skills, financial capital as well as broader market access through the networks of the multinational enterprises which are involved in foreign direct investments. Contingent to legal regulations, this resources and skills tend to diffuse inside the local enterprises in the host economy. The theory of determinants of FDI flows has developed

[70] UNCTAD (2005) Investment Policy Review, Kenya. United Nations: New York and Geneva.

substantially over time. Beginning with the neoclassical approach, summarized by MacDougal[71], other theories include Jorgenson's[72]model, the radical theories, the relative competitive advantage approach, Hymer[73] and the theory of industrial organization, Agarwal[74],

3.5.1 Domestic market size and its growth

There are several factors which are taken into consideration when measuring the market size. Market size and its growth are especially important for FDI targeted at supplying the local market.[75] The most important factor is the size of GDP of Kenya. To estimate the amount which can be put into consumer investment and spending, it is vital to know the amount of aggregate production which will in turn indicate the aggregate revenue of the economy. To be more specific about the market size of a country, to some point the market size of the neighboring countries is normally considered. This will help in obtaining a better idea of the total market size which could be served through local production on the country.[76]

Kenya's main partners in trade include EAC member countries, United States of America, the COMESA (common market for eastern and southern Africa), United Arab Emirates and the European Union and Japan. Looking at the location where Kenya is located, Kenya enjoys the geographical which makes it suitably placed to

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[71] MacDougal, D. (1960). "The benefits and costs of private investment from abroad: A theoretical approach". Economic Record 36: 13-55.

[72] Jorgenson, D.W. (1963). "Capital Theory and Investment Behaviour". American Economic Review, Supplement 53 (2): 247-259.

[73]Hymer, S. (1976). The International Operation of National Firms: A Study of Foreign Direct Investment. Cambridge: MIT Press.

[74]Agarwal, J.P. (1980). "Determinants of Foreign Direct Investment: A Survey". WeltwirtschaftlichesArchiv – Review of World Economics 116 (4): 739-773.

[75] Kumar, Nagesh (1996). "Foreign Direct Investments and Technology Transfers in Development: A Perspective on Recent Literature". Institute for New Technologies (INTECH) Discussion

[76]Bende-Nebede, A. (2002) "Foreign Direct Investments in Sub-Saharan Africa: A Co-Integration Analysis",Economics Bulletin, 6(4) pg 1-19

become financial hub and transport in the region. This makes Kenya very attractive to the investors who may be considering getting into the EAC market. Kenya's well positioned to allow easy access to any investor to tap into the East African Community's population.

3.5.2 Political Stability

Dupas and Robinson[77] maintain that there is close correlation between economic growth and political stability. This observation may be explained by the fact that political unrest causes anxiety and uncertainty and hence increases the risk of investments made by both local and foreign investors. In most scenarios, civil unrest is coupled by social unrest which also threatens the safety of the investors themselves. During the 2007 general elections in Kenya, Kenya had maintained an image of a relatively stable country in Africa. This perception had created an ideal environment for both tourists and investors. From independence, the country's economy was performing well and despite a few effects especially in the electioneering periods, it was seen as relatively stable.

Both political stability and economic development are two factors that have made Kenya a good example for other African countries for a long period. This changed in the wake of the post-election violence in 2007. Investors' confidence in the country was shuttered and this lead to massive capital flight from the country during that particular time. As a result, this slowed down the economic growth in the country. Most investors will argue that political stability should be taken into consideration in any country a firm will want to invest in. Future unrest creates more anxiety among investors.

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[77]Dupas, P. & Robinson, J. (2011) "The (Hidden) Costs of Political Instability: Evidence from Kenya's 2007 ElectionCrisis".Department of Economics, University of California, Los Angeles.

The other main risk considered when investing in any nation is criminal related risks. By this I mean presence of criminal networks and crimes carried out against investors in the country. Larossi[78] shows how crime can significantly add to the general cost of doing business in the country. The additional costs are obtained from theft and counter-theft preventive measures such as provision of security and protection costs for the investment activities. Foreign investors are more exposed to the risk of robbery than the local investors. Kenya police is also another factor considered by investors. The police are ranked as the most corrupt institution in the country. This mean that investors may at times be forced to part with bribes in order to secure any services from the investors. Criminal gangs sometime collude with the police officers who are bribed not to take actions on the gangs. Given that criminals have the perception of foreign investors' wealthy status, there tends to be a high risk of robbery and violence activities against them.

3.5.3 Macroeconomic Stability

Macroeconomic stability is another risk which is taken into consideration by foreign investors when they decide on where to put their investment. Inflation and exchange rates are key issue for businesses involved with trade businesses. The shilling in Kenya had been perceived to be relatively stable against all the other currencies in the last decade. Coming the year 2008 after the 2007 post-election violence, the Kenyan shilling plummeted by losing about 13 percent of its value against the U.S. Dollar. After that crisis, Kenya become unstable politically which made foreign investors and tourists who make up bulk of the foreign exchange earnings in the country go to relatively more stable neighboring countries. This caused the international demand

[78]Larossi, G. (2009). "An assessment of the investment climate in Kenya." The International Bank forReconstruction and Development and The World Bank. Washington, USA.

for the Kenyan shilling to drop. At present the shilling has managed to recover and has regained its relative stability again. When investors see these kinds of fluctuations often, they tend to feel insecure in the long run.

Investors who are involved in international businesses will all be confronted by the adverse effect of the exchange rates in a country. This is why investors will run a chance of having their profits being affected as a result of exchange rates fluctuations. The fluctuation of the shilling is a risk to investors since the shilling is linked to the Dollar and Euro. This effect is then associated with the eventual profits and costs of firms. Generally, when the shilling drops property investments profits also drops.

Inflation is another significant economic risk to be looked at. It can be defined as the annual percentage change in consumer price. In any economy that is well stable and well-functioning, it is a normal occurrence and it will be followed by an increase in wages. This is important to maintain the purchasing power of a shilling. In Kenyan context, a rise in wages may not be beneficial in the long term attraction of Foreign Direct Investment. Since low wages combined with highly educated workforce serves as the right ingredient for the attraction of FDI inflow in a country. When the wages rise too much, the country may lose it comparative advantage and then investors might be looking for alternative locations to invest from the country. High inflation also diminishes the attractiveness of a country to foreign investors. This is because businesses will not be attracted to invest in a high inflation economy because it is unlikely that the investments will be more profitable in the future as a result of increased costs.

The other effect for inflation is the increased costs for the existing investors in the country. This implies that prices of goods bought in Kenya are likely to go up due to the general inflation.[79]Kenyan investors may witness low turnovers if the investors who are located in different countries are able to maintain low prices. In general, a stable currency and exchange rate stands to benefit both the investors and the economy. A stable currency helps the investors to budget for future costs and hence make future investments more reliable in the country of interest. A stable currency improves the international stature of a country and makes it more attractive to future investors.

3.5.4 Corruption

Corruption is dishonest or fraudulent conduct by people in offices who engage in bribery to gain their personal needs. Corruption creates a lot of disturbances on the investors in a country. The role of corruption in FDI brings about a lot of distortions by providing false information, pitfalls, and ultimately increases uncertainty. According to Larossi[80], investors in Kenya complain that all procedures in the country required money. The payments made are normally divided into two parts; the official payments and the unofficial payments (bribes). This problem does not only apply to foreign investors in Kenya, but also affects the indigenous people as well. Most investors have named the Kenya Revenue Authority as the most corrupt, since they often have to encounter their officials on a regular basis. Transparency International's Corruption Perception Index (2011) showed that, in the year 2010, Kenya scored 2.1 on a scale of 10. According to this scale, a country with a higher score is seen to be

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[79]Inflation in this context means that the average cost per unit will increase because it is more expensive to produce those goods or deliver the services. In such a case, the investors are forced to factor in such costs in the final prices of the products.

[80]Larossi, G. (2009). "An assessment of the investment climate in Kenya." The International Bank for Reconstruction and Development and The World Bank. Washington, USA.

less corrupt, while a country like Kenya with very low scores is perceived to be very corrupt. The index also measures the extent of corruption, in terms of size and frequency of the bribes in both private and public sectors.

Public servants and employees of the government are the most bribed, accounting for up to 99 Percent of all the bribes. These are the same officials that most foreign investors have to deal with on a regular basis. The study also shows that the bribes can range from Kshs 200 to Kshs 50,000. The general conclusion is that corruption is high and rampant in Kenya. This looks like a way of life in the country thus discouraging FDI inflows into the country[81].

3.5.5 Infrastructure, labour and Technological Capability

Investors driven with the motive of both resource and asset seeking in the country, the availability of good infrastructure is of essence. The structure and availability of infrastructural network is a positive aspect for all the sectors in any country. There are various overlaps between investment motives and locational preferences. According to the development of infrastructural network, the overlap is quite obvious. I will limit the definition of infrastructure to mean railways, roads, communication network, ports, airports and availability of electricity. The UNCTAD[82] Report describes the infrastructural network in Kenya as fairly well developed than its neighboring regions. The nation has a railway line which runs from the port city of Mombasa to the Kenya/Ugandan border. It has three main international airport with the largest being Jomo-Kenyatta International airport in Nairobi. Mombasa port is the gateway to the

[81]Transparency International-Kenya (2011). A Call for Expression of Interest In A Survey Consultancy to Map out Integrity Issues Surrounding Tax Administration And Other Fiscal Malpractises In Kenya.
[82]United Nations (2005). "Investment Policy Review: Kenya." United Nations Conference on Trade andDevelopment.New York and Geneva.

East African region for most of the shipping. Looking at the communication network, internet and telephone penetration is relatively low. There is 1 per 100 fixed line phone connections and this is low but better than others in the area. It is of essence to know that the development of good infrastructure cannot be looked down upon. When foreign investors plan to move to developing nations to take advantage of low labor costs, they have to deal with disrupted services and high transportation costs due to inadequate infrastructure, they may opt not to move. Cargo transportation ought to be reliable and fast since the speed of transportation will be a determinant of the vast life of the product and the price it will be offered to the producer.

Kenya is particularly attractive due to its combination of low cost labor and relatively highly educated workforce. The country has a huge labor force. The educational system in the country has gone through some significant changes and challenges over the past years. Early of 1970s, the government implemented the Free Primary School Education (FPE). The initiative has led to an increase in primary school enrollment rates.[83] However due to the global oil crisis in the 1980s and the introduction of the Structural Adjustment Programs by the IMF led to a start of cost sharing program which saw a huge drop in the primary school enrollment numbers. In 2003, the government again started the FPE which provided free access to education for every child. Introduction of such programs means that most Kenyans can be able literate. Another important aspect of the educational system is that Kenya being a former colony of the British makes English the native language and thereby easing the communication barriers with the investing firms. Because of the high cost of tertiary education a large part of the population does not have access to the system. Presently

[83]Nishimura, M. &Yamano, T. (2008).School Choice between Public and Private Primary Schools under the FreePrimary Education Policy in Rural Kenya. GRIPS Policy Information Center: Discussion paper.

the gross tertiary enrollment rates in the country are at 4 percent, this is still the highest rate in EAC region when compared to other regional member countries who both have enrollment rates of 2 percent and 1 percent in that order. Since most of Kenyans possess these skills which are basic, it makes the arrangement with foreign investors easier.

Higher education is often seen as an important factor to investment firms especially in the services sector. This is as a result of the employees needs to have the skills to work with computers and also have organizational duties which are the assets to the investment firms in the services industry. The presence of relatively new technological advances becomes more attractive for investors.[84]

3.5.6 Trade Policy

Protection of the local market influences MNCs' choice between exporting to that market and producing in it, and the balance between FDI and licensing as alternative modes of production in the host country.[85] Tariff barriers can encourage inward FDI and might increase spillovers. In the long run, however, such protectionism may reduce spillovers through slower economic growth and slower accumulation of technical competence.[86] Excessive trade liberalization in the country may induce MNCs to export to that market instead of producing there. Import liberalization may also however stimulate competition, thereby encouraging foreign firms to transfer technology to their affiliates in the liberal market to maintain competitiveness.[87]

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[84]Noorbakhsh, F, Paloni, A. & Youssef, A. (2001). "Human Capital and FDI Inflows to Developing Countries: NewEmpirical Evidence." World Development, Vol. 29:9, pp. 1593-1610.
[85] Kumar, Nagesh (1996). "Foreign Direct Investments and Technology Transfers in Development: A Perspective on Recent Literature". Institute for New Technologies (INTECH) Discussion
[86]Blomström, M. and F. Sjöholm (1999). "Technology Transfer and Spillovers: Does Local
[87] Ibid

3.5.7 Investment or FDI Policy

FDI policy is the degree to which foreign ownership is constrained and business decisions of foreign investors are regulated.[88] These policies determine the amount and quality of FDI inflow into the country. To encourage development of local firms, restrictive FDI policies were pursued in Kenya. Trade policy in Kenya has favored joint ventures over wholly owned subsidiaries in the world. Kenya's Policies that lower the risk of investment like minimal restrictions on equity ownership attracts FDI inflows into the country. Foreign investors prefer a country with transparent and predictable FDI policies that prohibit discriminatory treatment of foreign investors and provide an open and competitive business environment.[89] Liberalization of investment restrictions may favour FDI over licensing. Policies that discourage inward FDI in any form like those that reduce profitability of foreign investment will reduce spillovers while those that require or encourage MNCs to transfer technology more quickly will enhance potential spillovers.[90]

3.5.7 Commitment to International Rules and Agreements

Anchoring domestic regimes to international rules and agreements, through commitment and membership, reassures foreign investors. The World Trade Organization (WTO) and other international agreements on investment and trade and bilateral investment treaties (BITs) are particularly important.[91]

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[88] Ibid

[89] Eglin, R. (2001). "Trade and Investment in the WTO", Background Note for the Panel Discussion, WTO Secretariat.

[90] Haddad, M. and A. Harrison (1993). "Are there Positive Spillovers from Direct Foreign Investment?" Journal of Development Economics 42: 51-74.

[91] Ethier, W.J. and J.R. Markusen (1991)."Multinational Firms, Technology Diffusion and Trade". Journal of International Economics 41: 1-28.

3.5.8 Natural Resources

The availability of natural resources have in the past been considered very important factor in the attraction of FDI. This is due to the need by the developed economies of Europe and North America to access and secure reliable sources of minerals and raw materials for their firms. Even if the importance of natural resources is not important as such, it remains an important factor for inward investments in countries which have abundant natural resources. The availability of natural resources has been found to be positively related to Foreign Direct Investments flows into developing countries especially in Africa. Kolstad and Tondel[92] argue that regardless of other factors like political stability, countries which are rich in natural resources are attracts more FDIs.

The mining industry in Kenya has not been traditionally a major recipient of FDIs. Mining industry in Kenya is known for the production of industrial minerals, mineral fuels and metals. Some of the minerals found in Kenya are gypsum, granite, and limestone, gold, marble and iron ore. Over the past few years, mining industry in the Kenya has steadily reduced. This is attributed to lack of political interference, poor policies set by the government and investment. Kenya has no significant natural resource endowments apart from abundant wildlife and the rich agricultural land.

[92]Kolsad, I and Tondel, L. (2002) "Social Development and Foreign Direct Investments in Developing Countries"Chr. Michelsen Institute, Development Studies and Human Rights, Bergen

CHAPTER FOUR: DATA ANALYSIS

4.1 Introduction

Literature concerning the main impediments to the growth of foreign direct investment inflows has been discussed in the previous chapters. In chapter one, statement of the problem was explained together with the objectives of this study and the hypothesis was set. This chapter will present findings as found in the study.

4.2 Factors Impeding FDI inflows into Kenya

This section sought information about the main impediments towards the growth of FDI inflows into Kenya. Results in this section are presented using the tables, figures, means and standard deviations.

Respondents were asked to rate the extent to which factors that have impeded FDI inflows into Kenya. Respondents were asked to use a scale of 1 to 5 where 1 is to a very great extent and 5 is to no extent. Table 4.3 presents factors impeding FDI inflows into Kenya

Table 4.1: Factors impeding FDI inflows into Kenya

	Mean	Std. Deviation
Political Instability	2.07	0.67992
Institutional constraints	2.56	0.74217
Kenyan FDI Investment Policy Framework	2.93	0.98097
Corruption	2.62	1.21331
Macroeconomic instability	2.51	1.02669

High cost of living	2.05	0.88367
Poor Infrastructure	2.08	0.91824
Crime and theft	2.80	1.06175

Source: Research Data

4.2.1 Kenyan FDI Investment Policy Framework

Kenya has a framework in place that ensures FDI inflows into the country are maximized. Investors consider different dimensions of the potential business environment's legal framework before undertaking investment. Different researchers like (Dupasquier and Osakwe, 2006) have drawn relationship between FDI inflows and the following elements of regulatory frameworks: poor governance and inhospitable regulatory environments; several specific trade and FDI policies like, foreign ownership ceiling in sectors open for FDI, policy on repatriation of capital and remittance of profit, government regulations and restrictions on equity and holdings by foreigners. Majority of the respondents in this study were in agreement that Kenyan FDI Investment Policy Framework on a high extent has impeded FDI inflows into Kenya. This scored a mean score of 2.93. Crime and theft had a mean of 2.80.

4.2.2 Corruption

Corruption is another issue to be seen in relation to the legal system. Corruption hampers economic activity and economic development in Kenya. The presence of excessive corruption and low transparency has negative effect on the inflow of FDI. The findings from the study have shown that corruption impedes the inflow of FDI into the country where this variable scored a mean score of 2.62.

4.2.3 Political Instability

The effect of political stability on the inflow of FDI is ambiguous. On a rigorous essay entitled "Foreign Direct Investment and the Inter-state Military Conflict" done by Li[93] showed that FDI flow and military conflict are inversely related. Political stability has been statistically a significant factor affecting the inflow of FDI. This study found out that Political Instability has impeded the inflow of FDI into the country on a great extent having scoring a mean score of 2.01 alongside with Poor infrastructure which scored a mean score of 2.082. This indicated that Kenyan FDI Investment Policy Framework has impeded greatly FDI inflows into Kenya.

4.2.4 Macroeconomic factors

Economic growth and economic competitiveness have been identified as determining factors for impeding FDI inflows to developing countries including Africa. There is strong evidence that relative wealth significantly affects inward foreign direct investment. Real income is a significant factor determining the inflow of FDI into the country. This factor is highly related to the market accession potential of a nation. Most foreign investors do not consider the size of the market in making a decision to invest in a country. Findings from the study indicate that macroeconomic factors affect the flow of FDI into the country to a great extent having scored a mean score of 2.51. Inflation rate is also a macroeconomic factor of consideration as it may tell a story about economic stability of a country.

[93]Li, Hao. (2008). New Trend of FDI in the World and New Characteristics of Utilizing Foreign Capital.Forum ofWorldEconomy & Politics.No.1.

In testing the hypothesis, the researcher used chi-square statistics which is the test of independence of categorical variables and this is what the study required. Under chi-square, if the p value is less than or equal to (.05) then you reject H0 (null hypothesis)

The hypothesis under study:

H_0: Macroeconomic instability, high cost of doing business and the taxation regime are disincentives to FDI growth in Kenya.

Chi-Square Tests	**Value**	**Asymp. Sig. (2-sided)**
Pearson Chi-Square	8.323	0.022

In this case the p value is 0.022. This value is less than α, so we reject H_0 hypothesis and accept the alternative hypothesis. That is, macroeconomic instability, high cost of doing business and the taxation regime are disincentives to FDI growth in Kenya.

4.3 Influences of FDI inflows into Kenya

Respondents were asked to rate the extent to which various criteria's influences FDI inflows into Kenya. Table 4.6 presents influences of FDI inflows into Kenya.

Table 4.2: Influences of FDI inflows into Kenya

	Mean	Std. Deviation
Provision of tax and fiscal incentives and a strong investment promotion program	1.92	0.759
Creation of export processing zones	2.18	0.806
Availability of resources	2.48	1.026

Availability of skilled labor	2.33	0.978
Size of domestic market	2.33	0.961
Trade openness	2.07	1.014
Low cost of doing business	1.44	0.646
Availability of infrastructure	1.83	0.969

Source: Research Data

4.3.1 Availability of resources

The availability of natural resources has been found to be positively related to Foreign Direct Investments flows into developing countries especially in Africa. Countries which are rich in resource availability attract FDI inflows into the country. In Kenya, the study has found out that availability of resources influence the investment decisions into the country. This is shown with a mean score of 2.48 where majority of the respondents were in agreement that availability of resources influence FDI inflows into Kenya.

4.3.2 Size of Domestic Market

Domestic market characteristics expressed by the market size and the direction of trade flows influence investing decisions in countries. The market size emphasizes the importance of a large market for efficient utilization of resources and exploitation of economies of scale. A direct relationship is expected between market size and inward FDI.

The relationship between the host country trade openness and FDI inflows appears to be complex. The effect of trade openness on FDI can be seen from the two components of international trade, namely import and export. From the export side,

potential foreign investors may target those countries that are export oriented as that gives them access to foreign market in addition to the domestic market. It is also a signal that there is a strong support for investments engaged in export from most countries hence higher export is expected to induce FDI. High imports by a country indicate that there is demand that cannot be met by local supply that calls for foreign investors to take part.

From both import and export side, FDI inflow is supposed to be positively affected by total trade. In general, higher trade openness indicates better integration of a country to the international market having a positive signal to potential foreign investor to undertake investment. In Kenya, the study has shown that size of domestic market influences the investment decisions by investors. This is shown with a mean score of 2.33.

Table 4.3: Factors influencing investors to invest in Kenya

	Mean	Std. Deviation
Develop products/services for global market	2.6066	0.84219
Access to skilled manpower	2.2623	0.91107
Foster proximity to existing customer/supplier	2.1639	0.66283
major customer/supplier moved to Kenya	2.9836	1.33531
Diversify Existing product portfolio	2.2459	0.92477
Risk spreading	1.9836	1.00816

Source: Research Data

Majority of the respondents were in agreement that major customer/supplier moved to Kenya influences the FDI inflow into Kenya. This scored a high score of 2.9836 followed by developing products/services for global market which had a mean score of 2.6066. Third was access to skilled manpower which got a mean score of 2.2623, fourth was diversifying existing product portfolio with a mean score of 2.2459, fostering proximity to existing customer/supplier which had a mean score of 2.1639 was fifth and last was risk spreading which scored 1.9836. This indicates that in Kenya there is a potential market for products because of the wide customer base and availability of suppliers.

Most of the investors who were interviewed stated that expansion and diversity of markets were the main influences that influenced them to invest in Kenya. In choosing the location within Kenya, majority of the investors stated that market size and cheap labour is what influences them to choose a location within Kenya. Few investors stated skilled labour, means of transport like airports and natural resources as the influences.

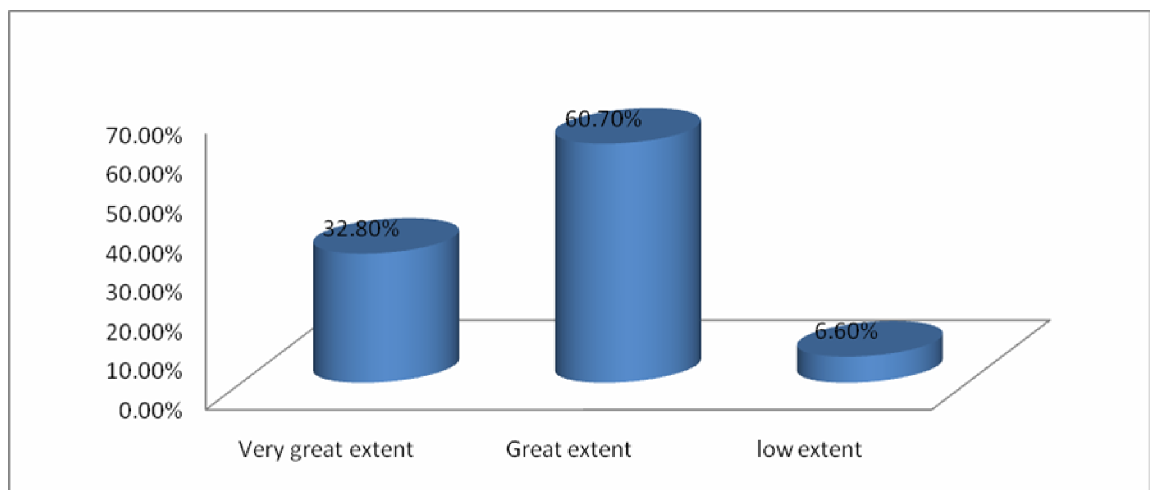
4.4 Political Stability and Good Governance

The political model involves variables of strictly political nature as well as variables in which the political component is implicit but nevertheless dominant. The presence of a political system hospitable to foreign capital in terms of property rights and civil liberties plays a favorable role for attracting FDI. The host governments' ethics also impacts directly the inflow of FDI as widespread government financial corruption imposes difficulties for the effective conduct of business. These variables with strict

political nature are not entertained in this study as such due to problem with data availability.

For this study, respondents were asked to rate the extent to which political stability and good governance encourage FDI inflows into Kenya. Figure 4.4 presents influence of political stability and good governance

Figure 4.2: Influence of Political Stability and Good Governance



Source: Research Data

Majority of the respondents (93.5%) were in agreement that political stability and good governance influence FDI inflows into Kenya on a great extent. A significant minority (6.6%) felt that political stability and good governance do not influence FDI inflow into the country. This was subjected under hypothesis test and it was found that good governance and political stability resulting in low levels of corruption, insecurity and crime will result in an increase in FDI inflows into Kenya. Table 4.3 Presents influence of political stability and good governance hypothesis testing.

Influence of Political Stability and Good Governance Hypothesis Testing

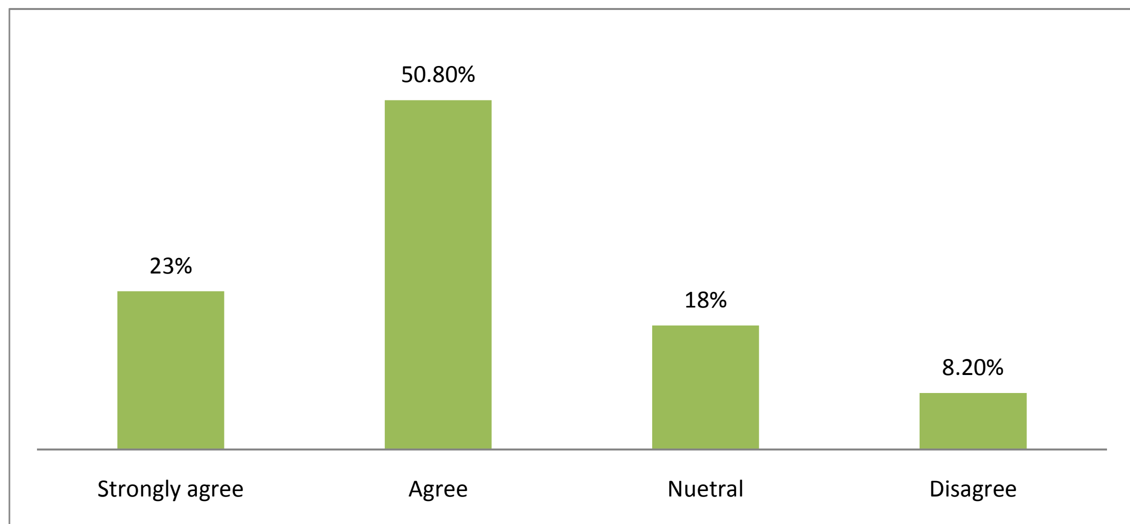
Chi-Square Tests	**Value**	**Asymp. Sig. (2-sided)**
Pearson Chi-Square	8.323	0.028

In this case the p value is 0.028. This value is less than 0.05 so we reject H_0 hypothesis and accept the alternative hypothesis. That is, Good governance and political stability resulting in low levels of corruption, insecurity and crime will result in an increase in FDI inflows into Kenya.

4.5 Institutional Constraints

Respondents were asked the level at which they agree with the statement "institutional constraints like delayed work permits and lengthy business registration processes discourages foreign investors in Kenya". Figure 4.4 presents institutional constraints.

Figure 4.3: Institutional constraints



Source: Research Data

From the results, majority of the respondents (73.8%) agreed with the statement. 18% of the respondents were neutral and 8.2 of the respondents disagreed. This indicates that institutional constraints like delayed work permits and lengthy business registration processes are very important and the government should ensure that such constraints are reduced. This section rejected the H_0 which stated that Institutional constraints like delayed work permits and lengthy business registration processes does not discourage foreign investors in Kenya.

Institutional Constraints Hypothesis Testing

Chi-Square Tests	**Value**	**Asymp. Sig. (2-sided)**
Pearson Chi-Square	8.323	0.029

In this case the p value is 0.029. This value is less than α, so we reject H_0 hypothesis and accept the alternative hypothesis. That is, Institutional constraints like delayed work permits and lengthy business registration processes discourages foreign investors in Kenya.

4.6 Challenges for FDI in Kenya

In most developing countries, lack of infrastructure hinders the development of FDI. Inability to provide necessary land on time highly contributes to poor performance of FDI in the Africa. The other important thing is the decline of the cost of doing business in the international market. But recently this situation is changing and many FDI investors are involving in the Africa with pleasure.

This study sought to determine challenges that hinder FDI inflows in Kenya. Table 4.12 presents challenges for FDI in Kenya.

Table 4.4: Challenges for FDI in Kenya

	Mean	**Std. Deviation**
Corruption	2.6885	0.78615
Finding partner and location in Kenya	2.8333	0.86684
Arranging finances for investment	2.9836	0.74144
Approval process	2.918	0.93622
Finding qualified personnel	3.082	0.80198
Difference in work culture	4	0.63246
Language problem	3.8852	0.98486

Source: Research Data

Majority of the respondents were in agreement that difference in work culture challenges the FDI in Kenya. This scored a mean score of 4. Language problem scored a mean score of 3.8852 and finding qualified personnel scored a mean score of 3.082. Approval process scored low having a mean score of 2.918 and arranging finances for investment had a mean score of 2.9836.

The researcher interviewed the respondents about the challenging factors that caused or continue to cause a problem for them in the investment process and operation in Kenya. Majority of the respondents (6) stated lengthy work permit processing period

as the major challenge. Other challenges aired by the investors are: Corruption amongst government officials; poor infrastructure; high electricity costs; political instability coupled with civil wars amongst some communities; macro-economic instability; lack of skilled labour; volatile Kenyan shilling; insecurity in neighboring countries like Somalia and the recent terrorist attacks.

Measures to improve FDI inflows into Kenya

Key measures that were recommended by the respondents that need to be taken to improve FDI inflows into Kenya are: maintain political stability to boost investors' confidence; formulation of policies encouraging good investment environment; shorten the process of business registration; improve infrastructure; address corruption; expedite issuance of work permits; developing and building of skilled human capital; reduce electricity tariffs to reduce cost of production; marketing Kenya as an investment destination; monitoring and evaluation of policies.

From the interview results about the recommendations required towards improving the investment climate in Kenya, respondents stated good governance should be encouraged; lengthy work permit processing period be reduced; infrastructure be improved and security be assured to achieve the desired FDI inflows in Kenya.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The study summarized that Kenyan FDI Investment Policy Framework which had a mean score of 2.9344 and hence impeded to a high extent the FDI inflows into Kenya. Political instability and poor infrastructure are factors that have considerably impeded FDI inflows. The study further summarized that availability of resources influence FDI inflows into Kenya. This has a mean score of 2.4754. Size of domestic market, creation of export processing zones, low cost of doing business and availability of infrastructure scored a mean score of less than 2.3279.

The study also summarized that various factors like major customer/supplier moved to Kenya and developing products/services for global market as factors influencing investors to invest in Kenya scored a mean score of more than 2.6066. The study further summarized that expansion and diversity of markets were the main factors that influenced investors' decision to invest in Kenya. In choosing the location within Kenya, majority of the investors stated that market size and cheap labour is what influences them to choose a location within Kenya. Few investors stated skilled labour, means of transport like airports and natural resources as factors to consider. Majority of the respondents (4) did not use any advisory institution/body in choosing the location in Kenya.

Majority of the respondents (93.5%) were in agreement that political stability and good governance influence FDI inflows into Kenya on a great extent. On the issue of institutional constraints like delayed work permits and lengthy business registration

processes which discourage foreign investors in Kenya, majority of the respondents (73.8%) agreed with the statement. On the challenges that affect FDI in Kenya, Majority of the respondents were in agreement that difference in work culture challenge the FDI in Kenya. Language problem scored a mean score of 3.8852 and finding qualified personnel scored a mean score of 3.082. Approval process scored low having a mean score of 2.918 and finding qualified personnel had a mean score of 2.9836. Amongst the factors listed by the investors, corruption and poor infrastructure scored high. The study summarized that, enhancing political stability to boost investors' confidence, formulation of policies encouraging a good investment environment and shortening the process of business registration and expediting the processing of work permits would lead to an increase in FDI inflows into Kenya.

Finally the study summarized that Good governance and political stability resulting in low levels of corruption, insecurity and crime will result in an increase in FDI inflows into Kenya, Institutional constraints like delayed work permits and lengthy business registration processes discourage foreign investors in Kenya and Macroeconomic instability, high cost of doing business and the taxation regime are disincentives to FDI growth in Kenya.

5.2 Conclusions

The study concludes that Kenyan FDI Investment Policy Framework, Crime and theft and Corruption, political instability and poor infrastructure and are the four major factors that have impeded FDI inflows into Kenya. It also concluded that availability of resources, size of domestic market, and creation of export processing zones influence FDI inflows into Kenya. In influencing investors to invest in Kenya, major

customer/supplier moved to Kenya, develop products/services for global market and access to skilled manpower are the major influences. The study further concluded that investors were influenced by expansion and diversity of markets. Investors indicated that market size and cheap labour influenced their location within Kenya.

The study concluded that Good governance and political stability resulting in low levels of corruption, insecurity and crime will result in an increase in FDI inflows into Kenya; Institutional constraints like delayed work permits and lengthy business registration processes discourages foreign investors in Kenya and Macroeconomic instability, high cost of doing business and the taxation regime are disincentives to FDI growth in Kenya.

5.3 Recommendations

- The government of Kenya should divert a larger portion of FDI to investment in agriculture because about 70% of its population depends on agriculture. Agricultural trade liberalization is particularly important and growth in agriculture has a proportionate effect on economic growth.
- Aid donors and foreign investors should provide a framework for the implementation of aid funds. Foreign investment can and does have an impact when provided within a framework that acknowledges the drivers for broad based growth. Well-targeted investment increases the ability of Kenya to maximize the benefits of trade liberalization, improve the environment for investment and ensure that the poor have the ability to contribute in achieving growth.
- The role of the government and public agencies in encouraging FDI in Kenya is largely missing. Very few firms seem to have contacted the government for any

form of assistance. There appears to be a lose link between the government and its related agencies with the foreign investors. Most foreign investors perceive the government to be unfriendly and hostile to their operations. There is need for a greater government's appreciation of the importance of FDI through provision for an avenue for interaction in order to address their concerns.

- The study found that high cost of doing business impedes FDI inflows into the country. Consequently therefore, the study recommends that the government should aim at bringing down the energy costs by liberalizing the energy sector and improving infrastructural development especially road and rail transport in the country.
- Lastly, political stability and good governance will play a major role in increasing FDI inflows into Kenya. Hence, the study recommends that good governance practices be embraced and political stability within Kenya and the horn of Africa be prioritized.

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APPENDIXES

Appendix One: Questionnaire.

SECTION ONE: DEMOGRAPHIC INFORMATION

1. Gender Male [ ]

   Female [ ]

2. Age bracket (Tick whichever appropriate)

   Less than 20 Years [ ]

   21 – 30 years [ ]

   31 – 40 years [ ]

   41 – 50 years [ ]

   More than 51 years [ ]

3. Marital Status Single [ ]

   Married [ ]

4. For how long have you served in the organization?

Less than 2 years	
2 – 5 years	
6 – 10 years	
11 years and more	

5. What is your highest level of education?

Certificate	
Diploma	
Higher Diploma	
Bachelors	
Masters	
PhD	

SECTION B: IMPEDIMENTS TOWARDS THE GROWTH OF FDI

6. Various factors have impeded foreign direct investment inflows into Kenya. To what extent have they impeded FDI inflows? Use a scale of 1 to 5 where 1 is to a very great extent and 5 is to no extent.

	1	2	3	4	5
Political uncertainty and bad governance					
Institutional constraints (lengthy processes of business registration and acquisition of work permits)					

Kenyan FDI investment policy framework					
Corruption					
Macroeconomic Instability (Taxation, inflation etc)					
High cost of doing business (requirements associated with entry and exit, Labour regulations, access to credit and government bureaucracy)					
Poor infrastructure (transportation, telecommunication and electricity costs)					
Crime and theft					

7. According to your knowledge? To what extent do the following criteria influence FDIinflows into Kenya? Use a scale of 1 to 5 where 1 is to a very great extent and 5 is to no extent.

	1	2	3	4	5
Provision of tax and fiscal incentives and a strong investment promotion program					

Creation of export processing zones (EPZs)					
Availability of resources					
Availability of skilled labor					
Size of domestic market					
Trade openness					
Low cost of doing business					
Availability of infrastructure (transportation and telecommunication)					

8. To what degree do the following factors influence investors on the investment decision to Kenya?

	Very highly relevant	Highly relevant	Moderate	Low relevant	Not at all
Develop products/services for Kenyan market					

Develop product/services for global market					
Access to skilled manpower					
Foster proximity to existing customers/suppliers					
Major customer/supplier moved to Kenya					
Diversify the existing product portfolio					
Risk spreading (e.g. exchange-rate hedging)					

9. To your knowledge, to what extent does political stability and good governance encourage FDI inflows into Kenya?

   Very great extent [ ]

   Great extent [ ]

   Moderate [ ]

   Low extent [ ]

   Not at all [ ]

10. Institutional constraints like delayed work permits and lengthy business registration processes discourages foreign investors in Kenya. What is your level of agreement on this statement?

Strongly agree [ ]

Agree [ ]

Neutral [ ]

Disagree [ ]

Strongly disagree [ ]

SECTION C: CHALLENGES FOR FDI IN KENYA

11. According to your knowledge, to what extent do the following challenges affect foreign investors in the investment process and operation in Kenya? Use a scale of 1 to 5 where 1 is to a very great extent and 5 is to no extent.

	1	2	3	4	5
Corruption					
Finding partner and location in Kenya					
Arranging finances for investment					
Approval process for FDI in Kenya					
Finding qualified personnel					
Difference in work culture					
Language problem					

12. According to you? What are the measures that are needed to improve FDI inflows into the country?

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Appendix Two: Interview Questions

SECTION A: GENERAL INFORMATION ABOUT YOUR FIRM IN KENYA

1. Firm name:

   ………………………………………………………………………………….

2. No. of branches / locations in Kenya:

   …………………………………………………………………………………

   …………………………………………………………………………………

   ………………………....

3. Please specify the primary industry sector your company is active in:

   …………………………………………………………………………………

   …………………………………………………………………………………

   …………………………

4. Type of business activities of your company in Kenya:

   …………………………………………………………………………………

   …………………………………………………………………………………

   ………………………………………………

SECTION B: FOREIGN DIRECT INVESTMENT INTO KENYA

5. What influenced the investment decision to Kenya?

   …………………………………………………………………………………

   …………………………………………………………………………………

   …………………………………………………………………………………

6. What influenced the location decision within Kenya?

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7. Did you take help of any advisory institutions / bodies in selecting partner and location in Kenya? If yes kindly specify the advisory institution / body

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8. What are some of the challenging factors that caused or continue to cause a problem for you in the investment process and operation in Kenya?

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………………………………………………………………………………………

9. Do you plan to make further investments in Kenya (within next 2-3 years)? If yes, in which operations do you plan to invest further?

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10. What recommendations would you make towards improving the investment climate in Kenya?

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