

**THE FACTORS DRIVING FOREIGN DIRECT INVESTMENT INFLOWS IN KENYA:**

**1980-2020**

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**A RESEARCH PAPER SUBMITTED TO THE SCHOOL OF ECONOMICS IN PARTIAL  
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# Declaration

## Declaration by the Candidate


This is to declare that this thesis is my original work and has not been presented for a degree in any other institution.

Sign.....  ..... Date..... 30/11/2022 .....

**Purity Wanjugu Mahugu**

**X50/70235/2019**

This thesis has been submitted for examination with my approval as a University supervisor.

Sign.....  ..... Date..... 30/11/2022 .....

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## Dedication

I also dedicate this research paper to my many friends and family especially my parents: *Joseph Karimi and Janet Mahugu* who have supported me throughout the process.

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# Table of Contents

Declaration .....	ii
Dedication .....	iii
Acknowledgements.....	iv
Table of Contents.....	v
List of Figures .....	vii
List of Tables.....	viii
Acronyms and Abbreviations.....	ix
<i>Abstract</i> .....	x
CHAPTER ONE .....	1
INTRODUCTION .....	1
1.1 Background of the Study .....	1
1.2 The FDI Trends in Kenya.....	3
1.3 Eastern Africa FDI Inflows .....	6
1.4 Evolution of FDI policies in Kenya (1980-2021) .....	6
1.5 Statement of the Problem .....	9
1.6 Research Questions .....	10
1.7 Objectives of the Study .....	10
1.8 Significance of the Study .....	10
1.9 Organization of the Study .....	10
CHAPTER TWO .....	11
LITERATURE REVIEW .....	11
2.1 INTRODUCTION.....	11
2.2 Theoretical Literature .....	11
2.3 Empirical Literature .....	13
2.4 Overview of Literature .....	15
CHAPTER THREE .....	16
RESEARCH METHODOLOGY .....	16
3.0 Introduction .....	16
3.1 Theoretical Framework .....	16

3.2 Empirical Model.....	19
3.3 Data, Data Types and Sources.....	21
3.4 Estimation Techniques .....	21
CHAPTER FOUR .....	22
DATA ANALYSIS, RESULTS AND DISCUSSION .....	22
4.1 Introduction .....	22
4.2 Summary Descriptive Analysis.....	22
4.3 Normality Test.....	23
4.4 Correlation Matrix.....	24
4.5 Stationarity Test.....	25
4.6 Regression Analysis .....	26
4.7 Discussion of Results .....	27
CHAPTER FIVE.....	29
SUMMARY, CONCLUSION AND POLICY IMPLICATIONS.....	29
5.1 Introduction .....	29
5.2 Summary and Conclusion .....	29
5.3 Policy Implications.....	30
REFERENCES .....	31

# List of Figures

Figure 1: Trends of FDI Inflows in Kenya from 1980 to 2020 .....	3
Figure 2: Factors that make Kenya a competitive Investment Destination.....	5

## List of Tables

Table 1. 1: Regional FDI Inflows from 2014 to 2019 in Millions (KES).....	6
Table 4. 1: Descriptive Analysis Results.....	22
Table 4. 2: Summary of Normality Test Results - Shapiro-Wilk Approach.....	23
Table 4. 3: Summary of Feature Correlations .....	24
Table 4. 4: Summary of VIF Scores.....	24
Table 4. 5 Summary of Stationarity Test - ADF Technique.....	25
Table 4. 6: First Order Differencing.....	26
Table 4. 7 Summary of Regression Results .....	26



# Acronyms and Abbreviations

ADF	Augmented Dickey-Fuller
EPZ	Export Processing Zone
FDI	Foreign Direct Investors
GDP	Gross Domestic Product
GDPR	Gross Domestic Product Growth Rate
GLS	Generalized Least Squares
GMM	Generalized Method of Moment
IM F	International Monetary  Fund
INF	Inflation
IPAs	Investment Promotion Agencies
IPC	Investment Promotion Centre
IT	Information Technology
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
MNE	Multinational Enterprise
NSE	Nairobi Securities Exchange
OECD	Organization for economic cooperation and development
OLS	Ordinary Least Squares
RER	Real Exchange Rate
UNCTAD	United Nations Conference on Trade and Development

## Abstract

*In the last 60 years, the government of Kenya has used numerous policy attempts to attract more significant FDI. Despite these efforts, FDI inflows have fluctuated over time. The major goal of the study is uncovering aspects that affect FDI inflows to Kenya, including real exchange rate, inflation, GDP growth rate, corruption index, tax incentives, ease of doing business, and political stability. This paper analyzed the link between independent variables and FDI, then made policy suggestions. The method of analysis utilized time series data between 1980-2020 from World Bank development indicators and KNBS (foreign investment survey reports and economic surveys). The Ordinary Least Squares (OLS) was employed in the analysis. According to the regression analysis, our model is typically significant, and all independent variables are jointly significant in estimating FDI. GDP growth rate explains FDI flows into Kenya the most. The variables which include rate of GDP growth, inflation, real exchange rate, the ease of doing business, and corruption index had a positive influence on FDI. On the contrary, tax incentives and political stability influenced the FDI negatively. In conclusion, FDI inflows play an important role in the expansion and growth of the Kenyan economy.*

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background Study

Historically, governments have applied various policy instruments to attract foreign investors into their economies. Foreign Direct investments (FDI), as defined by Devereux & Griffith (2002) is a cross-border financial flow, which play an active role in rejuvenating an economy's growth through international economic integration. According to the OECD in 2002, FDI is a source of private financing for developing countries. It's an essential element for a transparent and effective international systems of economy and significant promoter of development. Foreign direct investment is the primary catalyst for other types of economic flow and the world's greatest source of capital. This explains why governments worldwide, especially African governments, have been formulating and implementing FDI-motivated economic policies to position their countries at competitive edges relative to other nations. Lai et al. (2001) note that African countries have made effort to liberalize their economies. Since the mid-1980s, there has been foreign investment campaigns, reduction of entry and foreign-owned barriers, enhancements of legal and regulatory framework for FDI. Similarly, the creation of investment driven agencies to publicize commerce prospects and the international regulation of investments through mutual investment agreements have been evident.

According to Tung and Cho (2000), foreign direct investment is stimulated mainly by investors' expectations to make profits in the long run and from production activities they directly control. Dunning (1998) notes three key elements that motivate firms to act as MNEs: advantages related to ownership, the longing to adopt the rewards, and the gains accrued by joining the location-specific resources with these assets. In addition, Gachino and Rasiah (2003) identified various drivers that account for FDI. The need by foreign investors to attract new sources of demand for their products include; entry to markets where excessive gains are attainable, enjoyment of full benefits from economies of scale, and cheaper factors of production (e.g., labor, land). Similarly, there is also the reaction to trade restrictions and foreign currency volatility, and the existence of a stable political environment. Therefore, FDI can be efficiency-seeking, market-seeking, and resource-seeking.

A country may require substantial inflows of foreign investments to attain a sustainably high trajectory of economic growth. If the Kenyan economy is to grow at the anticipated rate of 10% annually, there needs to be an investment of about forty percent of her gross domestic product. The national savings, however, falls short of FDI by 10%. Foreign direct investments and borrowing are expected to meet the savings-

investments gap. In their efforts to woo foreign investors to invest in Kenya, successive governments have focused mainly on expanding and improving infrastructures. There have also been efforts to offer incentives for particular production activities, strengthening the ease of doing business, ensuring political stability, developing human capital, and ensuring efficiency and effectiveness of property rights and legal structure. These are crucial in promoting growth and investment (Glaeser et al., 2004).

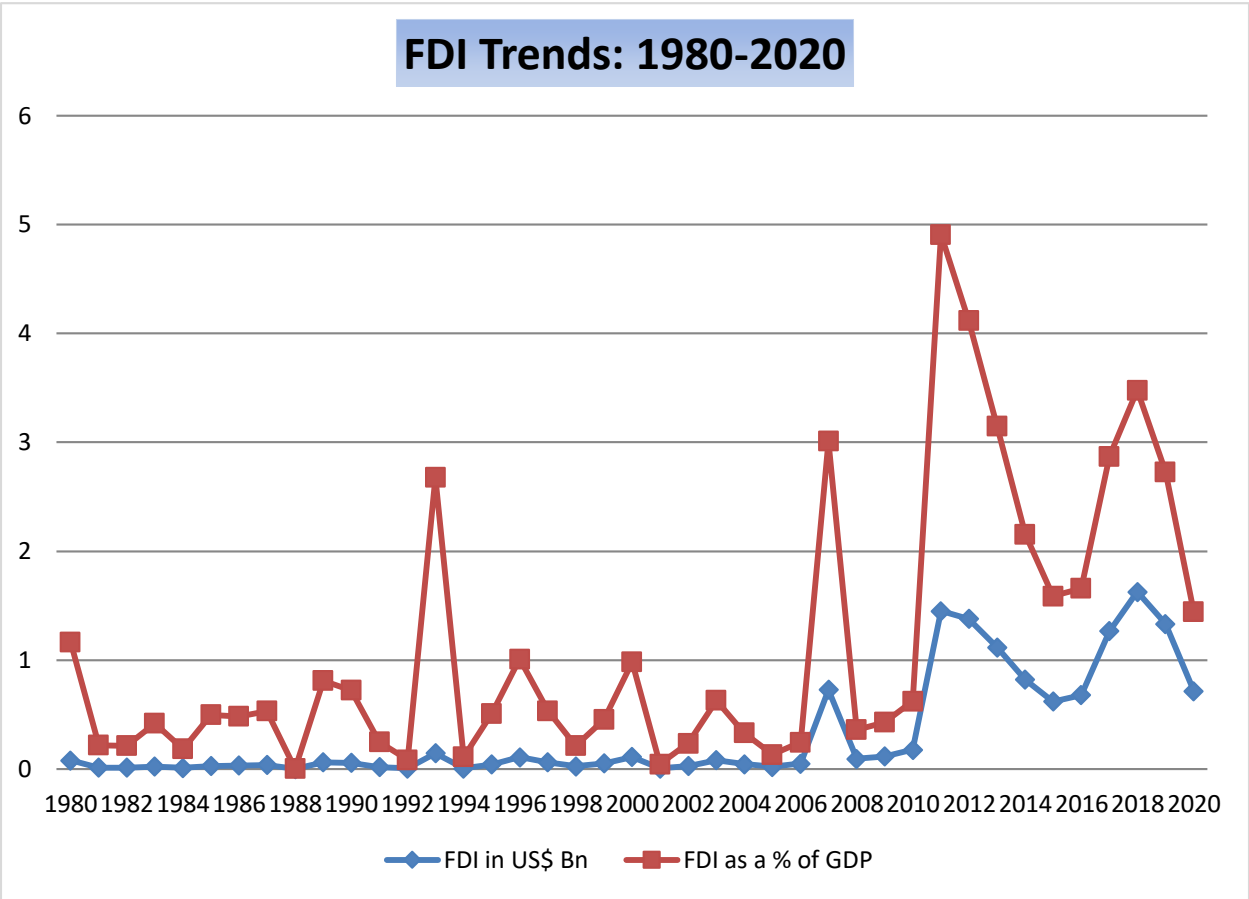
FDI is defined as the amount of equity capital invested in a country and reflected in its balance of payments (UNCTAD, 2014). There are five distinct forms of foreign direct investment: horizontal FDI, vertical FDI, conglomerate FDI, and Greenfield & brownfield FDI. Horizontal FDI is where a company extends its operations by opening another company in a foreign country to produce similar products as the parent company. As such, the investor cuts the tariff and transport costs. An example is the Toyota Company, which manufactures identical vehicles in Japan and the UK.

On the other hand, vertical foreign direct investment happens when an investment is made within an existing supply chain of a company that may or may not be engaged in similar production activities as the investor company. Low-cost inputs such as cheap labor and raw materials play big role when making considerations. Vertical FDI is further subdivided into backward and forward vertical integrations. In regard to forward vertical integration, investments are made to another company abroad ranked higher in the chain of supply, e.g., a grocery company in Kenya investing in a coffee company in Ethiopia. In the case of backward vertical integration, the investing firm acquires a supplier in the supply chain (moving towards the raw materials), e.g., the Argo tea company in the USA investing in tea plantations in Kenya. Conglomerate FDI is where investments are made in two distinct companies of entirely different industries, for instance, the Kenyan retailer Naivas investing in Jaguar motors of Britain. Greenfield investment is made when a company or an individual purchases the bonds or stocks of an already established company. An investor would choose to undertake Greenfield projects where there is little local competition in each line of business or when there are no acquisition opportunities in the target market. In the case of brownfield investment, an investor purchases a production facility or an existing business.

Investment in a foreign firm might take the form of equity capital, intra-company loans, or retained earnings, as stated by UNCTAD (2008). Equity funding involves a domestic investor buying stock in an overseas firm. Reinvested earnings consist of the investor's retained profit which is reinvested by affiliates. A parent business is expected to own at least ten percent of ordinary shares if unincorporated or its equivalent for the incorporated enterprise in order to meet the threshold for the control of assets used in production abroad.

## 1.2 The FDI Trends in Kenya

Figure 1: Trends of FDI Inflows in Kenya from 1980 to 2020



Source: UNCTAD, FDI/MNE database

Foreign Direct Investment inflows remain relatively low in Kenya, considering her economic size, level of development, and policy initiatives implemented by the government to attract more FDI. Kenya, nevertheless, is among the highest recipients of FDI in Africa. There had been a steady FDI growth in the 1970s, and Kenya served as the gateway for foreign investors who sought to penetrate the Southern and Eastern African markets. The relatively higher level of growth and development, better infrastructure, openness to foreign investments when other nations had relatively closed trade regimes, the country's increased market size and the subsequent influx of foreign direct investment (FDI). In 1970, FDI stood at \$10 Million and rose to \$80 million between 1979 -1980. FDI inflows started to fall from 1981 -1999, averaging only \$22 million annually due to deteriorating economic performance. This was due to inconsistent structural reforms and economic policies, poor quality infrastructures, poor public services, and growing corruption problems in governance. FDI flows to Kenya fell even further when Tanzania

and Uganda opened their economies to foreign investors in the 1990s, when Kenya's economy was in a slump.

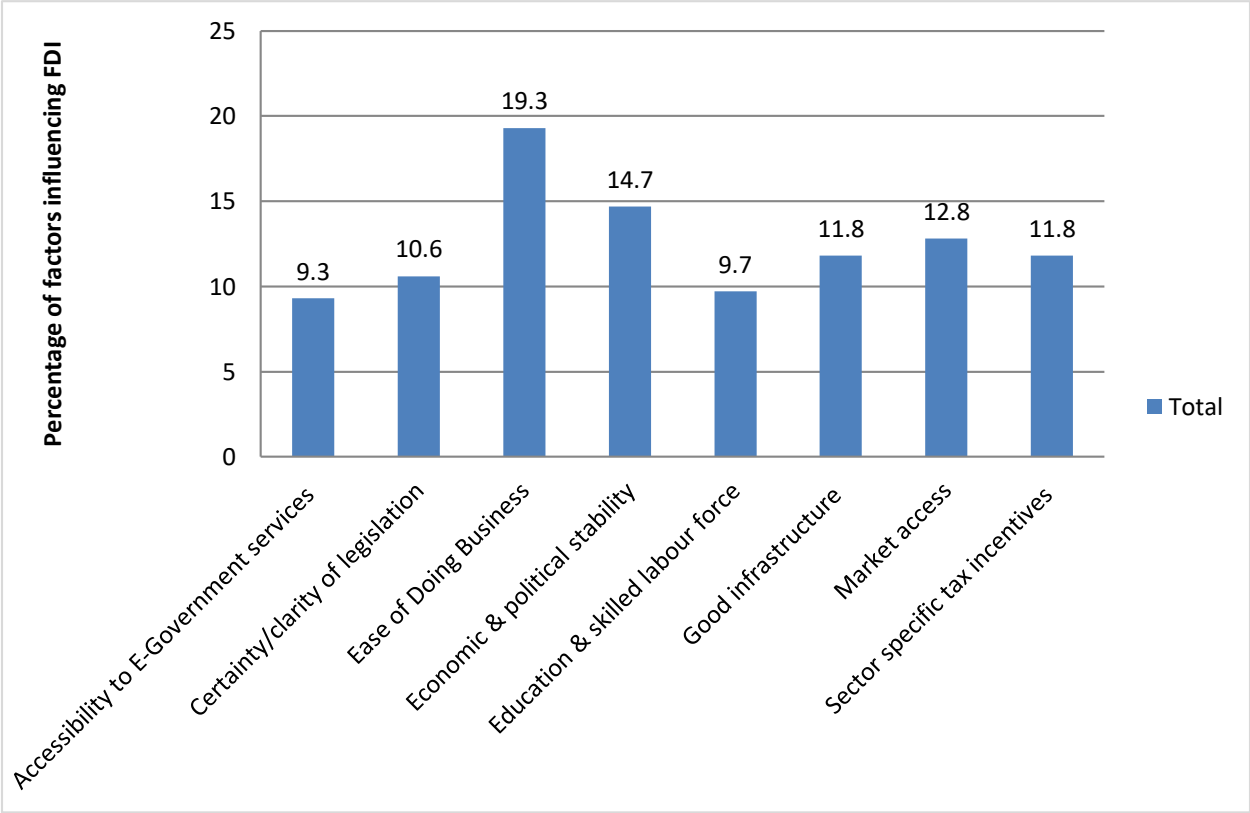
Data from UNCTAD (2011) show that Tanzanian and Ugandan governments have made great strides in making their nations more attractive for investors since 1994. Discovery of oil and gas reserves and various business tax incentives attributed to Uganda's FDI growth (Ngowi, 2005). The increase in FDI inflow in Tanzania has been explained by the mining sector, especially tanzanite, uranium, oil, and gas discoveries. Arguably, according to Kajara (2010), Tanzania also has favorable policies that have deregulated foreign and local investments. The end of South Africa's apartheid in 1994 brought on board more competition to Kenya in attracting large MNEs, especially those searching for an English-speaking nation in the continent to set up their headquarters. In 2000, FDI inflows to Kenya dropped to about their average in the 1980 and 90s despite the over \$100 million earned from selling mobile phone licenses to Kenya-international joint enterprises. The inflows rose later in 2003 following investments in textiles through EPZ. According to UNCTAD (2004), the FDI stock in 2003 represented a mere 7.5 percent of the Gross Domestic Product as contrasted with Africa's 25.3 percent and 31.5 percent for all developing countries.

With the entry of a new government in 2002, coordinated efforts to enact economic and social policy reforms were made to place Kenya on a sustained high-growth path. One of these reforms was adopting an economic recovery strategy in 2003 that focused on wealth creation. The strategy incorporated reforms to accelerate economic growth through wealth creation and the stimulation of private investment. It also aimed to attract higher FDI inflows and enhance their contribution to economic development. Between 2004 and 2013, the stock of FDI averaged about 5.5% of the economy's GDP. With the Vision 2030 economic plan launched in 2008, there has been efforts to lure more FDI to expand the economy's growth. It aims at transforming Kenya into a middle-income state, induce more industrialization and attain a GDP rate of growth of 10 percent by 2030.

Despite the new projects in the health and IT sectors, the 2020 UNCTAD World Investment Report indicate that inflow of FDI to Kenya dropped in 2019 by eighteen percent to \$1.3 billion from \$1.6 billion in 2018. The investment in fiber optic in 2009-2010 in the ICT sector has enabled it to attract more FDI relative to other sectors. Banking, infrastructure, extractive, and tourism industries are the other sectors the FDI targets. The top investors in Kenya are from the United Kingdom, Mauritius, Belgium, South Africa, the Netherlands, and China (KNBS, 2018). Following the Covid-19 pandemic, which struck the global economy in 2020, FDI inflows have fallen significantly, with the UNCTADs Global Investment Trends Monitor indicating that flows of FDI to Sub-Saharan Africa felt by 11 percent to about \$28

billion. In Kenya, the FDI inflows is approximated to have decreased by about 44.8 percent to \$717 million in 2020 from \$1.3 billion a year earlier (UNCTAD, 2020).

**Figure 2:** Factors that make Kenya a competitive Investment Destination



**Source:** KNBS Foreign Investment Survey 2018 Report.

### 1.3 Eastern Africa FDI Inflows

Despite the continued attempts by the Kenyan government to ensure a more favorable investment climate in the country through policy initiatives and expenditure, Kenya FDI inflows has been relatively low in the region. Ethiopia, Tanzania, and Sudan have been highly competitive, with each controlling a fair share of the total inflows of FDI to Eastern Africa, as shown in Table 1 below.

Table 1. 1: Eastern Africa FDI Inflows from 2014 to 2019 in Millions (KES)

Year	2014	2015	2016	2017	2018	2019
Kenya	821	620	679	1266	1626	1332
United Republic of Tanzania	1416	1561	864	938	1056	1112
Uganda	1059	738	626	803	1055	1266
Ethiopia	1855	2627	4143	4017	3310	2516
Somalia	261	303	330	369	408	447
Rwanda	459	380	342	356	382	420
Burundi	47	7	0.1	0.3	1	1
South Sudan	44	0.2	-8	1	60	18
Sudan	1251	1728	1064	1065	1136	825

Source: UNCTAD, FDI/MNE database

### 1.4 Evolution of FDI policies in Kenya (1980-2021)

#### 1965 - 1986

The government of Kenya has been active in tailoring and enacting economic reforms to allure more inflows of FDI. Several economic amendments and policy initiatives formulated purposely to foster increased flows of FDI to Kenya were outlined in the Sessional Paper No.10 of 1965. From 1965 – 1985, the government administered a strategy on import substitution, but this was overturned by the 1986 Sessional Paper No.1, which advocated for an export-driven industrialization structure. The KenInvestment Centre, formerly known as the Investment Promotion Center (IPC), opened its doors later that same year in 1986.

#### 1986 - 1992

According to World Bank, 2003, IPC's key role was to market Kenya as an appropriate destination for investors by serving investors with any investment information required, including the licensing process



of new ventures and the country's investment environment. Kenya dropped excessive controls on prices, exchange rates, and interest rates in 1992 when she liberalized her economy.

#### **2004 to date**

Today, the significant FDI governing statutes are contained in the Investment Promotion Act of 2004. Among the other vital indentures capturing the legal framework on FDI are Kenya's 2010 Constitution, the Foreign Investment Protection Act of 2016 (amended), the Companies Act of 2015, and the Companies Ordinance of 2019. To ensure insured FDI against non-commercial risks, the government joined the World Bank's MIGA. MIGA provides insurance covers for cross-border investments in developing countries. To enhance FDI inflows, the Kenyan government instigated the Kenya Investment Policy and Country Investment Handbook in 2019. Investment Policy purpose is to guide drafted laws towards enhancement of investments in the country.

To bolster investors' engagement in the infrastructure sector, the Kenyan government enacted a public-private partnership policy in 2013. An extensive privatization program has been implemented in various sectors, including construction, energy, food processing, and education. The export processing zones and special economic zones have been benefiting from earmarked inducements. To instill a more appealing investment environment in the extractive industries, the government amended the 2015 Mining Law, limiting foreign investors' involvement in mineral mining, gas, and oil sectors. A Business Registration Services Act was ratified in 2015 to supervise the registration of companies and allocate the name registration and a company's concepts to counties. Since its implementation, this Act has ensured a reduced cost in the registration of companies. The Kenyan government introduced the Insolvency Act of 2015 to ameliorate the legislative framework in cases where a company becomes bankrupt. Until 2015, foreign investors were not allowed to own more than 75% of a firm enlisted in the NSE. However, the government repealed the regulation, allowing foreign investors to own listed companies fully. A regulation was also legislated in 2015 by the government directing that Kenyans should own not less than 15% shares of capital on stock derivatives, including futures and options (U.S. Embassy Economic Section, 2020).

To ensure an improved investment climate, the Kenyan government initiated the Finance Act and Tax Laws in 2018. These were made to lower costs on construction permits, smoothen & ease tax payments via the iTax platform, simplify procedures of registering small businesses and hasten the cross-border movement of commodities through a 'one-stop shop' system

Tax reforms form part of Kenya's policy initiatives utilized to attract FDI. The three main objectives of any tax reforms are to enhance the equitable distribution of income, increase tax revenue to fund government operations, lower government borrowing & stir or demoralize specific exercises. Even so, implementing tax reforms in ways that deliver an ideal tax system, meet the ever-increasing competing needs, and encourage investment through lower taxes has remained a key challenge for most countries. In recog-

nizing that taxation is a crucial policy instrument in influencing foreign investments, Kenya considered reducing taxes, which resulted in tax incentives. Investment promotion incentives and export promotion incentives are the two types of relevant tax incentives in Kenya. While the former refers to tax incentives that affect financial and physical capital, the latter aims to encourage exports by allowing exporters access to inputs at world prices and ensuring competitive produce. For example, Under investment promotion incentives, the Investment Deduction Allowance of 1991 was made to boost investments in equipment, machinery, and buildings for industries; Mining Deductions Allowance aimed at enticing investors to enter the capital-intensive mining industry; the Farm Work Deduction of 1985 to oversee the modernization of equipment and accumulation of capital in the agricultural sector; and Industrial Building Allowances of 1974 aimed at promoting investment in industrial buildings. The three central schemes introduced under the Export Promotion Incentives are the EPZ, Tax Remissions Export Office, and Manufacture under Bond.

However, some regulatory policies implemented by the Kenyan government have given several regional member countries a competitive edge over Kenya. For instance, the requirement by the Mining Act of 2016 that Kenyans should own at least 60% of the mineral dealerships and that the reservation of mining rights for Kenyans has directly restricted the participation of foreign investors in the sector. In addition, the Private Security Regulations Act (2016) directs that Kenyans should hold not less than 25% of shares of any private security firm in the country. Under the National Construction Authority Act (2011), at least 30% of the contractual work in construction should be done by local firms, and foreign contractors are required to pursue joint ventures or sub-contracts with local companies.

Moreover, the Kenya Insurance Act (2010) expects only a maximum of two-thirds ownership by foreigners and that a single person should control no more than 25% of the insurer's capital. According to an ICT policy of 2020, Kenyans can own up to 30% of a foreign firm offering ICT services in Kenya, up from 20%. Taxes were introduced on foreign ship owners by the Finance Act in 2019. The Finance Act of 2020 enacted a 1.5% tax on digital services, which went into force in 2021. (U.S. Embassy Economic Section, 2020). There remains to be a rising uncertainty on the government's plan to better the investment climate in the long run with these conflicting economic reforms and tax policies.

Other policies affecting FDI inflows to Kenya include prohibiting foreigners from owning land (they can only rent for 99 years) and requiring foreigners to invest at least USD 100,000 if they have to enjoy specific incentives from the Kenyan government.

## 1.5 Problem Statement

FDI has been of great significance to Kenya's economic growth for various reasons: technology transfer to Kenya, job creation, ensuring increased efficiency in production and management, solving the problem of savings and foreign exchange inadequacies, and bridging the revenue gap in the country among others. KNBS Economic Survey (2014), indicates 1.2% of the GDP was explained by FDI. The Kenyan government has encouraged FDI further through promotional campaigns, forums, and legal and institutional frameworks. Policy initiatives such as the introduction of export processing zones, the embracement of export-driven strategy, and the elimination of price controls have been part of the country's reforms to stand a chance of attracting more FDI within the region.

As shown in Figure 1, FDI flows to Kenya have been inconsistent despite the government's commitment to providing favorable incentives to foreign investors. The FDI inflows rate as compared GDP have remained the same.

Different research studies have been published to analyze the determinants of FDI (Abala, 2014; Hasli et al., 2015; Muthoga, 2003; Obwana, 2001; Blonigen et al., 2014). According to these studies, economic growth and foreign direct investments are market-seeking. They are both affected by infrastructural development, political stability, exchange rates, lending rates, and the openness of the economy, external debt, market size, corruption index, inflation, GDP, trade balance, and taxation policies. The increasing cases of insecurity and crimes were determined as being some of the main hindrances to FDI inflows and economic growth. However, Kwoba and others determined in a 2016 study that GDP, inflation, and exchange rate had a negligible impact on foreign direct investment.

However, the previous studies have not exhaustively studied the key drivers of FDI inflow, given that there are numerous drivers of FDI across different places in the world. These researchers have also used varying data analysis methods and data sources in their studies on FDI flow. While Hasli et al. (2015) adopted a fixed effects model on panel data, Blonigen et al. (2014) used a Bayesian statistical method, Njoroge (2015) analyzed primary data using descriptive methods. The tools used for analysis by the researchers could have the underlying causes of the varying observations.

As a result of these contradictory findings, the purpose of this study is to explicate the influence of inflation, currency rates, and GDP on FDI influx to Kenya by incorporating tax incentives, ease of doing business, and corruption as independent factors. This study shall use time series data from World Bank, KRA, and KNBS from 1980 to 2020.

## 1.6 Research Questions

The research attempted to answer the following questions:

- i. What are the primary factors influencing FDI inflows in Kenya?
- ii. How do FDI determinants affect foreign direct investment?

## 1.7 Study Objectives

The primary purpose is to identify the drivers of FDI inflows in Kenya.

The specific objectives are:

1. Identifying the drivers of FDI inflows in Kenya.
2. To assess the impact of the factors on Kenya's FDI inflows.
3. To suggest policy implications based on the study's findings.

## 1.8 Significance of the Study

Through FDI, the receiving economies have acquired resources often imperfectly traded in markets, including improving management skills, entry to international production networks and access to established markets, advanced technology, and skilled nature. Such resources accelerate economic growth and facilitate the modernization of the economies of recipient countries. The findings are important to policymakers and policy implementers when coining other policies to lower the volatility of the flows of foreign investments to Kenya. Additionally, the findings can be of use to potential foreign investors in making decisions on investment. The study results also add to prevailing information on FDI.

## 1.9 Organization of the Study

This section discourses the literature review. It is divided into three levels; theoretical literature, empirical literature, and literature overview highlight the gaps identified in the review. It is then followed by the section on research methodology, which includes the theoretical framework to bring out the theory upon which the study is conducted. Independent variables are also discussed, significantly how they impact the FDI. The variables are defined, and their measurements specified in the following section. Finally, in chapter 4 and 5 the data analysis, results, and discussions along with policy implications are discussed. The paper ends with a list of references.

# CHAPTER TWO

## LITERATURE REVIEW

### 2.1 INTRODUCTION

This chapter is divided into three sections. The first section reviews the published theoretical studies on the topic of foreign direct investment. There is an emphasis on empirical literature reviews in sections two and three, followed by a broader discussion of literature reviews in the last section.

### 2.2 Theoretical Literature

FDI attracts and flourish in an economy where the business environment is favorable. Several criteria affect whether or not the economy is favorable to investment. These characteristics are the primary indicators overseas investors use in making well-informed decisions about where to put their money. Ease of doing business relates to the regulatory environment of a country, including its political stability, infrastructure improvements, economic growth rate, real exchange rate, availability of trained people, tax advantages, and clarity of legislation.

Corruption is characterized as the misuse of authority for private gain, which has a chilling impact on an organization's tendency for innovation (Aurora et al., 2015). Wei (2000) investigated the effects of corruption on capital flows in a few nations and discovered that, similar to a tax; corruption inhibited FDI while having a lower effect on other forms of capital. Ketkar et al. (2005) found that FDI increased by 0.5% of GDP for every point improvement in the corruption index. Since its independence, Kenya has suffered from a high corruption rate. This year's Transparency International Global Corruption Perception Index ranks Kenya at 137, up from 144 in 2018. Kenya's success in attracting foreign direct investment (FDI) has lagged below that of its neighbors, Tanzania and Ethiopia (ranked 96th place in 2019). Numerous corruption cases in Kenya identified by investigating bodies have yet to be resolved due to unchecked political influence. According to Habib and Zurywicki (2002), investors often oppose corruption because they regard it as unethical and ineffective.

Governments have a significant role in facilitating the construction of essential physical structures. Whether it's a building or a social or economic system, it can all be considered part of the "infrastructure" category. The term "social infrastructure" refers to the interconnection of housing, schooling, and healthcare systems as well as other essential human development amenities. Production processes and the availability of goods are directly influenced by the economic infrastructure, which includes fundamental amenities like electricity generation, transportation, and communication. Infrastructure is very important

to foreign investors when deciding where to set up their businesses because it helps a country's economy grow. Investment data from 2015 shows that firm efforts in sales, marketing, and production were the most important factors in attracting FDI to Africa. The government of Kenya, since its independence, has done an admirable job of investing in and extending the country's infrastructure to foster the creation of new jobs and the promotion of equitable and sustainable economic growth. Total infrastructure spending for the fiscal year 2015/2016 was KES 41.3B, a 26.7 percent increase from the previous year's total of KES 32.6B. (KNBS 2016). (KNBS 2016).

Taxes and tax policy are crucial to the success of any economy. Taxation is a vital fiscal policy tool used by both emerging and developed countries to influence FDI inflows, typically through the employment of tax incentives (Edmiston, Mudd & Vale, 2014). A tax incentive is a beneficial condition granted to an activity or individual in order to reduce their tax burden relative to the industry average. Direct foreign investment (FDI) in China strongly correlates with tax benefits (Tung & Cho, 2000). These kinds of incentives can make an investor more likely to invest in a certain type of FDI, like a contractual or equity joint venture or a foreign company that the investor owns. Zolt (2014) argues that a nation's investment climate dramatically affects the success of tax incentives in luring foreign direct investment (FDI), with a more favorable investment climate predicting success. Foreign direct investment (FDI) in politically or economically unstable countries cannot be compelled through tax incentives; additional mechanisms, such as arbitration, must be used. Githaiga (2013) found that a shift in tax incentives had a negligible effect on FDI in Kenya.

Nonetheless, the research revealed a significant link between FDI and depreciation provisions. Neither the deduction for industrial buildings nor the deduction for investments in machinery and equipment had any discernible effect on FDI inflows. According to a 6-year study on tax subsidies conducted by KRA, Kenya lost an average of KES 36.8B in revenue per year, or 1.7% of GDP, between 2003/2004 and 2008/2009 due to offering tax benefits. Ngumo (2013) discovered that tax incentives such as farm work allowances, investment expenses, mining operation exemptions, farm work allowances, and industrial allowances significantly affected FDI. According to Thuita (2017), the use of tax breaks also has a positive impact on the attraction of FDI.

Instability in government has been a major drag on economic growth in a lot of countries (Hammed, 2018). Howell (2001) defines political risk as the possibility that a country's political and social environment would cause businesses and investors to lose money. Hussain (2009) adds that the success of a country's business climate depends on how secure the country's government is. Akbar and Khan (2013) found that political instability made investors less likely to make investments because it made the business environment less certain. Loss of life, property, and economic activity due to politically

instigated violence and unrest directly results from political instability. Due to the failed coup attempt in 1982, Kenya witnessed political instability. Struggles for the multi-party system occurred in 1992. Similarly, the political upheaval of 2007-2008 led to a slowdown in economic development from 7% in 2006 to 1.6% in 2007.

Changes in exchange rates have a big effect on the amount of direct foreign investment. The level and volatility of exchange rates are important because they affect how much FDI comes in and how much the government spends. When the value of a country's currency declines relative to that of other countries, domestic production costs become more competitive. It means investors will have a lower relative cost of capital and, consequently, a more significant share of the overall wealth share. Although a currency's depreciation typically attracts FDI because of the convenience of its home country's location, the last two decades have seen significant fluctuations in the value of the currency exchange rate, which has contributed to the unpredictability of the country's investment market. Businesses face substantial exposure to exchange rate risks because such recurrent variations in the rates make long- and short-term predictions impossible, creating uncertainty in the global market. Since exchange rates are frequently adjusted, either willingly or involuntarily, through monetary policies to make an economy competitive on the global stage, research on the correlation between FDI and exchange rates is urgently needed.

According to the World Bank's 2020 Ease of Doing Business Report, Kenya has moved up to 56th place globally in terms of how easy it is to do business from 61st place in 2019. GoK has been enforcing several laws to cut down on the cost and inconvenience of starting a business. Nnadozie and Njuguna (2011) state that a country's level of business friendliness is essential in determining the amount of FDI the country receives. Improvements in business creation, building permit processing, property registration, finance availability, protection of investors, cross-border trade, and enforcement mechanisms are all directly and strongly connected with FDI influx in Asian economies, as stated by Shahada (2014).

## 2.3 Empirical Literature

Analyzing a panel of data from 1990 to 1998, (Kinoshita & Campos2003) determined the patterns of FDI flows in 25 CIS, CEE, and Baltic nations (CEEB). The CIS members were Poland, Armenia, Russia, Georgia, and Ukraine; members of the CEEB included the likes of Poland, the Czech Republic, Estonia, and Hungary. They used the Generalized Method of Moments (GMM) and Instrumental Variable (IV) to conduct the analysis (GMM). These findings suggest that institutions are crucial in determining the location of FDI. Low labor costs, availability of natural assets, and free commerce with other countries were also important factors. It was difficult to collect particular data for many countries, and the results did not accurately represent the individual countries because the research was a cross-national study.

Asiedu (2002) used cross-sectional data from 71 developing countries to examine whether or not the same factors that encourage FDI in other regions are at play in Sub-Saharan Africa. The study included 32 countries from SSA and 39 from other regions. Between the years 1988 and 1997, Asiedu ran his analyses using Ordinary Least Squares. FDI served as the dependent variable, with liberalization, political uncertainty, effective governance, economic development, Gross domestic product, and rate of inflation serving as the independent factors. According to the study, the poorest regions of sub-Saharan Africa do not benefit from an increased marginal capital product or better infrastructural development. Although trade openness positively affects FDI in Sub-Saharan Africa, its effect is smaller than in countries outside of Sub-Saharan Africa. Many investors avoid financial commitments in Africa because they perceive the continent as too risky.

Tefera (2016) carried out research in order to have a better understanding of the factors that drive FDI in East Africa. Using panel data from the International Monetary Fund and the World Bank, indicators were empirically analyzed to find the factors that affected FDI in five East African states from 2000 to 2015. The time period covered by this study is from 2000 to 2015. The problems of heteroskedasticity and autocorrelation were avoided by using the extended least squares model that he developed. Gaussian mixture model was applied to investigate the tracking of the FDI dynamic effects. The findings of the study indicated that the levels of FDI flowing into the five East African nations were influenced by their respective rates of economic growth in terms of infrastructure development, effective real exchange rates, openness to trade, rates of inflation, and levels of political stability. With the exception of inflation, every other indicator had a positive impact on FDI. According to the findings of the study, neither the total capital formations nor GDP had a substantial impact on FDI.

Kwoba (2016) conducted research to determine the effects of various macroeconomic indicators on FDI in Kenya. They discovered that the exchange rate, GDP, and inflation did not have an effect on FDI. According to the findings of the research, FDI is influenced by market forces in addition to monetary policy. SPSS was used to conduct an analysis of the time series data, and the interrelationships between the variables were studied. Abala (2014) highlighted that the key factors of real GDP in Kenya were a growing GDP, solid infrastructure, free markets for products and services, peace and stability, and reduced corruption. It allowed for increased foreign investment and economic growth. Security events and crimes are on the rise, negatively impacting FDI and economic growth. The investigation relied on time series data spanning from 1970 to 2010.

Muthoga (2003) examined the factors that were influencing FDI flows to Kenya from 1970 to 1999 by using the GLS method. The entirety of the theoretical work was carried out in accordance with Wilhelm's (1998) Institutional Fitness methodology. Interest rate, currency rate, GDP growth, savings rate, domestic



credit given by the banking sector, payment of external debt, inflation rate, primary school enrolment rate, economic openness, and FDI all had a role in explaining the amount of FDI. Economic openness emerged as the single most important element in bringing in FDI. The expansion of the nation's gross domestic product, variations in its currency, increases in internal rates of return, and domestic investment were also considered essential.

## 2.4 Literature Overview

Economic openness, inflation, political stability, inflation, the real exchange rate and external debt levels are all factors that affect FDI in developing nations like Kenya, as indicated by a review of the relevant literature. Contradictory findings have been found in numerous investigations. For instance, tax incentives for FDI in Kenya were found to have a positive effect by Ngumo (2013) and Thuita (2017), but to have no effect by (Githaiga 2013 & Tirimba et al., 2016). Kwoba et al. (2016) observed no correlation between these factors and FDI inflows, in contrast to previous research on the drivers of FDI (Hasli et al., 2015; Abala, 2014 & Blonigen et al., 2014). More research on the factors that most affect FDI in Kenya is necessary in light of the contradictory findings in the literature (Njoroge et al., 2015). In order to confirm the link between FDI, GDP, inflation, and exchange rate, the author of this research used time series analysis. In order to account for heteroskedasticity and autocorrelation, an extended least squares model was used. Effects of FDI over time were also modeled using a Gaussian mixture.

# CHAPTER THREE

## RESEARCH METHODOLOGY

### 3.0 Introduction

This section delves into the chapter's theoretical framework, empirical model formulation, variable definition and measurement, estimate methods, and data type and data sources.

### 3.1 Theoretical Framework.

Several FDI models have been put forward to study the key drivers of FDI flows in an economy. Among the factors identified in economic theory as crucial in determining FDI flows include the expected returns from capital investment, high demand for the firm's products, and a business-friendly environment, as investors perceive. Additionally, possession of economic advantages, especially on production inputs, technological and monopolistic advantages by the MNEs over local firms make it possible for them to consider investing abroad.

This study adopted the following specific theoretical model:

$$FDI = RER + INF + GDPR + TI + EDB + CI + PS \dots\dots\dots (3.1)$$

Below is a detailed definition of the variables identified in equation 3.1.

The dependent variable in the model is FDI. Salvatore (2008) created the term "foreign direct investment" to denote money invested in a company based in a country other than the investor's own. Numerous "independent" variables, including the Real exchange rate, Inflation, GDP growth rate, Corruption index, Tax Incentives, ease of doing business, and political stability, all contribute to this phenomenon's explanation.

The implications of corrupt practices on FDI have been the topic of inquiry. According to Akinyemi (2004), corruption develops when individuals in positions of authority steal from those who are more deserving. There are two opposing ideas on FDI in the academic literature. According to the conventional viewpoint, corruption is a vice that hampers foreign investment in a variety of ways. According to the opposing view, corruption has a positive social impact on FDI inflows. According to Alemu's (2012) grabbing-hand hypothesis of corruption, corruption is a vice that increases corporate expenses, attracts lower-quality investments, and decreases FDI inflows. According to a 2008 Transparency International survey, corruption adds around 10% to the cost of investments. (2009, Transparency International)

Kim (2010) found, however, that countries with low levels of democracy and high levels of corruption were more successful at luring foreign investment. According to Gutierrez (2015), high levels of corruption do not hinder foreign investment in Argentina because the majority of these corporations are simply interested in harvesting the country's natural resources.

As defined by Keen & Mansour (2009), a tax incentive is an exclusion, deduction, or exemption from tax burden by a government as a way of enticing foreign investors to engage in specified investment activities. Edmiston, Mudd & Vale (2014) note that tax incentive is one of the key measures used in developing and developed countries to enhance more inflows of FDI. Tax incentives help expand the outlook of investment opportunities and enhance societal welfare through incentives directed toward healthcare and education. According to Klemm & Parys (2009), tax incentives make it possible to lower over-reliance on production in the agricultural sector, which is often distressed by instabilities in the market. Foreign direct investment (FDI) in Kenya is boosted through tax breaks such farm labor allowances, investment write-offs, mining deductions, and industrial allowances (Nagumo, 2013). However, regimes on tax incentives in emerging nations like Kenya are often affected by a lack of transparency, cumbersome administration, and weak designs, which in turn cause distortions in the economy and loopholes for corruption, thus reducing the incentives' attractiveness. Generally, tax incentives tend to attract more efficiency-seeking foreign direct investment, which is motivated by relatively lower production costs. Countries embracing this tax incentives strategy have encountered considerable costs, which include tax evasion, fiscal losses, administrative costs, economic distortions, and rent-seeking. Githaiga (2013) concluded that a shift in Kenya's tax incentives has a little impact on the country's influx of foreign direct investment.

Political stability is a crucial aspect of FDI because investors' confidence in a country's investment climate is greatly influenced by investors' evaluation of the country's political stability (Krugman, 2009). Previous investigations have yielded conflicting results. Foreign direct investment (FDI) is more likely to be made in countries with high levels of political instability and corruption, according to Haksoon (2010). Jadhav claims that FDI is unaffected by government stability (2012). Across all examined factors, political risk was found to be a major deterrent to FDI in Lebanon's economy (Bitar et al., 2019). Political stability, however, has been demonstrated to significantly impact FDI by (Daude, 2007, Tintin, 2013, Benassi et al., 2007).

The majority of studies that have estimated the relationship between FDI flows and business friendliness have discovered a positive correlation between the two. EDB sub-indicators include Contract Enforcement, Starting a Business, Cross-Border Trade, Managing Construction Permits, Property Registration, Access to Credit and Electricity, Taxation, Protection of Minority Investors, and Resolving

Insolvency. Multiple studies on the effect of EDB on FDI in selected Sub-Saharan African states have determined that for every percentage point increase in EDB, FDI flows into the region, resulting in a 0.79 percent net gain (Nketiah et al., 2020). According to Hossain (2018), who analyzed the impact of EDB's indicators on FDI inflows between 2011 and 2015 around the globe, the 'Enforcing Contracts' indicator is substantially connected with FDI inflow. Once procedures such as property registration and credit provision were implemented, it was observed that foreign investment decreased.

Tax payments and the development of new firms were shown to have little impact on FDI. The study indicated that less burdensome procedures for registering property, securing finance, and enforcing contracts increased FDI inflow. Using least squares regression and e-views, the study examined data from 177 nations as part of their investigation of the relationship between the elements. All measures were averaged to assess EDB's impact on FDI, as opposed to examining their individual values.

The GDP growth rate is the annual average production growth rate and is frequently expressed as a percentage of the yearly change in total output level. According to Kandil (2011) and Al Nasser (2010), economic growth is a crucial stimulant of foreign investment inflows. There are numerous reasons why foreign investors would prefer to invest in faster-growing economies. According to Blonigen and Greenaway (2007), economies of scale, production cost efficiency, and production scope are all strongly related to market size. Other factors held constant, Carstensen and Toubal (2004) contend that rapidly growing and larger markets enable greater production efficiency and are thus more appealing to FDI than smaller markets. A high GDP growth rate indicates and measures increased market demand, which appeals to foreign investors. According to Zhang (2001) and Lim (1983), more excellent profit opportunities and higher aggregate demand levels are informed by a higher rate of economic growth, which in turn implies the presence of higher incentives for investments and, as a result, increased levels of foreign investment inflows. Jensen (2003), (Buchanan et al., 2012), and Wint & Williams (2002), noted that the economic growth rate has a remarkable inverse correlation with FDI attraction in developing nations. Although several developed economies experienced a recession in the early 1980s, these countries experienced increased levels of foreign direct investment. As a result, higher levels of foreign investment inflows are linked to high levels of economic growth.

High and growing inflation implies apprehension in a nation's investment climate and depicts the authorities' reluctance to instill stability in her monetary policies. In the case of high inflation levels, FDI inflows would reduce since investors would not be willing to risk their expected profit margins. The higher the uncertainty levels, the higher the chances that investors would ask for higher price levels to compensate for their exposure to inflationary risks, negatively affecting investment volumes. According to study conducted by Singhania and Gupta (2011), the factors that drive FDI in India's inflation rate also

influence the nation's potential to attract new FDI. In an investigation of the relationship between per capita GDP and inflation rate, foreign investment inflows to the United Arab Emirates (UAE) were shown to be unaffected by inflation (Alshamsi et al., 2015).

The currency exchange rate is a crucial economic factor that foreign investors consider when deciding where to spend their capital (Auboin et al., 2011). Numerous theoretical and empirical studies have examined the relationship between the exchange rate and FDI. Generally, the inflow of foreign direct investment is stimulated by currency devaluation in the receiving country, and that currency appreciation lowers the inflow of these investments. A depreciated currency in the FDI-receiving nation implies lower costs of production in terms of the foreign currency and, consequently, higher gains for foreign investors involved in the exportation of commodities they manufacture locally. Higher returns naturally attract foreign investments. Following currency devaluation, the inputs of production become cheaper for foreign investors relative to the domestic investors so that the wealth of the foreign investors, whose capital is held in foreign currency, rises, and makes it easier for them to acquire more of the domestic assets.

Mwega and Ngugi (2005) conducted a study on the impact of the exchange rate on foreign direct investment (FDI) in Kenya and discovered that the real exchange rate is substantially correlated with FDI inflows. In addition, Ogunleye (2008) discovered that a depreciation of the currency rate promoted FDI inflows, while an appreciation of the currency rate hindered inflows. However, investors' decisions to invest in a foreign nation are largely impacted by the anticipated rate of return. Therefore, a currency appreciation in the recipient country elevates investors' expectations of future profitability.

### 3.2 Empirical Model

According to the studied literature and theoretical model, factors such as the real effective exchange rate, inflation, GDP growth rate, tax incentives, and the ease of doing business, the corruption index, and political stability impact the decisions of foreign investors. The following mathematical formulae describe these interactions:

$$FDI = a_0 + a_1RER + a_2INF + a_3GDPR + a_4TI + a_5EDB + a_6CI + a_7PS + \mu \dots \dots \dots (3.1)$$

The table below defines these variables, the symbol used, and the expected correlation.

**Table 3. 1: Variables Definition**

<b>Variable</b>	<b>Symbol</b>	<b>Definition and Measurement</b>	<b>Expected Sign</b>
Foreign Direct Investment	FDI	Defined as the aggregate volume of investment at a point in time. To be measured as a share of the GDP in US dollars.	
Real Exchange Rate	RER	The nominal rate of exchange multiplied by the price ratio between two countries. The US dollar will be used as the base against Kenyan shilling in measuring RER	Positive (+ve)
Inflation	INF	The rate at which general price levels for goods/services rise, resulting in lower purchasing power of currency. A change in Consumer Price Index (CPI) will be used to measure inflation	Negative (-ve)
Gross Domestic Product Growth Rate	GDPGR	The average annual rate of growth of GDP. To be measured as the yearly proportional change of aggregate production level.	Positive (+ve)
Tax Incentives	TI	An exclusion, deduction, or exemption from tax burden by government to investors to invest in or having invested in the country. To be measured as a proportion of GDP and in US dollars	Positive (+ve)
Ease of Doing Business	EDB	Indicates the index of the performance of an economy and a scale of best practice across a set of predetermined parameters	Positive (+ve)

Corruption Index	CI	Countries are ranked on the Corruption Perceptions Index (CPI) according to their perceived levels of public sector corruption, as determined by expert assessments and opinion surveys. Corruption is the misuse of trust for financial gain.	Negative (-ve)
Political Stability	PS	Measured by judgments on the possibility of a politically-motivated violence or/and <i>political instability</i> ; an index relative of other countries	Negative (-ve)

### 3.3 Data, Data Types and Sources

The investigation made use of time series data spanning from 1980 all the way to 2020. The dependent variable in this study is known as foreign direct investment (FDI), and it can be explained by a number of other economic and political factors. Some of these factors include inflation, the real exchange rate, GDP growth, tax incentives, and how easy it is to do business in the country. Other factors include the degree of political stability and the level of corruption. The World Bank and the Kenya National Bureau of Statistics both provide helpful secondary data through their own development indicators (foreign investment survey reports and economic surveys).

### 3.4 Estimation Techniques

The Ordinary Least Squares (OLS) approach is used to estimate the link between GDP, inflation, and the exchange rate since it mitigates the impacts of heteroscedasticity and autocorrelation. To evaluate the time series characteristics of variables, unit root tests and stationarity tests are conducted at each level. A stationarity test is one approach to assess the number of differentiations a variable experiences before reaching stationarity. Cointegration is used to determine whether or not two or more variables have maintained a consistent correlation throughout time. The augmented Dickey-Fuller (ADF) test is employed to determine the order of integration of economic variables.

# CHAPTER FOUR

## DATA ANALYSIS, RESULTS AND DISCUSSION

### 4.1 Introduction

In this chapter, the focus is on the empirical results which will be in line with our model developed in the previous chapter. Precisely, this chapter outlines: results from descriptive analysis, normality test, stationarity test, regression analysis, serial correlations, multicollinearity test and discussion of these results.

### 4.2 Summary Descriptive Analysis

**Table 4. 1:** Descriptive Analysis Results

Variable	Mean	Std Dev	Min	Max	Skewness	Kurtosis
<b>FDI</b>	0.803902	0.823729	0.01	3.46	1.594728	2.079075
<b>RER</b>	59.19463	31.950349	7.42	106.45	-0.327581	-1.28323
<b>INF</b>	11.64805	8.477629	1.55	45.98	2.106695	5.966977
<b>GDPR</b>	3.866829	2.352491	-0.8	8.41	-0.338469	-0.89007
<b>TI</b>	28.8926	4.475961	23.209	43.42	1.543739	3.22595
<b>EDB</b>	64.17	2.510003	54.98	73.2	0.109352	9.353064
<b>CI</b>	23.37917	2.536531	19	31	0.768518	1.020846
<b>PS</b>	-1.17455	0.124594	-1.43	-0.65	1.80402	7.709694

**Source:** Author 2021

Table 4.1 above outlines the basic features of the variables under study for the period 1980-2020. Over this period, the FDI stock averaged, in KES Billions, at 0.804 and recording a max and min inflows of 3.46 and 0.01 respectively. The FDI had a standard deviation of 0.82 KES in billions. GDP rate of growth averaged at 3.87% over the period, with a peak of 8.41% and low of -0.8% and an overall standard deviation of 2.35%. INF had a mean of 11.65%. The highest average inflation recorded was at 45.98% and the lowest at 1.55%. INF had a standard deviation on 8.48%. RER averaged 59.19, with a standard deviation of 31.95. The highest and lowest RER recorded were of 106.45 and 7.42 respectively. TI averaged at 28.89, with high and low of 43.42 and 23.209 respectively, and a standard deviation of 4.475. EDB score recorded a mean of 64.17 and a standard deviation of 2.5. Highest EDB score was 73.2 and lowest at 54.98. CI averaged 23.379 with a peak of 31 and bottom of 19. Its standard deviation was of



2.537. For PS, the mean was of -1.17 and standard deviation of 0.12, and with a peak and bottom of -0.65 and -1.43 respectively.

While skewness measures the degree of asymmetry in a given probability distribution, kurtosis focuses on examining whether data are light-tailed or heavy-tailed in relation to the symmetrical normal distribution. From the descriptive analysis of data used, FDI, INF, TI, EDB and PS are negatively skewed while RER, GDPR and CI are skewed to the right. Except for GDPR, and based on kurtosis values, all the other variables are heavy-tailed, implying that they tend to be farther away from a Gaussian distribution.

### 4.3 Normality Test

**Table 4. 2:** Summary of Normality Test Results - Shapiro-Wilk Approach

<b>Variable</b>	<b>Statistic</b>	<b>P_Value</b>	<b>Alpha</b>	<b>Comment</b>
<b>FDI</b>	0.809	0.000	0.05	Not Normal
<b>RER</b>	0.902	0.002	0.05	Not Normal
<b>INF</b>	0.810	0.000	0.05	Not Normal
<b>GDPR</b>	0.954	0.096	0.05	Normal
<b>TI</b>	0.455	0.000	0.05	Not Normal
<b>EDB</b>	0.488	0.000	0.05	Not Normal
<b>CI</b>	0.920	0.007	0.05	Not Normal
<b>PS</b>	0.777	0.000	0.05	Not Normal

**Source:** Author 2021

A normality test was done on the data using *Shapiro-Wilk* technique and results tabled as shown on Table 4.2. A significance level of 5% (alpha) was employed to test the hypothesis. The metric was that, if  $p\_value > 0.05$  (alpha), then there is normality in the distribution of data. From Table 4.2, only GDPR has a normal distribution with a  $p\_value$  of 0.096 (which is larger than 0.05). All the other variables do not follow the Gaussian distribution.

## 4.4 Correlation Matrix

**Table 4. 3:** Summary of Feature Correlations

<i>Variable</i>	<i>FDI</i>	<i>RER</i>	<i>INF</i>	<i>GDPR</i>	<i>TI</i>	<i>EDB</i>	<i>CI</i>	<i>PS</i>
<i>FDI</i>	1							
<i>RER</i>	0.410294	1						
<i>INF</i>	0.064572	-0.3013	1					
<i>GDPR</i>	0.273054	0.137749	-0.4525	1				
<i>TI</i>	-0.27708	-0.13429	0.217666	-0.1112	1			
<i>EDB</i>	0.006066	0.023392	-0.02648	-0.23524	0.188132	1		
<i>CI</i>	0.339994	0.235938	-0.11785	0.069326	-0.37197	0.257158	1	
<i>PS</i>	-0.12931	-0.08012	-0.1078	-0.08876	0.045182	0.291209	0.137693	1

**Source:** Author 2021

Table 4.3 above shows how each variable relates to another. The coefficient of 1 across the diagonal makes sense, as a variable is perfectly correlated to itself. These correlations were used to compute the VIF score for each variable. This involved use of linear algebra; creating a new dataframe with the *inverse* of the matrix above.

**Table 4. 4:** Summary of VIF Scores

<i>Variable</i>	<i>RER</i>	<i>INF</i>	<i>GDPR</i>	<i>TI</i>	<i>EDB</i>	<i>CI</i>	<i>PS</i>
<i>InRER</i>	1.179635						
<i>InINF</i>	0.365951	1.494849					
<i>InGDPR</i>	0.038471	0.675209	1.400108				
<i>InTI</i>	-0.316560	-0.314176	-0.136147	1.358322			
<i>InEDB</i>	0.018612	0.226377	0.386596	-0.431107	1.376092		
<i>InCI</i>	-0.278061	-0.162502	-0.193194	0.605322	-0.483714	1.428701	
<i>InPS</i>	0.171677	0.221050	0.120317	-0.067668	-0.254439	-0.140154	1.144715

**Source:** Author 2021

As part of the pre-test, this study utilized Variance Inflation Factor (VIF) to quantify the degree of multicollinearity in the multiple regression variables. Based on the results in Table 4.4, there exists no multicollinearity among the variables. All the VIF scores are less the threshold of 10. The metric was that, if the VIF score < 10, then this would imply absence of multicollinearity and if VIF score >10, then multicollinearity would be present among the independent variables.

## 4.5 Stationarity Test

Analysis of non-stationary time series data gives incorrect and erroneous results due to the non-constant variance and mean of estimations derived from such data. As a result, it was necessary to determine the stationarity state of the employed data and the number of differencing required to make a series stationary. To test for unit roots, Augmented Dickey Fuller (ADF) was used.

The null hypothesis was to be rejected if p-value < 0.05, or similar, the ADF statistic > critical value (both in absolute terms), to conclude that the series is stationary; otherwise, the null hypothesis was to be accepted and series regarded as non-stationary. A significance level of 0.05 was used.

Results of the test were as shown in Table 4.5 below.

**Table 4. 5** Summary of Stationarity Test - ADF Technique

<i>Variable</i>	<i>ADF Statistic</i>	<i>P -Value</i>	<i>Critical -value (5% Confidence Level)</i>	<i>Comment</i>	<i>Order of Differencing</i>
<i>lnRER</i>	-0.742454	0.83544	-2.937	non stationary	
<i>lnINF</i>	-3.456432	0.009179	-2.937	stationary	0
<i>lnGDPR</i>	-3.557269	0.006633	-2.937	stationary	0
<i>lnTI</i>	-2.979271	0.036876	-2.946	stationary	0
<i>lnEDB</i>	-5.173967	0.00001	-2.944	stationary	0
<i>lnCI</i>	-2.620127	0.088908	-2.961	non stationary	
<i>lnPS</i>	-2.291359	0.17477	-2.939	non stationary	

As indicated in Table 4.5, lnINF, lnGDPR, lnTI and lnEDB were found to be stationary at order zero of differencing. However, lnRER, lnCI and lnPS were found to be non-stationary at order zero of differencing. To transform them to stationarity, differencing was further done yielding the following results:

**Table 4. 6:** First Order Differencing

<i>Variable</i>	<i>ADF Stat-Lag 1</i>	<i>P -Value</i>	<i>Critical -value ( 5% Confidence Level)</i>	<i>Comment</i>	<i>Order of Differencing</i>
<i>lnRER</i>	-5.88548	0.000	-2.939	stationary	1
<i>lnCI</i>	-5.741092	0.000001	-2.941	stationary	1
<i>lnPS</i>	-13.565577	0.000	-2.939	stationary	1

Source: Author 2021

First order of differencing the three series converted all to stationarity, with new set of ADF statistics, p-values and critical values as shown in Table 4.5.1.

## 4.6 Regression Analysis

Under this section, the focus is on results of regression model as specified in equation 3.1.1. Ordinary Least Squares (OLS) technique was used in empirical estimation. The estimated model results are as below.

**Table 4. 7** Summary of Regression Results

### Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	0.658 <sup>a</sup>	0.433	0.312	0.68317	0.433	3.593	7	33	0.006	2.102

### Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	p>/z/	95.0% Confidence Interval for B		Correlations		
	B	Std. Error	Beta			Lower Bound	Upper Bound	Zero-order	Partial	Part
1 (Constant)	-3.878	3.515		-1.103	0.278	-11.029	3.274			
RER	0.011	0.004	0.410	2.881	0.007	0.003	0.018	0.410	0.448	0.378
INF	0.042	0.016	0.436	2.717	0.010	0.011	0.074	0.065	0.428	0.356
GDPR	0.140	0.054	0.401	2.581	0.014	0.030	0.251	0.273	0.410	0.338
TI	-0.043	0.028	-0.235	-1.537	0.134	-0.100	0.014	-0.277	-0.258	-0.202
EDB	0.041	0.050	0.124	0.806	0.426	-0.062	0.143	0.006	0.139	0.106
CI	0.051	0.051	0.156	0.995	0.327	-0.053	0.154	0.340	0.171	0.130
PS	-0.403	0.928	-0.061	-0.434	0.667	-2.290	1.485	-0.129	-0.075	-0.057

Source: Author 2021

The results of the regression revealed an R<sup>2</sup> of 0.4325. Foreign direct investment changes in Kenya can be explained by the country's GDP growth rate, inflation rate, real exchange rate, tax incentives, ease of doing business, corruption index, and political stability, albeit this only accounts for 43.25 percent of the variance. With an F-value of 3.59 and a probability of 0.0055 at a confidence level of 5%, we can conclude that our model is statistically significant and that all independent factors were jointly significant in predicting our dependent variable, FDI. Except for TI and PS, all other the variables had a positive relationship with FDI as shown by the coefficients of each feature. This is further discussed below.

## 4.7 Discussion of Results

Foreign direct investment (FDI) and GDP expansion are positively correlated (with a correlation of 0.14). As seen by the accompanying t-statistic of 2.58, the GDP coefficient is statistically significant. If Kenya's GDP growth rate increased by one percentage point, FDI inflows would increase by 0.14 percentage points. This positive relationship is in tandem with economic theory that a growing economy tend to have more business opportunities and potential to earn investors more profits in the long run. This finding confirms to several other studies including those by (Blonigen et.al. 2014, Hasli et.al. 2015 & Abala 2014) and who also found a significant relationship between FDI and GDP in their studies.

We can conclude from the above regression results that inflation and FDI are positively related (coefficient = 0.042). This indicates that Kenya can anticipate a rise in FDI of 0.042 percent for every one percent increase in inflation that the country experiences. At the 5% level of significance, the t-statistic of 2.717 is greater than the p-value of 0.05, indicating that the variable is important in explaining FDI flows. This is because the t-statistic compares to the p-value. This is consistent with the findings of Omweri (2013), who discovered that the inflation rate was an important factor in determining FDI inflows.

A positive coefficient of 0.011 and a t ratio of 2.88 were found to exist between FDI and the real exchange rate. Using the t-test, we find that RER is a crucial variable in describing the dynamics of FDI into Kenya. If the real exchange rate changed by one unit, foreign direct investment (FDI) flows would shift by 0.011 percent. Depreciation raises the relative wealth of potential investors and decreases manufacturing costs in a host country, while appreciation represents a general rise in capital flows or intensifies protectionist tendencies (Cushman, 1985, Mehra & Caves, 1986). Similarly, when there is volatility in the currency rate of the host country, multinational corporations reduce exports to the foreign country and increase capital inputs and production in the host country to compensate.

From the analysis, it was found that the relationship between tax incentives and FDI flows to Kenya is negative. With a coefficient of -0.043, it implies that a unit increase in tax incentives result in reduction in FDI flows to Kenya. A t-stat of -1.537 implies that the variable was insignificant in explaining changes

in FDI flows to Kenya. This study finding is in tandem with the 6-year study by KRA on the impact of tax incentives on FDI flows that Kenya suffers revenue loss due to tax incentive provision i.e. the net FDI flows have not been offsetting the revenue used to provide tax incentives made to encourage more foreign investors to invest in the country.

It was discovered that an improvement in Kenya's business climate led to an increase in foreign direct investment. It was shown that there was a significant link between business friendliness and FDI inflows (coefficient = 0.041, t-statistic = 0.806). Each one unit increase in Kenya's ease of doing business would raise FDI by 0.041 percentage points. This supports previous studies' findings of a positive and statistically significant correlation between FDI inflows and business friendliness (Nketiah et al., 2020).

The relationship between corruption and FDI flows to Kenya was found to be positive with a coefficient of 0.051. A t-stat of 0.995 implies that corruption is statistically significant in explaining FDI flows to Kenya. An increase by 1% in corruption index in Kenya would result to increase in FDI inflows by 0.051%. This finding is echoed in a study by Kim(2010) who found that higher inflows of foreign investment are encountered in countries with rampant corruption.

According to our study finding, political stability relates negatively with FDI flows to Kenya. Its coefficient is of -0.403, implying that a unit deterioration in political stability in Kenya would lead to reduction of FDI inflows by 0.403. A t-stat of -0.434 and p-value of 0.667 means that political stability is statistically insignificant in explaining changes in FDI flows to Kenya. This is in line with a study by Jadhav (2012) who found that political stability had insignificant effect on the flows of foreign direct investments.

## CHAPTER FIVE

### SUMMARY, CONCLUSION AND POLICY IMPLICATIONS

#### 5.1 Introduction

The chapter will include a summary of the study and the study findings, as well as conclusions and policy implications based on the study results. In addition, areas for future research will be highlighted.

#### 5.2 Summary and Conclusion

This study aimed at determining the factors influencing FDI flow to Kenya by utilizing time series data for forty years, from 1980 to 2020, when there had been fluctuations in FDI inflows. Specifically, the study sought to understand the role of GDP growth rate, inflation, real exchange rate, corruption index, political stability, and ease of doing business in explaining foreign direct investment flows to Kenya. Under its pretest, the study presented a descriptive analysis of the dataset and tests on normality, multicollinearity, and stationarity. The study conducted a regression test to examine the strengths and relationships among variables, especially between FDI and the independent variables.

Under the normality test conducted using the Shapiro-Wilk technique, only the series of GDP growth rates were found to be normally distributed. The other series were found not to be following a Gaussian distribution. While testing for stationarity, the log of inflation, GDP growth rate, tax incentives, and ease of doing business were stationary at order zero of differencing. However, the log of the real exchange rate, corruption, and political stability was different to transform them into stationarity. The VIF scores computed showed no multicollinearity in the dataset used.

In regression analysis, the relationship between FDI and GDP growth rate was positive. Similarly, inflation, real exchange rate, corruption index, and ease of business positively correlated with FDI flows to Kenya. On the other hand, political stability and tax incentives had a negative relationship with FDI inflows. With a t- a statistic being more significant than the p-value in the GDP growth rate, inflation, real exchange rate, ease of doing business, and corruption were found to be statistically significant in determining the FDI inflows to Kenya. Only political stability was statistically insignificant in determining the FDI flows to Kenya. As the second objective of this study, the study found out how independent variables affect the dependent variable and the strength of such relationship, explained their directions of associations (negative or positive), and highlighted the supporting literature.

### 5.3 Policy Implications

The inflows of foreign direct investments play a massive role in the growth and development of the Kenyan economy. The following policy recommendations were coined to ensure continued growth in the FDI flows and based on the study results.

There is a need for the Central Bank of Kenya to strive to adopt sound monetary and fiscal policies that will manage to stabilize the exchange rates and inflation. This would cultivate more confidence among potential investors in the possibilities of wealth creation and predictability of the economy's performance.

In addition, the Kenyan government should put more measures in place to strengthen political stability. The country has suffered from inter-community disputes, inappropriate and uncontained political rants, and cyclical conflicts, especially after the presidential elections. It would be advisable that the relevant authorities tighten the governing laws and implement them effectively so that the country stands even better chances to compete in attracting more FDI within the region.

Furthermore, the treasury and KRA should reevaluate the relevance of the continued provision of tax incentives in their efforts to attract FDI. Having found an inverse relationship between tax incentives and FDI inflows in this study, it is essential that the two-state corporations find out the specific type/s of tax incentive/s costing the country her revenue. It would be important that revenue provided for such type/s tax incentive/s be used for other development purposes or be significantly reduced to, at most, match the FDI inflows.

Lastly, the government should strive to put measures in place to improve the investment climate, which will be more attractive to foreign investors. This would imply that the ease of doing business in the country would have been improved. The government should also promote and support more production activities by providing such benefits as subsidies to local manufacturers.



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