The Impact of Taxation on Foreign Direct Investment in Kenya

By

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Research Project Submitted in Partial Fulfilment of the Requirement for the Degree of Master of Business Administration, Faculty of Commerce, University of Nairobi. (UON).
DECLARATION

This Management Project Paper is my Original work and has not been presented for a degree in another University.

Signed

[Signature]

Eshiwani B.W.

Date 29th November 2006

This Management Project Paper has been submitted for examination with my approval as University Supervisor.

Signed

[Signature]

Mr. Moses Anyangu

Date 30/11/06
I dedicate this study to my wife Jacinta who, for her unwavering commitment and has been an ever present encouragement throughout the period of this study.

I am deeply indebted to my supervisor, Mr. Ahyang'a, Lecturer in the Faculty of Education, who unhesitatingly gave his time and energy. His patience, tolerance, supportive criticism, and rigorous examination of the way of supervision, form the cornerstones of this study.

I acknowledge the contribution of the faculty lecturers who provided essential foundation during my studies at the Lower Kabete Camps. Last but not in any way least, I am extremely grateful to my family for having provided the bare necessities, which without would have rendered the completion of this course an uphill task.
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>COMESA</td>
<td>Common Market for Eastern and Southern Africa</td>
</tr>
<tr>
<td>DTT</td>
<td>Double Taxation Treaty</td>
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<tr>
<td>EAC</td>
<td>East Africa Community</td>
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<tr>
<td>EPZ</td>
<td>Export Processing Zone</td>
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<td>EPZA</td>
<td>Export Processing Zone Authority</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FIAS</td>
<td>Foreign Investment Advisory Service</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GNP</td>
<td>Gross National Product</td>
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<tr>
<td>ICFD</td>
<td>International Conference on Finance and Development</td>
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<td>IDB</td>
<td>International Development Bank</td>
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<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
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<tr>
<td>IT</td>
<td>Information Technology</td>
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<tr>
<td>IPA</td>
<td>Investment Promotion Agency</td>
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<td>IPC</td>
<td>Investment Promotion Centre</td>
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<tr>
<td>KRA</td>
<td>Kenya Revenue Authority</td>
</tr>
<tr>
<td>Kshs</td>
<td>Kenya Shillings</td>
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<tr>
<td>M&amp;A</td>
<td>Merger and Acquisition</td>
</tr>
<tr>
<td>METR</td>
<td>Marginal Effective Tax Rate</td>
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The study was carried out in order to establish whether taxation had an impact on foreign direct investment. Foreign direct investment in Kenya has slightly declined over the past decade while taxation levels remained relatively consistent. It is examined whether this conclusion is valid.

The methodology used to analyze the data was regression analysis, an appropriate model was formed to find out the magnitude and direction of the impact of taxation on FDI. FDI was considered the dependent variable while the other four taxes were viewed as the independent variables in the model. The study was carried out across the world, including the Rowan Correlation Coefficient.

The findings of the study observed a positive and significant effect of taxation on foreign direct investment within the period 1994-2000. The effective tax rate showed a negative correlation to FDI, while the other three taxes exhibited a positive correlation to FDI. This study suggested that FDI in Kenya showed a high level of sensitivity to the tax regime.
ABSTRACT

The study was carried out in order to establish whether taxation had an impact on foreign direct investment. Foreign direct investment in Kenya has seen a somewhat stagnated growth over the past decade while taxation levels seemed to decline. It is with this in mind that this study sought to investigate the probable effect that taxation as a disincentive has on FDI. Data was collected from various government sources that deal with either taxation or FDI. The taxes that were employed in the study include marginal effective tax rate, marginal effective tax rate for transfers, marginal effective tax rate for retained earnings and an effective tariff rate. These stem from the formulation developed by Auerbach (1990).

The tool used to analyse the data was regression were an appropriate model was formed to find out the magnitude and direction of the impact of taxation on FDI. FDI was considered the explanatory variable while the other four taxes were viewed as the independent variables in the model. In the study analysis carried out various test were used including the Pearson Correlation Coefficient.

The findings of the study observed a taxation and foreign direct investment had a linear relationship within the period 1994-2003. The effective tariff rate showed a positive correlation to FDI, while the other three taxes rates exhibited negative correlation to FDI. This study suggested that FDI in Kenya showed a great deal of sensitivity to the tax regime.
1. INTRODUCTION

1.1 Background

1.1.1 Importance of FDI in an Emerging Economy

Foreign direct investment (FDI) is increasingly being recognized as an important factor in the economic development of countries. Besides bringing capital, it facilitates the transfer of technology, organizational and managerial practices and skills as well as access to international markets. More and more countries are striving to create a favourable and enabling climate to attract FDI as a policy priority. In addition to reducing the restrictions on the entry of FDI, they are actively liberalizing their FDI regimes. While the efficacy of incentives as a determinant for attracting FDI is often questioned, countries have increasingly resorted to such measures in recent years. In particular, they have been offering tax incentives, to influence the location decisions of investors.

The attitude towards inward foreign direct investment (FDI) has changed considerably over the last couple of decades, as most countries have liberalized their policies to attract investments from foreign multinational corporations (MNCs). On the expectation that foreign MNCs will raise employment, exports, or tax revenue, or that some of the knowledge brought by the foreign companies may spill over to the host countries’ domestic firms, governments across the world have lowered various entry barriers and opened up new sectors to foreign investment. An increasing number of host governments also provide various forms of investment incentives to encourage foreign owned companies to invest in their jurisdiction.

These include fiscal incentives such as tax holidays and lower taxes for foreign investors. In order not to confuse Foreign Direct Investment (FDI) with other investments that cross national borders, we will in this paper use the definition of FDI as determined and reported by UNCTAD (2000), whereby it is “… an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate
enterprise or foreign affiliate)". Even if this conceptualisation can be questioned from different perspectives, this is the way it is reported in international statistics and cited widely. In the international reporting of statistics, FDI is regarded as investments that have the following three characteristics:

i. Equity capital; i.e. the foreign direct investor’s purchase of shares of an enterprise in a country other than its own;

ii. Reinvested earnings; i.e. the investor’s share of earnings not distributed as dividends by affiliates or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested;

iii. Intra-company loans or intra-company debt transactions; i.e. short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises.

The equity forms of investment, as referred to above, are in the UNCTAD methodology distinguished from non-equity forms of investments. The non-equity forms of investments are for instance subcontracting, management contracts, turnkey arrangements, franchising, licensing and product sharing (UNCTAD 2000). These forms of FDI are not covered in this study.

1.1.2 An Overview of Taxation

The basic principles which include ease of administration, simplicity, compliance and minimal effect on resource allocation is in essence the underlying foundation of the Kenya Revenue Authority, which has been charged with the tasks that are revenue collection. In addition to these, five other issues which have been put in play give the tax system a ‘shot in the arm’. These considerations are:

i. The impact on government revenue.

ii. Economic efficiency – the impact on incentive, should not interfere with efficient allocation of resources.

iii. Fairness – effect on welfare distribution – seen to be fair.

iv. Effects on patterns of investment/production.
Administrative simplicity – how changes are to be enforced and at what cost.

This study will focus on the last two points and incorporate the divergent views on taxation and FDI in Kenya.

The trends in revenue collection has seen a shift to indirect taxes such as import duty. Excise duty, VAT on domestic manufacturers, VAT on import manufacturers, business and trading licences and licences and fees under the Traffic Act to direct taxes that include Income tax and Estate duty. Indirect taxes comprised over 60% of total tax revenue collected during the periods 1989/90 and 1997/98. Tax capacity – defined as excise duty as a proportion of GDP – for excise duty increased from 2.1% to 4.4% in 1996/97, all other taxes had mixed results during this period. This steady increase elevated the significance of excise taxes from the bottom to third position after income tax and VAT with a capacity of 8.7% and 5.1% respectively (Okello 2001). It would be also of interest to note that the corporate tax which was 45% in 1989 was reduced to 35%, 32.5% and then 30% in the fiscal years 1995/96, 1997/98, and 1999/00 respectively.

Corporate taxation is one of the factors that determine the rate of return on FDI. By creating a wedge between its pre-tax and post-tax rate of return, taxation can discourage FDI flows. At the same time, the differences in tax treatment of FDI across host countries can also affect the cross-country distribution of FDI. Tax polices have converged to some extent over the past decades, but differences in corporate tax systems across Organisation for Economic Cooperation and Development (OECD) countries remain wide. In a world of increasing capital mobility, these differences in tax burden may influence investment decisions by attracting FDI to locations where the pre-tax cost of producing goods is higher but the production cost is lower in the presence of relatively low tax burden, possibly resulting in tax-induced distortions in the allocation of capital flows (ECO/WKP 2003). Productive internationalisation is one of the central aspects of world economy’s globalisation. The main tool it uses is investment flows made by operators in countries other than those where their activities are located (Foreign Direct Investments or FDI).
The fiscal treatment is one of the main factors determining country's competitiveness and seems to be also one of the major determinants of FDI flows in industrialised countries.

The long-term trends of the variables under examination seem to point out the existence of a negative relationship between "taxation" and FDI inflows. In the period under examination, 1990-1998, the FDI localisation decisions in the EU countries were strongly influenced by fiscal variables. In that lapse of time, low-taxation countries experienced larger FDI inflows as a percentage to GDP than those observed in medium- and high-taxation countries. Blomstrom and Kokko (2003) provide a compelling argument that the types of long-term benefits that are generated by FDI may not justify the short-term costs. These benefits include the positive spillovers between firms and across sectors that researchers continue to try to identify. Governments may make excessive long-term financial commitments for the employment and political gains that are received in the short term.

"Strong promotion efforts show that the government is actively doing something to strengthen employment, productivity, growth, or some other policy objective...Another reason is that some of the perceived benefits (in particular, the jobs created by FDI) are easily observable while some of the costs (particularly related to tax breaks and fiscal incentives) are distributed over long periods of time and hard to measure."


1.2 Statement of the Problem

During the last two decades, many emerging economies have dramatically reduced barriers to FDI, and countries at all levels of development have created a policy infrastructure to attract multinational firms. Standard tactics to promote FDI include the extension of tax holidays, exemptions from import duties, and the offer of direct subsidies. Since 1998, 103 countries have offered special tax concessions to foreign corporations that have set up production or administrative facilities within their borders.
Exemptions last for less than a decade from the initiation of a new project, though in some cases they are long-lived. Most countries also offer exemptions to foreign corporations on import duties, where these tend to be restricted to inputs that are used to produce exports or, in a few cases, capital goods. Exemptions from value-added taxes are a somewhat less common tax concession that countries grant multinational firms. Similar tax concessions are also available to domestic firms in some countries, though these concessions are for the most part tied to participation in EPZs. Export activities outside of such zones, or production in officially designated priority sectors or regions is a slight increase in the number of countries offering exemptions from valued-added taxes and import duty. (Price Waterhouse)

Taxes affect the net return on capital and should, at least in the mind of numerous policymakers, influence the capital movements between countries. For this reason, the study will attempt to evaluate if a generous tax policy could compensate for other obstacles in the business environment and thus, attract multinational companies. In the mid-1980s, the literature went one step further by exploring what kind of tax instruments should have the greatest impact on the location decision of multinational companies. Special attention was also given to the motivations and tax behaviour of the multinational company.

FDI inflows in 1996-2003 averaged Ksh 3.12 billion a year in Kenya (IPR- Kenya2005). Evidently there has been a period of low FDI that began in the early 1980's not withstanding the use of a combination of these factors over the years. However, unlike is the case with several other countries FDI has not shown growth commensurate with the implementation of these measures. It is therefore against the foregoing background that a study can be conducted to find out whether any relationship between taxation and FDI in Kenya essentially exists.
1.3 Objective of Study

To find out if there was any relationship between taxation and Foreign Direct Investment in Kenya during the last one decade.

1.4 Importance of the Study

The study will provide a greater understanding of the dynamics of Foreign Direct Investment, more so from a taxation standpoint by trying to understand the peculiar needs of the foreign investor today. This study aspires to provide policymakers impetus to formulate tax policies that are both beneficial to foreign investors and the host country where the tax regime cultivates symbiotic and synergetic coexistence.

The numerous studies that have been carried out up until now have explored the various facets of FDI encompassing a holistic outlook on factors arising therein. This study endeavours to look at one of the many factors by giving taxation prominence over all the others. A vivid pictorial of variations in FDI and the changes in taxation by way of establishing correlation or otherwise will be provided, as a product of this study.

The study will also give scrutiny to processes and formulation of tax policy with the view of improving the mechanisms of employing the best possible permutation for taxes. Anticipation of other studies stemming from this study is a revelation that the many areas of FDI need to be explored further to achieve a truly knowledgeable approach to the topic. A more favourable reading on FDI radar for Kenya would a gratifying turn of events and one that actualizes the purposes of this study.
2. LITERATURE REVIEW

2.1 Taxation in Kenya

2.1.1 Overview

The Kenya government generates a significant amount of revenue each year from both direct and indirect taxes. The taxation system in Kenya has gone through a metamorphosis that has seen indirect taxes given prominence over direct taxes. Such taxes include import duties, Value Added Taxes (VAT) on domestic and imported manufactured goods, excise duties, licences and specific levies.

Table 1.

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Proportion of Direct Tax in Total Revenue %</th>
<th>Proportion of Indirect Tax in Total Revenue %</th>
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<tbody>
<tr>
<td>1994/95</td>
<td>40.0</td>
<td>59.1</td>
</tr>
<tr>
<td>1995/96</td>
<td>39.0</td>
<td>61.0</td>
</tr>
<tr>
<td>1996/97</td>
<td>38.0</td>
<td>61.9</td>
</tr>
<tr>
<td>1997/98</td>
<td>38.1</td>
<td>61.8</td>
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<td>1998/99</td>
<td>35.5</td>
<td>64.4</td>
</tr>
<tr>
<td>1999/00</td>
<td>33.9</td>
<td>66.0</td>
</tr>
<tr>
<td>2000/01</td>
<td>32.5</td>
<td>67.4</td>
</tr>
<tr>
<td>2001/02</td>
<td>34.3</td>
<td>65.6</td>
</tr>
<tr>
<td>2002/03</td>
<td>37.2</td>
<td>62.8</td>
</tr>
<tr>
<td>2003/04</td>
<td>36.8</td>
<td>63.1</td>
</tr>
</tbody>
</table>

The table above highlights the reform efforts that increased the tax base by extension to cover imports, upward revision of taxes and switch from *ad valorem* basis for some goods.

2.1.2 Main Taxes Levied in Kenya

i. VAT

Value-added tax was introduced under the Value Added Tax Act (1990, with subsequent amendments) in 1990 to replace the sales tax. The law reflects modern principles of VAT structure and administration. The main structural weakness resides in the absence of clear accompanying regulations on transfer pricing VAT is levied both on goods and services, whether produced domestically or imported, while exports are zero rated.

There are 3 rates of tax:

(i) 16% - general rate of VAT applicable to most goods and services.
(ii) 14% - rate applicable to hotel and restaurant services.
(iii) 0% - for zero rated supplies e.g. exports, pharmaceuticals, foodstuff, medicine and agricultural inputs.

Businesses are required to register under the VAT Act if their sales of taxable goods exceed Sh3,000,000 per year, or if they deal in a list of prescribed goods or services. The administration of the VAT system follows standard international practice, which requires businesses to charge VAT to their customers and allows them to deduct input taxes from output taxes in calculating their monthly returns. Refunds are granted only to businesses that make zero-rated supplies or those that have incurred physical capital investment whose input tax exceeds Sh1,000,000. This includes exporters, which are the major claimants of VAT refunds. Other businesses recoup the excess payment from their subsequent returns.
ii. Corporate Income Tax

The structure of corporate income taxes is straightforward and in line with standard international principles in terms of reporting of income, deduction of expenses and investment allowances. The authorities have used the corporate income tax regime and investment allowances sparingly to provide targeted incentives to priority sectors. The framework for income tax (both personal and corporate) is set in the Income Tax Act (1974, with subsequent amendments).

Resident companies are taxed at a rate of 30 percent of earnings, regardless of sector of operation and ownership, while local branches of non-resident companies are taxed at a rate of 37.5 percent. The only concessions on the corporate income tax rate are granted to companies operating in export processing zones and to companies newly listed on the Nairobi Stock Exchange, which are taxed at either 25 percent or 27 percent for five years from the year of listing if they float a minimum of 30 percent or 20 percent of their capital, respectively. Services providers are also subject to a 5 percent withholding tax on agency or consultancy fees when the transaction involves two resident entities. Although this is an advance tax as the withholding is credited when income tax returns are filed at year end, it significantly affects the cash flow of the service provider.

The corporate income tax base is assessed based on deductions of "all expenditure incurred in that year of income which is expenditure wholly and exclusively incurred by him in the production of that income" (Income Tax Act), following standard international practice. Deductions are allowed for bad debts, depreciation of capital or contributions to a national provident fund on behalf of employees, amongst other.

The allowance for depreciation of capital is rather standard across sectors, with some modifications for mining and farming. Manufacturing and hotels also benefit from accelerated depreciation rates. The standard regime for investment allowances is as follows:

i. The cost of buildings or supplemental work on buildings (roads, water or
communication facilities, ...) can be depreciated on a straight-line basis at the rate of 2.5 percent per annum. Hotels qualify for an accelerated rate of 4 percent per annum.

ii. Most machinery qualifies for depreciation at a rate of 37.5 percent per annum on a declining balance basis.

iii. IT equipment qualifies for depreciation at a rate of 30 percent per annum on a declining balance basis.

iv. Vehicles and aircraft qualify for depreciation at a rate of 25 percent per annum on a declining balance basis.

v. Other office equipment and furniture and ships qualify for depreciation at a rate of 12.5 percent per annum on a declining balance basis.

The manufacturing sector also benefit from an "investment deduction" for expenditure on buildings and other capital spending, while hotels benefit from the investment deduction on buildings only. The investment deduction is an accelerated rate of depreciation in the first year. As of 2004 and until 2008, the investment deduction allows a 100 percent rate of depreciation in the first year. This rate has fluctuated widely in the past, sometimes according to the region in which the investment takes place.

Other provisions in the income tax law are relatively favourable to investors: loss carry forward is not bounded in time, and the capital gains tax has been suspended since 1985. The withholding tax on dividends is 10 percent for dividends paid to non-residents and 5 percent for dividends paid to residents. Agency or management fees (business or professional services) in turn, are subject to a withholding tax of 20 percent for non-residents.

Capital gains tax was introduced in Kenya in 1975 and applied to the transfer of all property owned by companies. Its impact was progressively softened by a series of amendments reducing the proportion of gains subject to tax, with capital gains tax finally suspended by the Finance Act 1985 with effect from June 1985.
Withholding tax at the appropriate rate must be deducted from payments to resident persons in respect of the following payments: dividends, interest, royalties, annuities, commissions paid by insurance companies, payments by authorised agents in respect of specified agricultural produce, pensions, consultancy, agent or contractual fees paid to certain individuals, royalties.

Withholding tax must be deducted from payments made to non-resident persons in respect of the following payments: management or professional fees, royalties, rents, leasing, dividends, interest, pensions, payments to sportsmen or entertainers, consultancy, agency or contractual fees.

2.1.3 Main Tax Incentives Available to Investors in Kenya

Policies to promote FDI take a variety of forms. The most common are partial or complete exemptions from corporate taxes and import duties. These policies are typically the result of formal legislation or presidential decree, which apply to all foreign corporations that meet certain restrictions. These restrictions vary considerably across countries. In many cases they require multinationals to establish production facilities in the host country in specified lines of activities or designated regions, such as export-processing zones (EPZs), and to export output embodying inputs imported duty-free. Direct subsidies and other types of concessions are often negotiated between multinational firms and the government on a case-by-case basis. In detail the incentives available to investors in Kenya:

1. Investment Allowance: businesses are entitled to an accelerated capital deduction on capital expenditure for building, machinery and equipment used for manufacture or on hotel premises. The new rate of 100% (as announced in the 2003 Budget) is a significant increase from the previous rate of 60%.

2. Special incentives are provided for enterprises operating in Export Processing Zones under the Export Processing Zones Act (1990, with subsequent amendments). Three types of activities can be carried out in EPZs: manufacturing, services and commercial. In
addition to potential incentives (including from export licences, facilitation services by the Export Processing Zones Authority), and the higher quality of infrastructure, the following fiscal incentives are granted to companies operating in EPZs:

1. Exemption from all customs and excise duties on machinery and equipment necessary for the establishment of the EPZ enterprise.

2. Exemption from registration under the VAT Act.

3. Exemption from the payment of income tax for the first ten years from the date of commencement for a rate of 25 percent for the subsequent ten years and the standard rate thereafter.

4. Exemption from the payment of withholding tax on dividends and other payments made to non-residents for the first ten years.

5. Exemption from stamp duty.

6. A range of other incentives or prohibitions on imports or exports, with the exception of those in regard to military equipment and other illegal goods.

India has entered Double Tax treaties with the following countries:

- Zimbabwe
- Denmark
- Germany
- Canada
- Sweden
- United Kingdom
- Federal Republic of Germany
- India

A number of such treaties have been signed but are not yet in force. Treaties with Uganda and Tanzania have been signed but are yet to be ratified by Uganda and Tanzania.

An Advance tax is payable annually in respect of all income accruing and chargeable to tax in the previous year and payable on the basis of the annual or quarterly capacity of the vehicle. The payment is available for offset against any subsequent tax liability of the person paying the tax.
addition to procedural incentives (exemption from certain licences, facilitation services by the Export Processing Zones Authority ...) and the higher quality of infrastructure, the following fiscal incentives are granted to companies operating in EPZs:

i. Exemption from "all existing and future taxes and duties payable under the Customs and Excise Act and Value Added Tax Act on all export processing zone imports for use in the eligible business activities of the EPZ enterprise."

ii. Exemption from registration under the VAT Act.

iii. Exemption from the payment of income tax for the first ten years from the date of first sale, followed by a rate of 25 percent for the subsequent ten years and the standard rate thereafter.

iv. Exemption from the payment of withholding tax on dividends and other payments made to non-residents for the first ten years.

v. Exemption from stamp duty.

vi. Exemption from any quotas or other restrictions or prohibitions on imports or exports, with the exception of trade in firearms, military equipment or other illegal goods.

Kenya has current Double Tax Treaties with the following countries:

- Zambia
- Denmark
- Norway
- Sweden
- United Kingdom
- Federal Republic of Germany
- Canada
- India

A treaty with Italy has been signed but is not yet in force. Treaties with Uganda and Tanzania have been signed but are yet to be ratified by Uganda and Tanzania.

An advance tax is payable annually in respect of all public service and commercial vehicles based on the load or passenger capacity of the vehicle. This payment is available for offset against any income tax liability of the person arising in that year.
Imports were subject to seven tariff bands ranging from 0 percent to 35 percent until the end of 2004, with a weighted average tariff of 13.3 percent in 2001. Under the protocol establishing the East African Community (EAC) Customs Union signed in March 2004, Kenya, Tanzania and Uganda adopted a common external tariff starting on January 1, 2005, however. Raw materials and capital goods are now subject to a tariff of 0 percent, with intermediate goods and final consumer goods taxed at 10 percent and 25 percent, respectively.

2.2 Determinants of FDI

The boom of FDI flows to developing countries since the early 1990s indicates that multinational enterprises have increasingly considered these host countries to be profitable investment locations. At the same time, various experts argue that the determinants of and motivations for FDI in developing countries have changed in the process of globalization. As a consequence, it would no longer be sufficient to offer promising markets in order to induce FDI inflows. Policymakers would face rather complex challenges in striving for locational attractiveness to FDI (Kokko 2002).

The subsequent account of FDI determinants focuses on location-specific factors. Firm-specific factors are ignored, as host country governments cannot influence them. Knowledge is fairly limited regarding the relative importance of different location specific FDI. The relative importance of some determinants is likely to vary between different types of FDI, i.e. resource-seeking, market-seeking and efficiency-seeking FDI. Furthermore, the relative importance of FDI determinants may change over time, e.g. due to ongoing globalisation.

2.2.1. Overall Policy Framework

The overall policy framework comprises quite heterogeneous elements, such as economic and political stability as well as regulations governing the entry and operations of multinational corporations (MNCs). These elements share one important characteristic, however: they may be intended to induce FDI, but it is open to question whether MNCs
will actually react in the expected manner. This is because overall stability and openness to FDI are necessary conditions for FDI, whereas these factors are far from sufficient to induce FDI. For example, the liberalisation of national FDI frameworks has become the dominant type of FDI policy change in dozens of developing countries since the mid-1980s (UNCTAD 1998). Likewise, the number of developing countries that have signed bi- or multilateral agreements, ensuring a liberal treatment of FDI and its protection after entry, increased dramatically in the 1990s. Nevertheless, FDI inflows have remained small in many of these liberalising countries.

MNCs tend to take more liberal FDI regimes for granted, and consider the convergence of FDI regimes to be the natural consequence of globalisation. As a result, the liberalisation of FDI regulations may be characterised by diminishing returns. Developing countries not taking part in the general move towards liberalisation are likely to suffer negative effects of restrictive policies on FDI inflows. But, a liberal FDI regime does little more than enabling MNCs to invest in a host country. It is a completely different question whether FDI will actually be forthcoming as a result of FDI liberalisation.

While the trend towards privatising state-owned enterprises is almost as broadly based in developing countries as the liberalisation of FDI regulations, privatisation differs from the latter in that it did induce substantial FDI inflows in various developing countries. Prominent cases include Latin American countries and transition economies in Central and Eastern Europe.

Privatisation contributed significantly to two structural shifts in the composition of FDI flows to developing countries:

i. the rising share of FDI in services, as privatisation, notably in Latin America, involved service industries in the first place; and

ii. the growing importance of mergers and acquisitions (M&As), as opposed to greenfield investment.

Yet, privatisation-induced FDI is controversially discussed for several reasons.
First, FDI related to the sale of state-owned enterprises is frequently said to leave the overall volume of investment unaffected. This is true in the sense that M&As, in contrast to greenfield investment, are no more than a change in ownership (the same is obviously true when public assets are sold to domestic private investors). Whether or not M&As increase overall investment depends on the use of government revenues from privatisation. Second, privatisation related FDI may be problematic from a competition-policy point of view. In the case of “natural monopolies”, a state monopoly would be replaced by a private monopoly (again this also applies when public assets are sold to domestic private investors). Hence, privatisation should go along with trade liberalisation and competition policies, preventing the misuse of monopoly power and enhancing competition by breaking up monopolies.

Third, privatisation-related FDI is often believed to be a one-off event. This is not necessarily true, however. Privatisation contracts may specify further investment to be undertaken after the original purchase. Changes in ownership have frequently been associated with significant additional investment in the rationalisation and modernisation of privatised firms. Reinvested earnings of firms, which foreign investors acquired through privatisation, may lead to FDI flows beyond those associated with the initial transaction. Finally, privatisation programmes help improve the climate for FDI in indirect ways, e.g., by indicating the government’s commitment to economic reform. Hence, privatisation-related FDI may prove to be the gateway to higher FDI inflows on a regular basis.

2.2.2. Economic Factors: Traditional Determinants

It is mainly with regard to economic determinants of FDI that the investors’ motivations for undertaking FDI are relevant. Three major types of FDI are typically differentiated: resource-seeking FDI, market-seeking FDI and efficiency-seeking FDI.

Resource-seeking FDI is motivated by the availability of natural resources in host countries. This type of FDI was historically fairly important and remains a relevant source of FDI for various developing countries. On a world-wide scale, however, the
The relative importance of resource-seeking FDI decreased significantly. The share of the primary sector in outward FDI stocks of major home countries was below 5 percent in the first-half of the 1990s (UNCTAD 1998). The relative decline of resource-seeking FDI may, at least partly, explain FDI patterns in countries such as Saudi Arabia. The decline is not only because natural resources account for a decreasing share of world output. At the same time, FDI may no longer be the preferred mode of drawing on natural resources (such as oil).

FDI was favoured over trade in the past, when resource-abundant countries lacked the large amounts of capital required for resource extraction or did not have the necessary technical skills. FDI tends to give way to joint ventures, non-equity arrangements with foreign investors and arm’s-length trade relations when host countries are no longer constrained in terms of capital and technical skills and are, thus, able to set up competitive indigenous enterprises.

The relative importance of market-seeking FDI is fairly difficult to assess. It is almost impossible to tell whether this type of FDI has already become less important due to economic globalisation. Regarding the history of FDI in developing countries, various empirical studies have shown that the size and growth of host country markets were among the most important FDI determinants. It is debatable, however, whether this is (and will be) still true with ongoing globalisation. Traditionally, FDI was the only reasonable means to penetrate local markets in various developing countries. For instance, exporting to Latin America was no promising alternative to investing there as local industries were heavily protected (Nunnenkamp 1997). FDI was used to circumvent import barriers. The situation has changed considerably in recent times. Many developing countries have liberalised their import regime, thereby enabling MNCs to choose between exporting and undertaking FDI. As a consequence, purely market-seeking FDI may decline. UNCTAD (1996) argued that “one of the most important traditional FDI determinants, the size of national markets, has decreased in importance”, even though conclusive empirical evidence is hard to come by.
It should also be taken into account that the possible decline of market-seeking FDI is largely restricted to FDI in manufacturing industries. On the other hand, market-seeking FDI received a major push by the opening of service industries to FDI. The bulk of FDI in services, which accounts for a rising share in overall FDI, is market-seeking almost by definition, as most services are not tradable in the sense of cross-border transactions.

2.2.3. Business Facilitation

Arguably, the decline of market-seeking FDI in manufacturing may also be counteracted by regional integration. Policy-makers all over the world consider regional integration to be instrumental in inducing FDI. The basic argument underlying this hope is that regional integration increases market size and enhances economic growth (UNCTAD 2000).

Second, integration-induced FDI may be concentrated in some member countries of regional integration schemes, while other member countries do not benefit at all. Third, an increase in market-seeking FDI does not necessarily go along with an increase in overall FDI. The positive effect of higher market seeking FDI may be offset if regional integration undermines the incentives to efficiency-seeking FDI by raising trade barriers against non-member countries.

Back to the question whether economic globalisation has changed (or will change) the rules of the game in competing for FDI? In various developing countries, market-seeking FDI was concentrated in sophisticated manufacturing industries in which host countries lacked comparative advantage. Import protection supported high rates of return so that the efficiency and international competitiveness of market-seeking FDI was not a major concern of foreign investors (UNCTAD 1998). By contrast, international competitiveness of local production, including local production by foreign investors, becomes the critical factor if globalisation alters the form and purpose of FDI.

Globalisation, essentially, means that geographically dispersed manufacturing, slicing up the value chain and the combination of markets and resources through FDI and trade are becoming major characteristics of the world economy. Efficiency-seeking FDI, i.e. FDI motivated by creating new sources of competitiveness for firms and strengthening
existing ones, may then emerge as the most important type of FDI. Accordingly, the competition for FDI would be based increasingly on cost differences between locations, the quality of infrastructure and business-related services, the ease of doing business and the availability of skills.

2.2.3. Business Facilitation

To a large extent, business facilitation relates to one of the factors mentioned already in the context of efficiency-seeking FDI, namely, the ease of doing business. However, promotional efforts may well go beyond narrowly-defined business facilitation and include fiscal and tax incentives. The latter are what Charles Oman (2001) has rightly labelled as the perils of competition for FDI.

Business facilitation is, typically, dealt with by investment promotion agencies (IPAs):

i. Investment-generating measures of IPAs include FDI campaigns, industry specific FDI missions and targeting particular MNCs. Particularly, the latter reveals the shift of IPAs’ activities from image-building to more specific FDI generation. A survey conducted in the mid-1990s among 81 IPAs showed that a great majority of them tried to identify and attract foreign investors (UNCTAD 1998).

ii. Investment-facilitation services consist of counselling, speeding up the approval process and assistance in obtaining permits. These services are often provided by “one-stop shops”.

iii. In addition, after-investment services related to day-to-day operational matters are offered to established foreign investors.

Underlying many of these measures is the governments’ wish to do more in terms of pro-active policies, given that FDI liberalisation alone suffers from diminishing returns. However, there is a trend towards a convergence of policies and practices, not only with regard to FDI liberalisation but also in the area of business facilitation. This may have tempted governments to enter into another race of competing for FDI by offering tax incentives and outright subsidies.
"Bidding wars" among governments may create major distortions in the allocation of investment resources. Subsidies discriminate against sectors and projects not targeted by incentives. Especially smaller investors and local investors may suffer discrimination. Moreover, "bidding wars" may be very costly and weaken public finances. UNCTAD (1998) noted that the use of investment incentives has proliferated: the range of incentives to foreign investors and the number of countries that offer incentives have both increased since the mid-1980s.

Incentives-based competition for FDI has become pervasive not only among national governments, but also among sub-national authorities (Oman 2001). Moreover, this type of competition is particularly fierce among neighbours, e.g. governments in the same region. This may render it fairly difficult to strengthen co-operation among IPAs in a regional context. It is at least questionable whether competing agencies are eager to engage in an exchange of expertise and experience, unless they realise that "bidding wars" are counterproductive and unlikely to induce more FDI.

This reasoning is plausible, but the major problem facing policy-makers remains: Incentives-based competition among short-listed countries may easily degenerate into costly "bidding wars". Pro-active FDI policies are a two-edged sword. A co-operative approach may help prevent costly "bidding wars", but the difficulties in orchestrating and enforcing effective co-operation among competitors should not be underestimated, not least because co-operation must involve local authorities, in addition to national governments. The real test comes when investors start playing governments off against each another to bid up the value of incentives. Moreover, it should be kept in mind that no promotional efforts or incentives will help attract significant FDI, if economic and political fundamentals are not conducive to FDI.

UNCTAD (1998) argues that globalization has led to a reconfiguration of the ways in which MNCs pursue their resource-seeking, market-seeking and efficiency-seeking objectives. The opening of markets to trade, FDI and technology flows has offered MNCs
a wider range of choices on how to serve international markets, gain access to immobile resources and improve the efficiency of production systems (Dunning 1999). Reportedly, MNCs are increasingly pursuing complex integration strategies, i.e., MNCs "increasingly seek locations where they can combine their own mobile assets most efficiently with the immobile resources they need to produce goods and services for the markets they want to serve" UNCTAD (1998). This is expected to have two related consequences regarding the determinants of FDI:

i. Host countries are evaluated by MNCs on the basis of a broader set of policies than before. The number of policies constituting a favourable investment climate increases, in particular with regard to the creation of location-specific assets sought by MNCs.

ii. The relative importance of FDI determinants changes. Even though traditional determinants and the types of FDI associated with them have not disappeared with globalization, their importance is said to be on the decline.

More specifically, "one of the most important traditional FDI determinants, the size of national markets, has decreased in importance. At the same time, cost differences between locations, the quality of infrastructure, the ease of doing business and the availability of skills have become more important" UNCTAD (1996).

It would have important policy implications if globalization had changed the rules of the game in competing for FDI. The policy challenge may become fairly complex: host country governments would have "to provide and publicize a unique set of immobile assets, pertinent to the types of economic activity they wish to attract and retain, vis-à-vis those offered by other countries" (Dunning 1999). Arguably, policymakers can no longer rely on the previous empirical literature stressing the overriding role of some clearly defined factors shaping the distribution of FDI.

Among more traditional FDI determinants, market-related factors clearly stand out. In a frequently quoted survey of the earlier literature on FDI determinants, Agarwal (1980)...
found the size of host country markets to be the most popular explanation of a country's propensity to attract FDI, especially when FDI flows to developing countries are considered. Subsequent empirical studies corroborated this finding. Even authors who dismissed earlier studies as seriously flawed came up with results supporting the relevance of market-related variables such as GDP, population, GDP per capita and GDP growth: examples are: Schneider and Frey (1985), Wheeler and Mody (1992), Tsai (1994), Jackson and Markowski (1995) and, more recently, Taylor (2000). Chakrabarti (2001), while questioning the robustness of various other FDI determinants, finds the correlation between FDI and market size to be robust to changes in the conditioning information set. Against this backdrop, the obvious question is whether the dominance of market-related factors no longer holds under conditions of proceeding globalization, while less traditional FDI determinants have become more important. Recent empirical studies on FDI determinants in developing countries hardly address this question explicitly. Yet, some of these studies offer at least tentative insights, e.g. on changes in the relevance of market-related and trade related variables.

As concerns market-related variables, Loree and Guisinger (1995) find per capita GDP of host countries to be a driving force of FDI from the United States in 1977, but not in 1982. The authors presume that this rather surprising result is due to a shift from local market-seeking FDI towards more world market oriented FDI. This reasoning suggests that the motives for FDI may have changed well before globalization became a hotly debated issue. However, data constraints prevented Loree and Guisinger from testing this proposition.

Moreover, industrialized host countries constitute about half of the sample analyzed in this study. Hence, it remains open to question whether the presumed shift in FDI motives applies to both industrialized and developing host countries. The results of Tsai (1994), whose sample consists of developing countries almost exclusively, indicate that the relevance of market-related variables did not decline in the 1980s, compared to the 1970s. Econometric tests performed by UNCTAD (1998) reveal that, in some contrast to...
UNCTAD's reasoning elsewhere in the same World Investment Report, market size-related variables remained the dominant influence on inward FDI even in the mid-1990s.

The findings of Tsai (1994) are surprising in another respect. According to the simultaneous equation model, FDI and the growth of host country exports were positively correlated in the 1970s, but no longer in the 1980s. One could have expected the opposite pattern as the motives for FDI are widely supposed to have shifted towards more world market-oriented FDI since the 1980s. The estimates of Tsai (1994) may rather suggest that host countries' openness to trade represents a fairly traditional determinant of FDI.

The analysis by Lucas (1993) of determinants of FDI in East and Southeast Asian countries tends to support this view. FDI in 1960–1987 is found to be somewhat more elastic with respect to aggregate demand in export markets than with respect to demand in the host country. Lucas (1993) suspects that the importance of local market size is overstated in various empirical studies because they omit export markets as a determinant of FDI.

More recent studies typically consider trade-related determinants of FDI:

Singh and Jun (1995) find export orientation to be the strongest variable for explaining why a country attracts FDI. Yet, it is somewhat heroic to conclude that their findings are "in line with the secular trend toward increasing complementarity between trade and FDI". The study also supports the tariff jumping hypothesis.

Gastanaga, Nugent and Pashamova (1998) address the tariff jumping hypothesis in the context of a panel analysis on the effects of host country reforms on FDI. Cross-section results suggest that FDI flows are motivated more strongly by tariff jumping than by potential exports, the effects of import tariffs on FDI tend to be negative in a time-series context.

According to the sensitivity analysis of Chakrabarti (2001), openness to trade (proxied by exports plus imports to GDP) has the highest likelihood of being correlated (positively)
with FDI among all explanatory variables classified as fragile. Asiedu (2002), using the same proxy for openness, comes to a similar conclusion when separating Sub-Saharan host countries from host countries in other regions. Africa differs significantly from non-African sample countries with regard to other FDI determinants, whereas the promotional effect of openness to trade on FDI is found to be only slightly weaker in Africa.

The problem with essentially all these studies is that they use trade-related variables that are seriously flawed. Import tariff rates capture at best part of the trade policy stance of host countries. The ratio of exports plus imports to GDP suffers from a large-country bias and may, thus, lead to unreliable results. One recent study on FDI determinants takes a different route in assessing openness. Taylor (2000) refers to survey results (World Competitiveness Report) on the degree to which government policy discourages imports. This measure of openness to trade is shown to be positively related to FDI undertaken by MNCs from the United States. By contrast, alternative measures tried as proxies of openness (tariff rates, coverage of non-tariff barriers) turned out to be insignificant when correlated with FDI.

Taylor (2000) resembles most other studies in that he does not assess changes over time in the importance of openness as an FDI determinant. His results do suggest, however, that a globalization-induced increase in the relevance of openness cannot be taken for granted. The positive correlation between openness and FDI is restricted to the manufacturing sector, whereas the correlation is insignificant for FDI by MNCs from the United States in the services sector. Considering that the recent boom of FDI in developing countries is largely because of FDI in non-traded services), the relevance of openness even may have declined.

Finally, the study by Noorbakhsh, Paloni and Youssef (2001) offers insights on non-traditional determinants of FDI in developing countries, though not with regard to trade-related variables. The focus of this study is on human capital as a determinant of FDI. Most importantly, "the results ... are suggestive of an increasing importance of human capital through time. The estimated coefficients of the variables used as proxies for
human capital as well as their t-ratios increase in magnitude across the consecutive sample periods". The authors attribute this finding explicitly to the process of globalization. Limitations of this study are twofold: The period of observation is restricted to 1983-1994, and changes over time are not studied for FDI determinants other than human capital.

2.3 Measures for Increasing FDI in Kenya

FDI grew steadily through the 1970s as Kenya was a prime choice for foreign investors seeking to establish a presence in Eastern and Southern Africa. The relatively high level of development, good infrastructure, market size, growth and openness to FDI at a time when other countries in the region had relatively closed regimes all contributed to MNCs choosing Kenya as their regional hub. FDI started at a low of around Ksh800 million a year in the early 1970s before peaking at Ksh 6.4 billion in 1979-80 (Graph 1).
Graph 1.

Magnitude of Kenya FDI Inflows
Shillings (Billions)

Source: UNCTAD, FDI/TNC TNC database (WIR04), World Bank (WDI 2004).

Table 2.

Magnitudes of Kenya FDI Inflows Shillings (Billions)

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<tr>
<td>FDI inflows (billion Kshs)</td>
<td>1.104</td>
<td>6.32</td>
<td>4.568</td>
<td>2.64</td>
<td>8.87</td>
<td>0.424</td>
<td>1.89</td>
<td>6.54</td>
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Source: UNCTAD, FDI/TNC database (WIR04), World Bank (WDI 2004).
A period of low FDI began to manifest in the early 1980s, and has subsequently continued to registered erratic movements to date. Inflows of FDI in the period 1981-1999 averaged only Ksh 1.76 billion a year. Although the sale of mobile phone licences to Kenyan-foreign joint ventures pushed FDI to over Ksh 8 billion in 2000, inflows fell again to around their average of the 1980s and 1990s, before rising again in 2003 on the back of textile investments in export processing zones (EPZs) that may not prove sustainable. Although Kenya was the lead destination of FDI to the East African Community (EAC) in the 1970s and 1980s, the relative level of inflows was never high by developing countries standards, the stock of FDI, which was only 7.5 percent of GDP in 2003, compared with 25.3 percent for Africa as a whole and 31.5 percent for developing countries (IPR-Kenya 2005). Kenya’s regional leadership in attracting FDI also disappeared as soon as Tanzania and Uganda started reforming their economies and opening up to foreign investors in the early 1990s, at a time when Kenya itself was suffering from economic stagnation. The end of apartheid in South Africa in 1994 also increased competition in the attraction of large MNCs seeking a single production or headquarter centre in Anglophone Africa.

FDI inflows in 1996-2003 averaged Ksh 3.12 billion a year, while inflows to Tanzania and Uganda surged to Ksh 22.4 billion and Ksh 17.60 billion, respectively, from negligible levels in the 1980s (IPR-Kenya 2005). In relative terms, Kenya fares even worse, as its economy was about 30 percent larger than Tanzania’s and twice as big as Uganda’s in 2002. While developing countries as a whole attracted an annual average of Ksh 3.280 of FDI per capita in 1996-2003, Kenya only drew average inflows of Ksh 104 per capita. This ranks Kenya as 129th (out of 140 countries) on UNCTAD’s FDI performance index in 2001-03. It has also never ranked better than 111th at any time since 1990.

Kenya has thus missed out on the global surge in FDI that affected most of the world in the 1990s. While its average annual level of FDI inflows doubled between 1981-85 and 1996-2003, the average inflow to African countries was multiplied by six, and average inflows to developing countries as a whole almost decupled.
2.4 The Role and Importance of Taxes for an Attractive FDI Climate

The ICFD, Monterrey consensus recognises the importance of sound tax systems and domestic taxation as the key source of finance for development. Governments need tax revenue to provide public services and investment. A well-functioning tax system is also a key element of good governance. Predictability and transparency of taxation is important for domestic as well as foreign entrepreneurs because it reduces financial risk related to their investments. Effective taxation contributes to the quality of the business climate.

2.4.1 The Role of Taxes

Tax is the most important source of government revenue. In addition, the tax system is an element of governance and in particular the enabling environment for private enterprise. According to most of the literature on foreign direct investment and private sector development, what applies to public policy in general also applies to taxation:

*The first-best strategy for sustained investment promotion consists invariably of providing stable and transparent legal and regulatory frameworks as well as adequate supporting institutions and facilities, and of putting in place a tax system that is in line with international norms.* (Tanzi and Zee, 2000)

Surveys reveal that investors rate tax incentives rather low among the factors they consider in choosing between locations. Political stability, geographic location, the quality of infrastructure and the availability of natural resources, support services and a well-educated population are equally or more important. Independent research, for instance, by the Economist Intelligence Unit (EIU), finds that the Netherlands has an attractive investment climate, even though it does not have a very good rating on tax. With regard to taxation, investors seek transparent tax legislation. Efficient tax administrations and predictable tax burdens are part of a good business environment. (Bols et al. 2001)
From the investor's perspective, weaknesses in the tax system introduce tax risks similar to the risks that they face due to uncertainties about ownership rights, macroeconomic instability and the right to repatriate profits. A capable administration facilitates tax assessment and reduces the cost of dealing with taxes.

2.4.2 Tax Incentives to Attract Foreign Investors

Foreign direct investment has positive economic effects in terms of employment, knowledge transfer, export revenues and economic growth. Recognising these benefits, many governments in developing countries have opened their borders to foreign direct investment and actively try to encourage such investment. In addition to other incentives they offer in this context, many Governments offer tax incentives, sometimes on a discretionary basis. Incentives may take many forms, including investment allowances, provisions for accelerated depreciation or outright reductions in tax rates (UNCTAD 2000). In view of the extensive use of tax incentives by governments all over the world, many economists have evaluated both their potential benefits (in terms of investment and its positive effects) and costs. The general understanding of studies done seems to be that tax incentives are a very costly instrument for attracting foreign investment and that there are limits to their effectiveness. These conclusions suggest that there is a considerable risk that governments of developing countries are "paying" too much compared with the benefits of the investments they attract. If that is the case, tax incentives create a net loss to the economy and governments have an opportunity to raise more revenue (Morisset and Prinia 2001).

It is also important to note that in many industries tax incentives are irrelevant to the investment decision compared with other factors such as closeness of markets and availability of natural resources; according to one survey "tax incentives are like a dessert", which seems to indicate that incentives are given without additional benefit to the economy (EUR 2001).

Tanzi and Zee (2000) suggest that investors in "footloose" and export -oriented industries, tax incentives are more important than in other industries as a factor
distinguishing one country from another; incentives are also important when countries become more similar in terms of factors such as closeness to regional markets, trade policies and basic economic regulation; in this context in particular, governments are caught in a prisoner’s dilemma— they have a common interest in ceasing to provide tax incentives, but choose to keep them in place out of fear that others will continue to do the same. In addition to reducing revenue, tax incentives make the tax system less transparent and predictable and potential investors are likely to perceive taxation as less stable (i.e. they introduce a governance problem); also, tax incentives for foreign investors shift the burden of taxation to immobile factors of production like labour.

2.5 Review of the Existing Empirical Literature

The recent empirical literature on the effects of taxation on inward foreign direct investment has focused exclusively on FDI in the United States. Interest in this topic has been stimulated of late by the extraordinary increase in the late 1980s of FDI into the U.S. Slemrod (1989) discusses to what extent that increase may be related to the tax changes in the Tax Reform Act of 1986.

Empirical study of the effect of taxation on the time series of FDI in the U.S. was pioneered by Hartman (1984). Using annual data from 1965 to 1979, he estimated the response of FDI, separately for investment financed by retained earnings and transfers from abroad, to three variables: the after-tax rate of return realized by foreign investors in the U.S., the overall after-tax rate of return on capital in the U.S., and the tax rate on U.S. capital owned by foreigners relative to the tax rate on U.S. capital owned by U.S. investors. The first two terms are meant to proxy for the prospective return to new FDI, the first term being more appropriate for firms considering expansion of current operations and the second more applicable to the acquisition of existing assets which are not expected to earn extraordinary returns based on production of differentiated products or possession of superior technology. The relative tax term is designed to capture the possibility that tax changes which apply only to U.S. investors will, by affecting the
valuation of assets, alter the foreign investor's cost and therefore the return to acquiring the asset.

Hartman does not attempt to measure either an effective withholding tax rate or the foreign income tax rate applied to the aggregate of foreign direct investment. He defends their absence by noting the likelihood that the average values of these tax rates are relatively constant over time. Furthermore, no attempt is made to measure the alternative rate of return available abroad to foreign investors. Hartman's regression results reveal a positive association of both after-tax rate of return variables with the ratio to U.S. GNP of FDI financed by retained earnings, and a negative association of the FDI-GNP ratio with the relative tax rate on foreigners compared to domestic residents. The model does not explain transfers from abroad as well as retained earnings, although coefficients of all three variables have the expected sign and are significantly different from zero. Hartman concludes from this research that the effect of taxes on FDI, both that implied by reinvestment of earnings and that accomplished by explicit transfer of funds, is quite strong.

Boskin and Gale (1986) re-estimate Hartman's equation using the updated tax rate and rate of return series from Feldstein and Jun (1986). Although the estimated elasticities of FDI to the rates of return are somewhat lower, none of the point estimates changes by more than one standard deviation. They also extend the sample forward to 1984, and in some cases backward to 1956, and experiment with a variety of alternative explanatory variables and functional forms. They conclude that although the results are somewhat sensitive to sample period and specification, the qualitative conclusions of Hartman are fairly robust.

Young (1988) uses revised data on investment, GNP and rates of return earned by foreigners to estimate similar equations. These changes increase the estimated elasticities with respect to the rate of return realized by foreigners and the relative rate of return. However, the equations for new transfers of funds estimated using the years 1956-84 yield very poor results, suggesting to Young that the simple Hartman model is inadequate.
for studying foreign direct investment through new funds when applied to the expanded sample period. Relaxing Hartman's assumption of a unitary income elasticity and including the lagged dependent variable as a right-hand side variable does not substantially alter the conclusions for retained earnings (although the estimated responsiveness is significantly lower), but the tax responsiveness of transfer of new funds still is not supported.

Newlon (1987) reexamines the results of Hartman as well as Boskin and Gale. During his attempt at replication, he discovered that the series measuring the rate of return on foreign direct investment, used in all earlier papers had been miscalculated from the original Bureau of Economic Analysis data for the years 1965 to 1973. Using the corrected series the equation explaining retained earnings does not fit as well, although the equation explaining transfers fits better. In explaining retained earnings, the estimated co-efficients on the return to FDI and the tax ratio are slightly larger in absolute value and remain statistically significant, although the estimated coefficient on the net return in the U.S. is lower and is no longer statistically significant. For transfers of funds, the estimated coefficient on the return to FDI is much larger and becomes significant, although the estimated coefficient on the net return in the U.S. becomes smaller and insignificant. When the sample period is extended to range from 1956 to 1984, Newlon's results also differ from those of Hartman and those of Boskin and Gale. In particular, the equation explaining transfer of funds fits poorly, and no estimated coefficient is significant.

It is notable that none of these studies has deviated very far from the approach taken in Hartman's 1984 paper. Although Young (1988) refers to Feldstein's (1982) dictum that, in the absence of a perfectly specified model, many alternative models should be investigated, the empirical research has been extremely one-tracked. This is a sufficient reason to explore alternative methodologies. Furthermore, there are several problems with the standard approach which bear further study. In the previous literature, the disincentive to investment caused by the tax system is implicitly measured by an average tax rate, computed as total taxes paid divided by a measure of profits. However,
the incentive to undertake new investment depends on the effective marginal tax rate which, as is well known, can deviate substantially from an average tax rate concept.

None of the existing studies attempts to estimate the effect of the home country's tax system on FDI in the U.S. Of course, collecting the appropriate data is difficult and perhaps, as Hartman argued, these tax rates have not in fact varied much. The observed stability, though, applies to statutory tax rates and not necessarily to the more appropriate effective marginal tax rates. There is also a theoretical reason to focus attention on the host country tax rate. Hartman (1985) has argued that only the host country's tax system matters for investment coming from subsidiaries' earnings, even when the home country taxes its residents on the basis of worldwide income. This is because the home country's tax equally reduces the parent's return to an investment and the opportunity cost of making an investment (remitting a dividend to the parent). Thus, for any subsidiary whose desired investment exceeds earnings, the tax due upon repatriation of earnings does matter. This situation would likely occur to newly formed subsidiaries. In any event, it is worthwhile to investigate empirically the impact of both the home country's rate of taxation and its system of taxing foreign-source income.

The interpretation of the estimated coefficient on the rate of return to FDI variable is also problematic, as stressed by Newlon. This rate of return is defined as the after-tax income from direct investment divided by the stock of direct investment. When the home country has a foreign tax credit with deferral, it is often optimal for the subsidiary to finance investment by first using retained earnings, and only when these earnings are exhausted to use funds transferred from the parent firm. This hierarchy of financing implies that whenever a subsidiary's investment exceeds its retained earnings, its retained earnings will exactly equal its income. Thus for these firms we would expect a direct association between the calculated rate of return (in which after-tax income is the numerator) on FDI and retained earnings, regardless of whether the average rate of return in fact influences decisions concerning new FDI. As Newlon notes, if subsidiaries were following a fixed dividend pay out rule (e.g., it pays out a fixed fraction of income), a direct association between income and retained earnings would also be observed. This
argument may also apply to subsidiaries of firms residing in countries that employ territorial systems of taxation, thus rendering problematic any observed empirical association between FDI out of retained earnings and realized rate of return.

Slemrod (in Razin and Slemrod, forthcoming) attempts to remedy some of the empirical problems discussed above. He extends and updates a Hartman-style model of aggregate FDI in the U.S., in part replacing a measure of the average rate of tax by a measure of the marginal effective tax rate on new investment. This analysis is generally supportive of a negative impact of U.S. effective rates of taxation on total FDI and new transfers of funds, but not on retained earnings.

2.5.1 Some Theory and the Empirical Model

The modern literature has, for the most part, concluded that the demand for FDI is primarily an issue of industrial organization. Dunning (1985, p. 6-7) has argued that FDI by firms of country A in country B is more likely if A's firms (i) possess ownership-specific advantages relative to B's firms in sourcing markets, (ii) find it profitable to use these advantages themselves rather than lease them to B's firms, and (iii) find it profitable to utilize their ownership-specific advantages in B rather than A. A large body of empirical literature has been addressed to testing this theory of international production, usually referred to as the "eclectic" theory. Much of this research has been cross-sectional, relating the extent of foreign investment in a given sector to characteristics of that sector that represent ownership-specific and location specific comparative advantages. Several examples of this type of analysis are contained in Dunning (1985).

Studies of the effects of taxation on FDI have generally taken the perspective that whatever its benefits to firms are, they must be balanced against the tax consequences of carrying out FDI. The studies hypothesize that the tax systems of both host country and the firm's home country can affect the incentives concerning FDI as well as how to finance a given pattern of FDI.
As do all countries of the world, asserts the right to tax the income originating within its borders, including the income generated by multinationals. The effective tax rate on this income depends in a complicated way on the statutory tax rate on corporate income, the extent of tax credits granted, and the definition of the tax base, including the system of depreciation and how gross income and deductions are allocated between country-source and foreign-source.

There are two approaches to measuring the effective tax rate on new investment. In the analytical approach pioneered by Hall and Jorgenson, one calculates the level of pre-tax return required for a stylized investment to yield a given return after tax. The wedge between the pre-tax rate of return and the after-tax rate is a measure of the tax-related disincentive to invest. This procedure requires details on the tax code, rate of inflation, economic depreciation rates, proportion of debt and equity finance, and costs of debt and equity finance. Thus the effective tax rate on equity transfers and retained earnings on FDI would be different.

The alternative approach is to calculate the ratio of taxes paid in a given year by an enterprise or Income that is independent of the definition of taxable income. This approach may capture some of the features of the tax law which are left out of the analytical approach, and also may more accurately capture some features which are present in the analytical models but are inadequately represented by the stylized assumptions that must be made to calculate marginal effective tax rates.

The country of residence of the multinational may also assert the right to tax the income that is generated. This is not, however, true of all countries. Some countries, notably France and Netherlands, operate a "territorial" system for active (i.e., non-portfolio) income earned abroad. Under a territorial system, the home country levies no tax of its own on the foreign-source income. Under the "worldwide" system of taxation, used by the United States, Canada, United Kingdom, and Japan among other countries, the multinational's home country asserts the right to tax its income regardless of where it is generated. In order to avoid two tiers of taxation, these countries offer their
multinationals a limited credit against domestic tax liability for certain taxes paid to foreign governments. The credit is generally limited to what tax liability the foreign-source income would incur if home country tax rules were applied. Finally, in most cases the tax liability (and credit) attendant to subsidiaries' foreign-source is deferred until dividends are repatriated to the parent company. Foreign-source income of branch operations is not, however, deferred but instead is taxable upon accrual.

Thus under the "new" view, the total tax burden on FDI financed by retained earnings of the foreign subsidiary is

Let \( t_u \) be the effective rate of tax on new investment imposed by the tax system. For a multinational from a country using the territorial system, \( r_m \) is also the total tax burden imposed. For a multinational from a country-with a worldwide system of taxation, there is another level of taxation to consider, that of the home country. The "old" view of this extra level of taxation is given by \( \max(\alpha(t_u - r_m), 0) \) where \( t_u \) is the tax rate of the home country and \( \alpha \) is a value between zero and one that reflects the benefits of being able to defer the tax liability on subsidiaries' foreign-source income until the earnings are repatriated. In the cases where earnings are never repatriated (\( \alpha \) is equal to zero), or when the firm is in an excess credit position (\( r_m > t_u \)), the home country tax is irrelevant. An opposite extreme case occurs when \( \alpha \) is equal to one, implying that the host country tax liability of the multinational can be fully offset by the home country tax credits. Note that \( t_u \) is generally closer to a statutory rate concept than an effective tax rate on investment, since the home country tax base for foreign-source income generally does not take account of such things as accelerated depreciation and investment tax credits that affect the taxable income due to domestic operations. Note that \( \alpha(t_u - r_m) \) can be negative if \( t_u \) is less than \( r_m \). In this case tax paid to the host country generates foreign tax credits that may be used to offset the tax that could otherwise be due on repatriations from low-tax country whose effective tax rate is less than \( t_u \).

The "new" view of the total tax burden on FDI, due to Hartman (1984), holds that if investment is financed by retained earnings of the foreign subsidiary, then the home country tax rate is irrelevant, so that the total tax burden remains at \( r_m \). The reasoning is that any taxes due upon repatriation to the home country reduce equally the opportunity cost of investment (a repatriated dividend) and the after-tax return to investment. Thus it
is irrelevant for the incentive to invest. Even under the new view, however, the home country tax rate would be relevant for home country multinationals that are contemplating a transfer of funds to a foreign subsidiary. It is difficult to reconcile, though, the simultaneous occurrence of transfers of funds and remittance of dividends from subsidiaries, since these activities incur an avoidable tax liability.

Thus under the "new" view, the total tax burden on FDI financed by retained earnings is $r_m$ but is $r_m+\alpha(t_u-r_m)$ for investment financed by transfer of funds. The old view did not distinguish debt and equity financing, using the latter expression for both cases.

The value of $\alpha$ will depend on the excess credit or limit position of the potential investor. If the multinational is in an excess credit position, so that the average rate of tax paid to foreign governments exceeds $t_u$, then at the margin there is no extra tax due to the home country government upon repatriation. If the multinational is in an excess limit position, where the average rate of foreign taxes paid is less than $t_u$, then the repatriation tax may be binding at the margin. Note that this depends on the average rate of tax paid to all foreign governments. Thus even if $r_m$ is less than $t_u$, if the overall foreign tax rate exceeds $t_u$, then the host country tax rate is the marginal rate ($\alpha$ is close to zero).

A recent paper by Scholes and Wolfson (1989) has suggested that the ownership of a given stock of domestic capital will depend on the relative tax rate paid by alternative owners. This implies that, in the contest for ownership of domestic capital, foreign owners will be more likely to be successful the lower is the ratio $[r_m+\alpha(t_u-r_m)]/r_m$. (This of course only applies if the home country operates a worldwide system of taxation). The surprising implication of this analysis is that, as long as $\alpha$ is greater than zero and $t_u$ exceeds $r_m$, an increase in $r_m$ will increase foreign ownership of domestic capital. The idea is that while an increase in $r_m$ applies fully to potential home country owners (or owners from countries with a territorial tax system), its effect on foreign owners is partly offset by credits taken against domestic tax liability. Thus it reduces the relative tax burden on foreign owners from countries with worldwide tax systems. Of course, to the
extent that $r_m$ reduces the incentive to undertake investment in host country, both
domestically and foreign-owned investment will decline. The overall impact on FDI thus
depends on the relative strength of the Scholes-Wolfson ownership effect and the volume
effect. Furthermore, the ownership effect applies only to investment from countries with
a worldwide tax system and only to the extent that the multinationals are in an excess
limitation position, so that additional taxes paid to the host government do in fact
generate additional foreign tax credits.

A.3 Sampling

The study sample comprised all the taxes that were reasonably expected to affect FDI and
were found to be consistent within the period of the study which was the tax years from
the year 1994-2004. There were various taxes that affected FDI, and these were effective
tax rates. Four alternate measures of the tax disincentive to new investment in Kenya:
three marginal (one each for aggregate investment, transfer and retained earnings) and
the fourth an average measure, effective until tax data on import duties and the rates of
import. The sample was reasonably easy to access as the information was with the
relevant government authorities.

A.4 Data Collection

Secondary data were collected from the Investment Promotion Centre (IPC), Nairobi
Stock Exchange (NSE) and Kenya Revenue Authority (KRA). Annual changes in volume
of foreign direct investment in Kenya from 1994–2004 were gathered. The various
independent measures that made up the effective tax rates and the effective yield rate during
the ten years were obtained from the Kenya Revenue Authority (KRA) and other
government agencies that deal with formulation and implementation of tax policy in
Kenya.
3. RESEARCH METHODOLOGY

3.1 Research Design
A survey/exploratory research design was employed in order to address and capture the objective of the study.

3.2 Population of the Study
The population of the study comprised all the taxes levied in Kenya by the Kenya Revenue Authority (KRA), other aggregate data on stocks and flows of FDI and other relevant variables for the period 1994-2003 that was assembled from a variety of sources.

3.3 Sampling
The study sample comprised all the taxes that were reasonably expected to affect FDI and were found to be consistent within the period of the study which was the ten years from the year 1994-2003. There were various taxes that affected FDI, and these were effective tax rates: four alternate measures of the tax disincentive to new investment in Kenya, three marginal (one each for aggregate investment, transfers and retained earnings) and the fourth an average measure, effective tariff rate: data on import duties and the value of imports. The sample was reasonably easy to access as the information was with the relevant government authorities.

3.4 Data Collection
Secondary data were collected from the Investment Promotion Centre (IPC), Nairobi Stock Exchange (NSE) and Kenya Revenue Authority (KRA). Annual changes in volume of Foreign Direct Investment in Kenya from 1994 - 2003 were gathered. The various taxation measures that made up the effective tax rates and the effective tariff rate during the ten years were obtained from the Kenya Revenue Authority (KRA) and other government agencies that deal with formulation and implementation of tax policy in Kenya.
3.5 Data Analysis

The data were checked for accuracy, consistency, and completeness. Descriptive statistics were put to use to find out and to present the main changes in the variable values during the period of the study. Finally, regression analysis using an appropriate model was carried out to find out the magnitude and direction of the relationship between taxation and FDI, if any.

### 4.1.1 Absolute Analysis

Table 3: Annual Volume of FDI inflows

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI Fols (Billions)</td>
<td>-0.57</td>
<td>2.64</td>
<td>1.24</td>
<td>4.28</td>
<td>1.27</td>
<td>1.39</td>
<td>3.87</td>
<td>0.42</td>
<td>1.69</td>
<td>0.34</td>
</tr>
</tbody>
</table>

Data Source: Various IPC Reports

This data can be depicted using comparative bar chart and pie chart as shown below.

The bar graph shows that inflows of FDI in 1994 were quite low at Kshs 0.57 billion, at its lowest and increased to Kshs 2.64 billion the next year. The graph also shows that 2000 had the highest volume of FDI inflows at Kshs 3.87 billion. The line graph conveys the same message as the bar chart.
4. DATA ANALYSIS AND FINDINGS

This chapter analyses the data collected using regression analysis tools. The analysis is divided into sections as follows:

4.1 Preliminary Analysis

4.1.1 Absolute Analysis

Table 3. Annual Volume of FDI Inflows

<table>
<thead>
<tr>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kshs (Billions)</td>
<td>0.37</td>
<td>2.64</td>
<td>1.24</td>
<td>4.28</td>
<td>1.27</td>
<td>1.39</td>
<td>8.87</td>
<td>0.42</td>
<td>1.89</td>
<td>0.54</td>
</tr>
</tbody>
</table>

Data Source: Various IPC Reports

This data can be depicted using comparative bar chart and pie chart as shown below:

The bar graph shows that inflows of FDI in 1994 were quiet low at Kshs 0.37 billion, at its lowest and increased to Kshs 2.64 billion the next year. The graph also shows that 2000 had the highest volume of FDI inflows at Kshs 8.87 billion. The line graph conveys the same message as the bar chart.
Graph 2: Volume of FDI Inflows

Graph 3: Annual FDI Inflows

Data Source: Calculated from information obtained from various government authorities.

The graph shows that marginal effective tax rates fell from 27.2% in 1994 to 2002.

The tax rates followed a gradual increase in the subsequent years declining to 25.8% the year 2003. Marginal effective tax rates then increased to 28.8% where they remained for both years 2002 and 2003.
The graph shows that marginal effective tax rate fell from 22% in 1994 to 20.33% in 1995, followed by an increased of 0.84% in 1996. The rate then showed a gradual decline in the consequent years declining to 15.89% the year 2000. Marginal effective tax rate then climbed to 18.61% where it remained for both the years 2002 and 2003.
### Table 5. Annual Percentage Change in METR (Transfers)

|------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|

Data Source: Calculated from information obtained from various government authorities

The marginal effective tax rate for transfers shows a downward trend with the tax rate being 25.44% in 1994 and falling to 22.14% in 1998. It showed a slight increase for the following year to 26.19%. In the years after the rate reduced to about 24% in 2002 and then plummeting to 16.97% in 2003.
Table 6. Annual Percentage Change in METR (Retained Earnings)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>( R_u ) %</td>
<td>40</td>
<td>39</td>
<td>40</td>
<td>38</td>
<td>34</td>
<td>43</td>
<td>38</td>
<td>39</td>
<td>43</td>
<td>32</td>
</tr>
</tbody>
</table>

Data Source: Calculated from information obtained from various government authorities.

The graph representing marginal effective tax for retained earnings shows an erratic trend in the percentage changes. The trend from the 1994 to 1996 was fairly stable with a slight change from 40% to 39% in 1995 and back to 40%. However, the following year showed a sharp decline of 2% and 6% in 1997 and 1998 respectively. The rate then peaked to its highest at 43% in 1999 and 2001 before spiralling downward to 32% in 2003.
Table 7. Annual Percentage Change in Value Import Duties

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mid %</td>
<td>26</td>
<td>31</td>
<td>28</td>
<td>34</td>
<td>31</td>
<td>27</td>
<td>33</td>
<td>26</td>
<td>28</td>
<td>29</td>
</tr>
</tbody>
</table>

Data Source: Calculated from information obtained from various government authorities.

The graph above shows an erratic movement of the rates from year to year. 1994’s rate was 26% climbing to 31% in 1995 and then going down to 28% in the following year. 1996 saw the rate shoot up to 34% reducing meagrely by 3% points in 1997. The trend continued with sharp ups and downs for the rest of the years where it stabilised at 29% in 2003.
4.2 Analysis of Taxation Impact on FDI

4.2.1 Analysis of Correlation Coefficients

In this section, we are interested in investigating whether the correlation is a significant one. The strength of a linear relationship will be measured using the Pearson Correlation Coefficient. It is expected that there is a significant relationship marginal effective tax rate, marginal effective tax rate for transferred funds, marginal effective tax rate for retained earnings, effective tariff rate and FDI inflows.

The Analysis of Correlation Coefficients indicates whether there is a significant linear relationship between taxation and FDI. We use a two-tailed value to determine whether the correlation is a significant one. So the hypotheses are as follows:

- $H_0: \rho = 0$ i.e. there is no significant linear relationship between taxation and FDI
- $H_1: \rho \neq 0$ i.e. there is a significant linear relationship between taxation and FDI

:. A two-tailed test

Table 8: Relationship between taxation and FDI

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>$r$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marginal Effective Tax Rate $R_m$</td>
<td>-.400</td>
</tr>
<tr>
<td>Marginal Effective Tax (Transfers) $R_t$</td>
<td>-.443</td>
</tr>
<tr>
<td>Marginal Effective Tax (R. Earnings) $R_u$</td>
<td>-.441</td>
</tr>
<tr>
<td>Effective Tariff Rate $R_i$</td>
<td>.662*</td>
</tr>
</tbody>
</table>

* Correlation is significant at 0.05 level (2 tailed)

4.2.2 Analysis of Marginal Effective Tax Rates

The table showed that there was a negative correlation for the marginal effective tax rate and FDI inflows where the correlation coefficient was -.400. The correlation coefficient for marginal effective tax rate (transfers) was -.443. Also showing a negative correlation. The marginal effective tax rate (retained earnings) showed a negative correlation with a coefficient of -.441. However, the correlation coefficients for effective tariff rate was different from the others at .662. Its correlation was significantly positive at the 5% level.
4.2.3 Analysis of the Model
The R in this model was 0.822, which is close to 1. This therefore can be interpreted to mean that the model is explaining what is happening to a fairly accurate level. R², which shows the proportion of variability in the dependent variables, is at 0.675, which is a high proportion. Therefore this suggests that our model is relatively fitting our model.

The Analysis of Variance which indicates whether there is a significant linear relationship between the dependent variable and the combination of the explanatory variables and the F-test used to test the Null Hypothesis that there is no linear relationship is 0.161. We can see in our study that there is no linear relationship with a significance value of less than 0.05.

4.2.4 Regression Analysis Results

Table 9: Model Summary

<table>
<thead>
<tr>
<th>Mode</th>
<th>R Squared</th>
<th>Adjusted R Squared</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.822(a)</td>
<td>.675</td>
<td>.416</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Import Duties, Marginal effective tax rate (transfers), Marginal effective tax rate, Marginal effective tax rate (retained earnings)

Table 10: ANOVA (Analysis of Variance)

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Regression</td>
<td>4</td>
<td>12.178</td>
<td>2.602</td>
<td>.161(a)</td>
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<tr>
<td>Residual</td>
<td>23.406</td>
<td>5</td>
<td>4.681</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>72.119</td>
<td>9</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Import Duties, Marginal effective tax rate (transfers), Marginal effective tax rate, Marginal effective tax rate (retained earnings)
b. Dependent Variable: FDI Inflows (Billions Kshs)
Table 11: Correlations

<table>
<thead>
<tr>
<th>FDI Inflows (Billions Kshs)</th>
<th>FDI Inflows Correlation</th>
<th>Marginal Effective Tax Rate</th>
<th>Marginal effective Tax Rate (transfers)</th>
<th>Marginal effective tax rate (retained earnings)</th>
<th>Import Duties</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1.000</td>
<td>-.400</td>
<td>-.443</td>
<td>-.441</td>
<td>.662(*)</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.252</td>
<td>1.000</td>
<td>.007</td>
<td>-.156</td>
<td>-.166</td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Marginal Effective Tax Rate</th>
<th>Pearson Correlation</th>
<th>Marginal effective Tax Rate (transfers)</th>
<th>Marginal effective tax rate (retained earnings)</th>
<th>Import Duties</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-.400</td>
<td>1.000</td>
<td>-.007</td>
<td>-.156</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.252</td>
<td>.985</td>
<td>.003</td>
<td>.752</td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Marginal effective tax rate (transfers)</th>
<th>Pearson Correlation</th>
<th>Marginal effective Tax Rate (transfers)</th>
<th>Marginal effective tax rate (retained earnings)</th>
<th>Import Duties</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>-.443</td>
<td>-.007</td>
<td>.826(**)</td>
<td>-.115</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.200</td>
<td>.985</td>
<td>.003</td>
<td>.752</td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Marginal effective tax rate (retained earnings)</th>
<th>Pearson Correlation</th>
<th>Marginal effective Tax Rate (transfers)</th>
<th>Marginal effective tax rate (retained earnings)</th>
<th>Import Duties</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-.441</td>
<td>-.156</td>
<td>.826(**)</td>
<td>-.382</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.202</td>
<td>.667</td>
<td>.003</td>
<td>.276</td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Import Duties</th>
<th>Pearson Correlation</th>
<th>Marginal effective Tax Rate (transfers)</th>
<th>Marginal effective tax rate (retained earnings)</th>
<th>Import Duties</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>.662(*)</td>
<td>-.166</td>
<td>-.382</td>
<td>1.000</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.037</td>
<td>.646</td>
<td>.752</td>
<td>.276</td>
</tr>
<tr>
<td>N</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

* Correlation is significant at the 0.05 level (2-tailed).
**Correlation is significant at the 0.01 level (2-tailed).
5. CONCLUSION AND RECOMMENDATIONS

5.1 Summary of Findings
This study was conducted in the area of taxation with specific reference to its impact on Foreign Direct Investment in Kenya. The study revealed in detail the how FDI is impacted by taxation. The study also sought to established whether there is a linear relationship between taxation and FDI. Based on the data collected and analysed, the study identified the impact and linearity of taxation on/with FDI.

The study shows that there was effective taxation levels reduction in the years from 1994 to 2003. FDI inflows show a cyclical trend with some years reporting robust growth of the volume with the highest recorded in 2000, while in some years it fell and remained stunted with the lowest volume in 1994. The study established that during the period 1994 – 2003, there was changes in taxation and also variations in the FDI inflows. These findings seem to confirming the findings of various other empirical studies in this area – that taxation has an impact on FDI.

All the effective tax rates except effective tariff rate showed a negative correlation. This analysis suggested that FDI showed a great deal of sensitivity to tax regime in Kenya, and this findings supported the findings of Shah and Slemrod (1990) that tax effects on FDI are quite strong, albeit this study including others were done over periods that spanned well over three decades.

5.2 Recommendations
In view of the sensitivity of FDI to tax regime in Kenya, Kenya must aim for tax rates closer to but not lower than the foreign country rates to eliminate any tax induced disincentives for investment as well as to ward off against any possible transfer of revenue from Kenya to other countries.

Kenya has already implemented tax reforms which make the tax regime here competitive with the other countries. Furthermore, effective taxation of reinvestments in Kenya is
lower than that of repatriations providing incentives for retained earnings. With the tax changes introduced over the years, the Kenyan tax system does not provide any special disincentives for foreign investment. In view of this, perhaps public policy attention needs now to be focussed on accelerating the process of deregulation of FDI already initiated in Kenya.

An important implication of the conclusions reached here for other developing countries, especially for those where the degree of FDI penetration is large, is that they need not worry about providing special tax incentives for foreign investment but must insure that their tax system is competitive with the foreign country tax regime.

5.2.1 Limitations of the Study

i. The study findings cannot be generalised to taxation since there are other factors that affected FDI.

ii. The data available was over a period of 10 years while other empirical study periods spurn beyond two decades.

iii. The study did not obtain all the data elements for the models for the effective rates, such as the fourth independent variables- an average measure of tax disincentive. The results may not therefore give the best results possible.

5.3 Suggestions for Further Research

There is an overriding conclusion captured in this study, and that is much of the volume of FDI inflows seems to be driven by taxation. However, the taxation policy of neighbouring countries are relatively the same, with these enjoying greater FDI inflows than Kenya at Kshs 22.4 billion and Kshs 17.6 billion for Tanzania and Uganda respectively over the same period. It is a recommendation of this study that future studies in this area evaluate the extent to which other factors besides taxation impact FDI.
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APPENDIX:

**Marginal Effective Tax Rates**: The following formulation developed by Auerbach (1990) is used in the calculation of marginal effective tax rates.

\[
r = \frac{[(r + \delta)(1 - t) - \delta) - s}{(r + \delta)(1 - t) - \delta}
\]

where:
- \( r \) - effective corporate tax rate
- \( t \) - weighted average cost of capital
- \( \delta \) = capital depreciation rate (assumed value)
- \( \tau \) = corporate tax rate (Kenya)
- \( s \) = rate of return to supplier of funds (calculated based on data from IMF: International Finance Statistics, various issues).

**Marginal effective tax rate for transfers** \( (r_a) \) utilizes the following expression for the weighted average cost of capital \( (r) \).

\[
r = \frac{\pi}{1 - \Phi} + (1 - h) \left[ \frac{\mu}{1 - \Phi} \right] - t_k
\]

Where:
- \( h \) - fraction financed by debt
- \( \mu \) - real discount rate for equity
- \( t_k \) - host country corporate tax rate
- \( \pi_k \) - Host country inflation rate
- \( t \) = the Kenya withholding tax on interest payments
- \( \phi \) = effective tax rate on real equity return

**For retained earnings**: \( r = \frac{\mu}{1 - \phi} \) is utilized in the effective tax rate formula.