EFFECT OF TAX INCENTIVES ON FOREIGN DIRECT INVESTMENT IN KENYA

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A RESEARCH PROJECT SUBMITED TO THE DEPARTMENT OF ECONOMICS, ACCOUNTING AND FINANCE, SCHOOL OF BUSINESS IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR THE AWARD OF POST GRADUATE DIPLOMA IN TAX ADMINISTRATION AT JOMO KENYATTA UNIVERSITY OF AGRICULTURE AND TECHNOLOGY.

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DECLARATION

This research project is my original work and has not been submitted for any degree or diploma in any other university.

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Declaration by university supervisor

This research project has been submitted for examination with my approval as the university supervisor.

Signed: …….. Date: …….

DR. MARION NEKESA

DEDICATION

This research project is dedicated to my parents: Prof. Evaristus M.Irandu and Mrs. Esther W. Makunyi, my siblings: Serah, Benson and Cynthia Irandu and my spouse Louis I. Owaya. I thank you all for being there throughout this journey.

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DEFINITION OF TERMS

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Term	Operational Definition as used in this study
Investment Deduction	Deduction granted on costs of buildings and machinery installed as an incentive to investors (KRA website, 2019).
Industrial Building Allowance	Allowance granted to investors who incur capital expenditure on a building used as an industrial building at the rate of 10% of the cost, net of investment deduction allowance if any (KRA website, 2019).
Wear and Tear Allowance	Allowance granted to investors to cater for the wear and tear on machinery (KRA website, 2019).
Farm Works Deduction	Deduction granted due to the expenditure that is incurred by agricultural land owners and tenants on farm works construction (KRA website, 2019).
Tax Incentives	Incentives that lower the enterprises' tax burden so as to induce them to make investments in selected sectors of projects. These are the exceptions to the general regimes of tax (UNCTAD, 2002).
Foreign Direct Investment	Increase in an investment in businesses that are located outside the nation or economy of an investor and include wholly owned subsidiaries, joint ventures, mergers & acquisitions (UNCTAD, 2002).

LIST OF ABBREVIATIONS

ADB - African Development Bank

DTA - Double Taxation Agreement

EAC - East African Community

EACCMA - East African Community Customs Management Act

EIT - Enterprise Income Tax

EPZ - Export Processing Zones

EU - European Union

FDI - Foreign Direct Investment

FWA - Farm Works Allowance

GDP - Gross Domestic Product

IBA - Industrial Building Allowance

ID - Investment Deduction

IMF - International Monetary Fund

KRA - Kenya Revenue Authority

LDC - Less Developed Countries

MNC - Multi National Corporation

MOA - Mining Operations Allowance

MUB - Manufacture under Bond

OLI - Ownership Location Internalization

PLC - Product Life Cycle

SEZ - Special Economic Zones

TREO - Tax Remissions and Exemption Office

UK - United Kingdom

US - United States

VAT - Value Added Tax

WIR - World Investment Report

W & TA - Wear and Tear Allowance

ABSTRACT

FDI is key to an economy as it creates employment, increases product diversity and facilitates local enterprises access to markets that are international. FDI also drives technology transfer and further helps to offer skills that are superior and techniques in management. As it enhances development in the economy, most countries strive to attract it. It is extremely significant in the world economies in terms of employment, trade and output. Tax incentives play a major role in attracting FDI inflows to countries. Various studies have shown conflicting findings regarding the effects of policies of taxation including tax incentives on FDI. This study was thus undertaken as a result of the various findings. The main objective was to identify the effect of tax incentives on FDI in Kenya. Specific objectives were: to determent effect of ID on FDI in Kenya, to establish impact of IBA on FDI in Kenya, to evaluate influence of W&TA on FDI in Kenya and to determine the impact of FWA on FDI in Kenya. The theories reviewed were: tax discrimination, eclectic paradigm, internalization and product life cycle. This study used descriptive research design. The study was undertaken on foreign direct investments in Kenya as a whole. The period of study was 2008 – 2017 and analysed in quarters. Secondary sources were used to collect data. They included Kenya Revenue Authority database and World Bank database. The relationship between the variables was ascertained by multi-variate regression analysis. Regression coefficients tested magnitude of FDI to the tax incentives: ID, IBA, WTA and FWA. Bivariate correlation analysis and ANOVA helped establish the model's significance. Correlation coefficient (r), coefficient of determination (R^2), and Adjusted (R^2), were found to be 0.803 (80.3%), 0.646 (64.6%) and 0.605 (60.5%) respectively meaning that a 60.5% change of tax incentives attributed to the change in FDI while 39.5% of other factors that influenced it were not explained. The F calculated had a higher value than the critical value which showed that the model was significant in explaining the relationship that existed between the variables and FDI in Kenya. The coefficients that corresponded to ID (0.011) and FWA (0.113) were positive with FDI, while IBA coefficient was negative (-0.025) thus negative relationship with FDI. WTA also had a negative effect on FDI with a coefficient of (-0.003). The p values showed variables significance in predicting FDI. It was noted that only ID (0.003) and IBA (0.006) had a significant influence on FDI while WTA (0.418) and FWA (0.134) did not. The level of significance used was 5%. It is recommended that policy makers control the tax incentives offered as they erode the revenue to be collected by Government and offer low value to the economy.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Makola (2003) noted that FDI is that situation when a company that is foreign creates subsidiaries to offer goods and services. A company undertakes foreign direct investments in foreign nations when it actually has ownership advantage over those local investors. Control and ownership of the foreign investment is however retained in the home or parent country. Countries should work on developing very favourable conditions so as to encourage FDI. Buckley et al. (2006) defined FDI as the process of asset acquisition that are physical in nature including plant and equipment internationally while the operations control remains in the home countries of the parent companies. He posits that FDI takes various forms including the establishment of new firms in the foreign countries either as subsidiaries or branches, expansion of the foreign branches or subsidiaries and acquiring of the foreign business enterprises or their assets.

According to Hayami and Godo (2005), FDI is significant in the developing nations since it has contributed to economic development in areas such as investment, foreign exchange and employment. This alleviates poverty in the host nations. The view was supported by Nwankwo (2006) who stated that FDI not only offers employment but is also an engine that has driven development and growth of the economy in Africa as it facilitates access of local firms to international markets. It provides technology transfer, increases diversity of products, offers superior skills and management techniques. Todaro and Smith (2003) established that flows of FDI close the gap between desired investment and domestically mobilized finance. FDI may raise tax revenue and also improve labour skills, management and technology in host economies. Developing economies in Africa, Asia and Latin America noted the benefits

of FDI which can be seen by the economic policies formulated to improve the domestic conditions. The economic reforms are liberalization of foreign trade, domestic markets, regimes of investment, and state economies privatization. This has affected the nature and flow of foreign investments. The purpose is to continue attracting FDI and in turn maximize those benefits in the economy (Tambunan, 2008).

For Kayonga (2008), attraction of FDI is very key for development strategies for developing nations including Kenya. FDI has gained increased attention by researchers more so with regards to globalization and tax competition which have influenced the flow of international investment. As per the World Investment Report by UNCTAD (2018), the FDI inflow for the world in 2017 was $1429.81 billion. The developed economies had an inflow of $712.38 billion while the developing economies comprising Carribean countries, Latin American countries, continents of Africa and Asia had an inflow of $670.66 billion. Developing economies in Singapore, Korea, China and Hong Kong had significant FDI inflows in 2017 with $124.63, $82.84, $31.66 and $24.68 billion respectively.

The WIR (2018) also reported that Africa had an inflow of $41.77 billion with North Africa leading at $13.27 billion and the lowest being Southern Africa at $3.83 billion. East Africa had an inflow of $7.62 billion with Ethiopia leading with $3.58 billion; Tanzania with $1.18 billion, Uganda with $0.69 billion and Kenya with $0.67 billion in 2017. The FDI outflow for the world in 2017 was $1429.97 billion. The developed economies had an outflow of $1,009.21 billion while the developing economies comprising Carribean countries, Latin American countries, continents of Africa and Asia had an outflow of $380.77 billion. Africa had an outflow of $12.07, with Southern Africa leading at $8.50, West Africa $1.88 billion,

North Africa $1.32 billion and the lowest being East Africa at $0.17 billion while Kenya had $ 0.10 billion in 2017.

Mutua (2011) stated that incentives of tax are deductions, exemptions and exclusions from liabilities of tax that are given to entice investors to engage in specified investment activities. Nwankwo (2006) found that tax incentives consist of designed measures that can affect size, location and industries of FDI projects. They achieve this by altering the risks on the projects or by influencing the relative costs by inducements which are not readily present to the domestic comparable investors. It is also the measures that offer a better treatment of tax of some sectors and activities that are specific compared to what is available to the industry in general.

Morisset (2003) noted that governments are working towards promoting these incentives because they are faced with pressures such as capital movement, globalization and fear of enterprises moving to other countries when they are not given concessions like taxes that are lower and regulations that are lax. Due to limited economic options, developing countries are making tax competition an integral part of their strategies for development. According to Nwankwo (2006), tax incentives are a representation of a statutorily deviation that is favorable compared to the normal or standard benchmarks of the tax systems of a country. Fiscal or tax incentives are realistic policy tools for nations that are developing in attracting FDI as no immediate need has arisen for the governments to search for money to fund investment projects that are relevant as compared to direct financial incentives like grants, subsidies and loan schemes. Tax incentives are policy tools in attracting and retaining FDI.

Morriset (2003) contended that foreign multinationals have benefited from tax incentives and global competition. This is however at the cost of Government revenue, domestic enterprise, workers, local authorities and the large environment. This is because the incentives have only attracted investments that are short term that neither build linkages to the domestic economy nor entice exploitative competition. Chaves (2010) posits that countries have reduced their corporate rates of taxes for specific sectors in recent years with the sole aim of attracting and promoting FDI. Countries have also broadened their tax base by revising the depreciation regulations which has limited the decline in revenues of tax because of lowering the corporation rates of taxes. Various factors impact negatively on FDI such as political instability especially in Africa. Konrad and Kovenock (2009) found that higher taxes discouraged the flow of foreign direct investments while lower or nil taxes such as tax havens encouraged FDI. UNCTAD's WIR (2018) confirmed that tax havens were attractive destinations for FDI. This is because they had nil or nominal taxes. British Virgin Islands had an FDI inflow of $70.78 billion in 2017 while Cayman Islands had an inflow of $30.37 billion the same year.

1.1.1 Tax Incentives

UNCTAD (2005) defined them as those incentives which lower the tax burdens of parties so that they are encouraged to venture in certain sectors and projects. KRA defines tax incentives as those provisions that grant a person or an activity conditions that are favourable which deviate from any normal provisions by tax legislations. These conditions are more favourable compared to those that are granted in the general industry. Mutua (2011) opined that they could be defined as exemptions, exclusions or deductions from any tax liability which are offered as an inducement to invest in specific investment activities such as manufacturing sector. Tax Incentives has various meanings including tax reduction so as to

encourage business operations such as FDI. It can mean special provisions that are purposed to promote certain behaviors that are a response to the benefits of tax. Tax incentives can also mean any provision of tax which entices certain behavioral aspects since objectively and despite the original rationale of the provisions, these behaviors have much more favorable consequences of tax than those of alternative forms of conduct.

Klemm and Parys (2009) stated that the reason tax incentives were granted was to exploit various opportunities in investment where the system of tax was viewed as problematic or hindrance to development. Tax incentives can also promote social welfare by improving education, health and savings for use in the future. In retrospect, tax incentives can be offered so as to discourage activities such as overproduction of produce in agriculture which may cause instability in prices. Basu & Srinivasan (2002) were of the view that it is of vital importance for countries that are less developed to provide them to foreign investors as they experience unfavorable conditions. These conditions include: volatility in politics, investment climates that are very poor, extremely high costs of doing business, instability of the macro-economic environment and infrastructure that is dilapidated. When these incentives are offered, these nations are able to entice the investors regardless of the climate that is hostile. ADB and IMF (2006) researched on tax incentives in East Africa and opined that these incentives were not crucial factors in enticing FDI. They confirmed that most of the countries that have successfully increased FDIs did not give large tax incentives instead, these countries have ensured a predictable macro-economic policy, political stability, infrastructure that is good and of quality and administrative costs that are low incurred during the businesses set up and their running.

Gray (1987) mentioned that countries that offer tax incentives are likely to benefit from gains that are non – economic through industrialization, training, transfer of technology, job creation and increase in tax revenues where the firms, should they have a long run existence, they will pay taxes. Gruber (2005) made a conclusion that since investment decisions are fairly sensitive to various tax incentives, then, tax policies are a powerful tool in influencing the flow of investments. The benefits of tax incentives are meant to reduce levels of poverty, enhance economic growth and contribute to higher employment rates. Tax incentives are exceptions to the general regimes of taxes and can take various forms such as lower rates of taxes, tax holidays, losses that have been carried forward for purposes of taxes, rules of accounting that encourage accelerated depreciation or, tariffs that have been increased which will have protection on domestic or local markets and lowered tariffs on the imported raw materials, equipment and components. Tax incentives are offered or granted to promote specific economic policies thus encouraging investments in certain sectors or zones such as EPZ in Kenya. They also attract FDIs. Tax incentives proponents have argued often that reduced tax burdens offer the investors a high net return rate. This in turn frees up the additional income tax which is then re-invested. By doing so, the host nation therefore enjoys increased FDIs, raising its income and further, benefiting from technology transfer.

In Kenya, tax incentives include; investment allowances, reduced tax rates and tax exemptions. There are also specific tax incentives which are offered and include tax remissions for exports, capital market incentives, capital allowances and EPZ benefits. The incentives are grouped into two: investment promotion and export promotion. The first group includes: investment deduction allowance, industrial building allowance, mining deductions and farm works deductions. These incentives attract physical capital investment like machinery, equipment, industrial buildings such as hotels, mining industry and agricultural

sector. Export promotion incentives include Tax Remissions and Exemption Office (TREO), EPZ's and the Manufacture under Bond (MUB). EPZ's main objective is encouraging economic activity and FDIs while TREO and MUB schemes are there to entice investors to manufacture for purposes of export within the nation (Budget Focus, 2012).

Kenya's tax acts: Value Added Tax Act, Income Tax Act and East African Community Customs Management Act (EACCMA) have provided for tax incentives including; Investment allowance of 150% on capital investments and MUBs for Exports. Others are: import duties exemption and VAT on raw materials and machinery, EAC Duty Remission Scheme for manufacture of goods for export, a ten (10) year corporate tax income holiday for EPZs. Although there is a belief that the fiscal and economic costs are higher than the relative benefits of providing tax incentives for investments, there are still reasons that favour their provision. Experiences that have been felt across nations include: in some the tax incentives failed in stimulating the investments while in some they were eliminated without causing harm to the investment flows in the host countries (Gumo, 2013).

Gruber (2005) noted that tax expenditures are losses in revenue incurred by Governments when it offers tax credits, tax deductions, tax exemptions or tax allowances, rates of tax that are preferential or legal tax payments that have been deferred. In Kenya, incentives of tax for investments have been ineffective in stimulating GDP growth. The current structure has been associated with disincentives that have resulted in massive losses of revenue by the Government in terms of reduced rates of tax, tax exemptions and the tax holidays. In KRA statistics (2009), Kenya approximately lost Kshs.220.8 billion in 2003-2009. Incentives of tax are varied and some are presented here below:

Tax holidays are widespread and very famous tax benefits targeted mainly for new companies and may not be available for operations already in existence. They are mainly linked to firm establishment than to the investment level as new companies are provided a time period where they are offered relief from the paying income taxes burden. An extension of this period can be offered where they pay taxes at a reduced rate compared to other firms in the general industry. According to studies made, tax holidays have been viewed as the least effective and efficient tax incentives forms as they can be administratively burdensome, prone to manipulation leading to losses in revenue and are rarely effective in attracting investors with an interest in long term projects. Some Countries may also achieve the same results that tax holidays will without revenue loss thus they are rendered inefficient (Devereux, Lockwood and Redoano, 2004). Tax holidays however became a disincentive to invest when firms that had huge start-up costs were provided with tax holidays at the beginning when production occurred as the taxes that were paid increased over the project life. This is due to the fact that when losses occur in the tax holiday period, the firms may not be given a chance to carry forward the losses to subsequent tax periods (Gumo, 2013).

In Kenya, this incentive may be applied in instances where no taxes would be paid at any event or where the taxes would be increased after the tax holiday. A ten (10) year corporate income tax holiday has been availed to specific firms that manufacture goods only for export under EPZ. A withholding tax holiday of ten (10) years on dividends and other remittances is also availed to non-residents except for those EPZ commercial licence enterprises (KRA website, 2019). According to the budget focus (2012), researchers recommended that tax holidays be abolished. Various nations no longer offer tax holidays, instead they offer lower rates of tax and selected tax incentives. The reason for this is that the tax holidays have been known to result in ‘tax shopping’. This is where the enterprises immediately exit once the

holiday expires. This has clearly been witnessed at the EPZ. Further, the tax holidays can cause tax shifting where Double Taxation Agreements (DTA's) exist.

A lower income rate of tax in priority areas has been known to create an environment that is incentivized for tax for enterprises that have been categorized as special. When viewed from a perspective of tax policy, these are not unreasonable rates so long as revenue authorities ensure that the companies continuously meet the established conditions to qualify for the incentive. For newly listed firms in Kenya, there are preferential corporate rates of tax that depend on the listed shares percentage such as: 20% rate for 40% listed and issued share capital (five year period), 25% rate for 30% listed and issued share capital (five year period) and 27% rate for 20% listed and issued share capital (three – year period). For Special Economic Zones (SEZ), the corporation tax rate is 10%. This rate is offered for only the first 10 years. A rate of 15% applies for the subsequent 10 years. When firms have operated for 10 years in EPZ, they are granted a 25% rate of tax for another 10 years (KRA website, 2019).

Devereux and Freeman (1995) studied tax effects on FDI and made a conclusion that tax failed to significantly influence investors on whether they are better off making investments in home nations or foreign. The only decisions that are influenced are the countries where FDI should be made. Bénassy Quéré et al. (2005) analysed FDI among eleven (11) countries in OECD for 1984 – 2000 and found a drop of 1% in statutory corporate tax rates of a host nation caused a rise of approximately 4% in FDI in that country. The criticisms of this tax incentive include: they apply only to a small enterprise group and not domestic firms. Further, since there are various preferential treatments of tax that can apply to the firms based on the locations and industries of operation, the same firm's profits are taxed differently with varying rates (Judson, 1998).

The main form of tax incentives is capital deductions which are made at the point of computing the profits or gains of a company or individual for any year of income (Keninvest website, 2019). Capital deductions are tax incentives offered for capital expenditures: ID, IBA, W&TA and FWA. It is a relief of tax derived from qualifying investments expenditure value. Capital deductions offer tax incentives that are higher than depreciation given for assets. It is advantageous as it reduces the firm's taxable income. Investment allowance is made in the acquisition year or an asset's first year of use. The tax allowance will not in later years reduce or lower the basis for a write off. Capital allowances are a common phenomenon with regards to various capital expenditure kinds more so industrial undertakings (KRA website, 2019).

Tax Credit lowers the tax amounts that should be paid. Investment credit is directly related to investments that are fixed. A percentage of investment expenditure is calculated and credited against tax. Tax credits often present the following issues: It is very difficult to define the eligible expenditure, to select the credit allowance rate and restrict their use. This incentive has low benefit for the firms that want quick profits as they prefer to take advantage of tax holidays (Holland and Van, 1998).

1.1.2 Foreign Direct Investments

Corporation tax in Kenya is charged on profits where resident firms (30%) and non-resident firms (37.5%). Labour income taxes are charged on an individual's labour income at a graduated scale rate of between 10-30%. Taxes paid by firms are influenced by the firm's profits, its legal status and source of finance. The systems of tax of both the home nations firms and potential host countries can influence the FDI incentives and how to finance certain FDI patterns (Devereux and Griffith, 1998). Other FDI components may include equity

increases and joint ventures which are comprised of financial capital investments. It is vital to breakdown the FDI components as each responds differently to tax rates and that data on investments in property, plant and equipment was the most appropriate FDI inflows measure since it relates to real investment (Auerbach and Hasset, 1993).

Tomonori (2012) did a research on corporate income tax effect on FDI. He opined that there has been an enhancement on labour and capital liquidity as a result of globalization. This has resulted in an acceleration of the global and efficient capital and human resources utilization. A lot of countries have now seen that it is important to attract FDI in order to vitalize and promote growth in the economy. This can be done by offering and developing environments that are attractive for investments and lowering the corporate tax rates. Joosung (1994) studied the extent of home and host countries tax systems influence on FDI and noted that tax rules significantly affect capital flow from FDI. Taxes in the home countries appeared to significantly impact FDI behavior. Opolot et al (2008) did an evaluation on factors that can determine FDI in countries of Sub-Saharan Africa. He found that the size of the market, development in infrastructure, rate of urbanization, openness in trade and investment rate of return have positively influenced FDI inflows, macroeconomic instability a negative effect while government expenditure, natural resources, financial institutions, wage and political rights were insignificant.

1.1.3 Relationship between Tax Incentives and Foreign Direct Investments

Eke (2003) stated that FDIs have increased and have continued to grow and to play significant roles in the development of several world economies by contributing to the GDP. Morisset (2003) defined tax incentive as a drop in corporate income rates of taxes by taxing or giving temporary rebates for investments of specific types or enterprises. Adegbile and

Fakile (2011) noted that the tax incentives are a part of developing countries tax systems and are usually given by governments so as to offer the investors who are foreign better attractive and conditions that are enticing for them to make investments in their economies. In order to attract FDI, tax incentives have been granted to investors. These incentives are further offered in order to promote some economic policies that are specific for encouraging investments in certain sectors.

Morisset & Pirna (2001) observed that tax policies had an impact on FDI more so the tax havens since international investors had been attracted to those countries. The tax policies have an influence on the choice of suitable investment locations. Goode (1984) researched that tax considerations had an influence on firms' choices. A more positive response was noted by the export oriented enterprises to the influence of rates of tax on the investment related decisions. This was in comparison to those with an interest on the location specific advantages and domestic market thus a much more positive response to the tax incentives.

Ndeche (2002) stated that Kenya was committed to attracting FDI using taxation policies. The Government is offering a myriad variety of tax incentives to the businesses so as to attract higher FDI levels into Kenya. There was a new EIT rate of 25% which was discovered to be competitive internationally. It is also relatively lower and conducive in enhancing the competitiveness of enterprises and attracting foreign investments. In the reports by OECD, researches done have showed that a 1% corporate tax decrease leads to a -0.5% FDI rise. There is however a variation that exists in findings of studies done on corporate taxes. This is mainly because the studies have been focusing on data for aggregated FDI inflows while tax impact on FDI is at firm level mainly. It has been noted internationally that the main factors for promoting foreign investment include big markets, political stability, rich human

resources, continuous improvement of the government and legal services; and tax preference is only one of the factors.

Devereux and Griffith (1998) in their U.S FDI into Europe study established that a 1% effective average UK corporate tax rate drop raised the U.S FDI into the UK by 1%. Deutsche Bundesbank (2005) found a 1:2 relationship for rates of tax and FDI impact. This was in their German firm-level investment overseas study. The flows of FDI into countries in the EU were found to be very sensitive to tax rates changes. Costs of labour and market size with a GDP proxy were other factors that were noted to significantly influence location of FDI. De Mooij and Ederveen (2003) noted a -3.3% median FDI tax-elasticity across twenty five (25) of the studies they did on tax impact on FDI in EU countries. A 3.3% FDI increase was caused by a 1% decline in the rate of tax of the host nation. This number was however found as misleading as tax effects on FDI can vary substantially. This is because of types of taxes, FDI activity measurement, tax treatment of host and parent nations. The foreign enterprises may experience taxes in both host and home nations resulting in double taxation complicating further the expected FDI tax effects.

Gordon and Hines (2002); De Mooij and Ederveen (2003) in their study confirmed that tax influences the level and location of FDI. Devereux and Freeman (1995) did an FDI analysis of seven major trading nations during the years 1984 – 1989. Conclusions were made that tax significantly failed to influence investors' decisions on whether to invest abroad or at home and instead influenced their decisions on the countries to make FDIs. Hansson and Olofsdotter (2010) opined that FDI in Western Europe is affected highly by GDP and agglomeration. FDI amount is impacted highly by corporate rates of tax compared to their impact on investing decisions. A study was done on the impact of state corporate taxes on

FDI. They determined that the effective corporate income rates of taxes of states faced by investors is impacted by the factor of property which is found in the taxes apportionment formula and thus on the FDI fraction that states received. A 1% rise in state corporate rates of taxes causes a 1% decline in the FDI share received by a state thus FDI was found to have sensitivity to state corporate rates of tax (Agostini and Tulayasathien, 2003).

Slemrod (1990) in the study he did on taxation effects on U.S FDI, found that there was existence of a negative influence of rates of taxation on the new transfer of funds and the total FDI. An examination on taxation effects on FDI was done where they found that it reacted sensitively to the policies of taxation of the nations in which it flowed (Cummins and Hubbard, 1995). An argument that incentives of tax are not good for developing nations since they are easily prone to corruption and distort investment decisions. Hence, their objectives are difficult to achieve. They proposed that Governments should establish objectives that are clear, evaluate their effectiveness from time to time and minimize corruption (Easson and Zolt, 2002).

1.1.4 Foreign Direct Investment in Kenya

FDI benefits from good economic policies and results to economic development. Incentives provided by governments attract FDI which has a direct contribution to the sector's growth. There has been an increase on tax incentives focus in developing nations. The reason for this is that investments are needed to ensure faster growth and tax breaks are effective in stimulating the investments (Ndemo, 2008). Thuronyi (1998) noted that to the prospective investors, the tax rates and tax bases of an economy also play a major role in making investment related decisions.

In Kenya, the following sectors have high investment potential: Agriculture, Tourism and Mining. FDI inflows in Kenya have mainly been received in manufacturing, agriculture and service sectors. Kenya's economy has benefited from strong and positive relationships that exist between FDI and its growth. Its impact on our economy has been clearly strong. Various factors contribute to the rise in FDI inflows level in these sectors and include: tax incentives, political stability, infrastructure and cost of doing business. These will play a great role in influencing investments level in developing economies. The country should be aware of the importance to address issues hindering its investment growth by formulating a good policy framework so as to tap the unexploited sectors of the economy (AAI and TJN-A, 2012).

Kenya's large FDI percentage has been export oriented and market seeking. The economy's liberalization has increased FDI and has mainly been concentrated in the manufacturing sector. Vision 2030 was launched in 2008 with the aim of achieving competitiveness in the global market and prosperity of the nation. A renewed commitment of attracting FDI has been promoted by the initiative which has enhanced the process of industrialization. Economic stability, bilateral agreements, market size and political stability are some very key FDI factors for the country and its neighbors'. Barriers of FDI in the country are: corruption, delayed work permits, crime and insecurity, delayed licenses, economic and political instability (Kinuthia, 2010).

The country has experienced dwindling FDI flows in the last three decades compared to its neighbours' Uganda and Tanzania despite the undertaken reforms and rise in foreign investors' incentives. In 1997 – 2001 period, it was highly witnessed since the approximate FDI was 0.6% - GDP whereas 1.9% was the African average. In early 80s, Kenya had

accounted for approximately cumulative net FDI (87%) in East African area but dropped to 22% in 2001 against 42% and 36% for Tanzania and Uganda respectively (Kinuthia, 2010). Kenya now ranks lowest after its neighbouring countries whose tremendous improvement has been propelled by the discovery of natural resources like gas reserves in Tanzania and Oil field in Uganda (Ajayi, 2006). UNCTAD (2005) noted that in the 70s, that Kenya had been one of the highly destinations that were FDI favoured in East African region where the flows were at $10 million and $80 million in 1980s. The inability of Kenya to attract FDI was due to the rise in poor infrastructure, high tax burden, deteriorating public service, inconsistencies in structural reforms and economic policies, corruption and poor governance. This economic backdrop is what led to Kenya being left out of the global FDI flows surge in the mid-1990s.

These two acts: Foreign Investment Protection and Investment Promotion (2004) were formulated to ensure that Kenya has a clear and well-articulated legal framework for FDI purposes. The Investment Promotion Act guides on the legal and administrative procedures that will create and enhance a more attractive climate for investment and trade. Foreign trade is beneficial to Kenya as it results in employment creation and increases foreign exchange earnings. It also promotes the transfer of skills and technology and also enhances backward and forward linkages. Government has increased its efforts in ensuring the promotion of FDI by improving the strategies whose main aim is to liberalise markets and attract investors. It has brought in reforms that are market based and offered incentives to foreign and local investors such as lowered import tariffs, tax incentives, freeing up the shilling exchange rate, cancelling current account restrictions and duties related to exports. It has also permitted citizens and non-citizens to open accounts of foreign currency with local banks and eliminated borrowing restrictions by domestic and foreign firms (Kimonye, 2014).

1.2 Statement of the Problem

FDI is important in the growth of economies worldwide. In pursuing the attraction of foreign investment into their countries, many nations offer exemptions of import duty, holidays of income tax, foreign firms' subsidies and measures such as monopoly rights, infrastructure and market preferences. They have however not determined what the impact of tax incentives on FDI is so as to guide policies that will maximize the FDI inflows (Bouoiyour, 2003). Kimonye (2014) stated that foreign direct investors would consider the following factors when choosing a location for investments: corporate rate of tax and labour corporate tax of host nations. The higher these host nation's tax levels are, they may hinder potential FDI. The results of empirical nature from these various researches show contrasting information.

The findings from the studies by Kemsley (1998) and Billington (1999) show that the host nation's rates of taxes significantly determines FDI inflows while the study by Wheeler and Mody's (1992) posits that host nation's rate of tax is not significant in influencing FDI. Ayanwale and Bamire (2004); Azam and Lukman (2010) did note the existence of a positive relationship between FDI and inflation. Others that were positive included: FDI and openness, FDI and GDP and also FDI and exchange rates. A relationship that was negative existed between taxation and FDI. Inadequate empirical literature in Kenya and inconsistencies in the previous studies results of the exact influence of tax incentives on FDI inflows necessitates further research to be conducted (Kimonye, 2014). Various studies have been carried out on roles of these incentives in promoting FDI, however, their relative impact in the country are yet to be clearly established. In the country, several studies have been done on factors that influence FDI in specific sectors, however, very few have been conducted to assess the nature of the relationship of tax and FDI in Kenya.

Kiarie (2011) studied the factors influencing FDI within Kenya EPZ at Athi River. Munyoki (2011) studied the role of Kenya Investment Authority in attracting FDI in Kenya, Onyango (2011) investigated FDI as an enterprise's operating strategy in the Kenyan cosmetic industry while Githaiga (2013) researched on tax incentives influence on FDI inflows for NSE listed firms. Musyoka (2012) had an objective in his study of doing a correlation between tax incentives and Kenya's FDI. The conclusion was that implementing them failed to cause a significantly improved FDI. Gumo (2013) studied influence of the incentives on the country's FDI while Kimonye (2014) studied an empirical analysis of Kenya's FDI. Few studies have focused on FDI in Kenya and instead focus was on particular sectors such as the Nairobi Securities Exchange and the EPZ. This study is therefore very important as it focused on incentives of tax and FDI in the country. It is against this backdrop therefore that this study aimed at evaluating the effect of tax incentives on foreign direct investment in Kenya.

1.3 Objectives of the Study

1.3.1 General Objective

The general objective was to examine the effect of tax incentives on foreign direct investment in Kenya.

1.3.2 Specific Objectives

The specific objectives were:

1. To determine the effect of investment deductions on foreign direct investment in Kenya.
2. To establish the impact of industrial building allowance on foreign direct investment in Kenya.
3. To evaluate the influence of wear and tear allowances on foreign direct investment in Kenya.

4. To determine the impact of farm works allowance on foreign direct investment in Kenya.

1.4 Research Questions

The research questions were**:**

1. What is the effect of investment deduction on foreign direct investment in Kenya?
2. What is the impact of industrial building allowance on foreign direct investment in Kenya?
3. What is the influence of wear and tear allowances on foreign direct investment in Kenya?
4. What is the impact of farm works allowance on foreign direct investment in Kenya?

1.5 Significance of the Study

Previous research studies have been conducted in various areas of the economy such as the cosmetic industry, export processing firms and listed firms in Kenya. Limited studies have however been conducted on the effect of the tax incentives on Kenya's FDI. This research provided a platform for reviewing of tax policies and conducting evaluations of their effectiveness which can be used in doing a cost benefit analysis and eliminating those with fewer benefits. It can help in the formulation of fiscal policies aimed at encouraging foreign investment in the country, reducing external borrowing, enhancing investment and employment creation. The policies main objective was on how to promote the rate of growth in the nation's FDI inflows performance and to improve world markets trade liberalization. A rise in the country's investment level has a likelihood of increasing government revenue by taxation. The government can determine whether these are right policies for the promotion of FDI in Kenya.

It could be valuable to the Managers, Researchers and the Policy Makers. Managers would use the knowledge from the study to act as catalysts in their various fields of management. It provided more knowledge on what impact tax incentives have on FDI inflows and findings would not only benefit firms in Kenya but over the world. This research provides them with the available tax incentives insight and on how they can be utilized to ensure increase of savings that would aid future investment.

It would be of significance to policy makers since the findings promoted a critical look on how FDI was influenced by taxation and develop strategies of promoting the foreign businesses in Kenya. This study isolated the specific Kenyan factors that influence FDI inflows variability and hence offer direction on how to control it to the country's advantage. The study benefits researchers who may focus on the current tax incentives as being important to foreign investors' decisions in the country as the findings would raise value to the literature in existence. Researchers would find the collected data beneficial and the gathered information would be a secondary data source for their studies. The findings promoted further researches as different research methodologies can be adopted or the analysis period can be extended. They found the research useful as the findings contributed in the discussion regarding the relationship that exists between tax incentives and FDI flows.

1.6 Scope of the Study

The study covered the effect of tax incentives on FDI in Kenya. The tax incentives selected as the independent variables were capital allowances with the dependent variable being FDI.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Theoretical information of variables and also results of previous research studies have been focused on in this review of literature. It ensures that the variables of study are critically operationalized to identify a gap in the existing literature. The chapter focused on theoretical and empirical review done by previous researchers and scholars who had conducted researches on tax factors that had influences on foreign direct investments. This review established the theoretical framework of the study: the effect of tax incentives on FDI.

2.2 Theoretical Review

There are many theories that were developed to give an explanation on the determinants and operations of FDI. Four theories will form the theoretical review of the study and include: Internalization, Eclectic Paradigm, Product life cycle and Tax discrimination. Various Economists noted FDI importance in the development of nations' economies and especially the developing countries like Kenya. The theories discussed aimed to give reasons why multinational companies venture into foreign markets. Taxation and especially tax incentives are an essential determinant in the locational attractiveness of countries to the investors thus promoting FDI. The theories are discussed below:

2.2.1 Product Life Cycle Theory

Vernon (1966) originated the theory where he explained the reason why MNCs move from exportation to FDI. The theory gives an explanation on both trade and FDI. PLC helps them decide whether they should export products or whether they should locate a production unit in other countries. Once the unit is located in a foreign market the MNC benefits from lower

production costs and is better placed to meet the product demand in the countries at a good price thus maximizing its returns. The theory is more crucial during the initial stage of entry for manufacturers in to the markets of foreign nations instead of MNCs already ventured in FDI.

UNDP (2011) noted that FDI had a dynamic model and explained that innovations are likely made in more developed nations like the U.S. Product development is segmented into three different stages. The first is the new product stage where the product is normally introduced to markets for local consumption though some could be exported. The second is the maturity stage where this product is better known to the market and standardization has been done. Firms during this stage have a tendency to venture or expand into new markets. The theory has an argument that FDI comes after the second stage. The companies begin to conduct operations in foreign markets in the less developed nations where they have lower production costs. This is due to enhanced competition in the local market by the local firms. In some instances, the MNCs can operate both locally and internationally at the same time (Woldemeskel, 2008).

The importance of the theory in this study is that it explains a strategic reason that offers motivation to enterprises for investing in foreign nations. With increased competition, the firms establish foreign subsidiaries in the countries that are less developed where they have access to cheaper labour costs. This enhances their competitiveness. This theory argues that FDI is a disadvantage to the source country as it loses its comparative advantage in its innovated product production. FDI is actually a reaction of firms to the threat they face of losing markets in the second stage as a product is maturing. Firms thus go searching for cheaper factor costs to enable them face competition in the imitation gap hypothesis which

has been used to explain for instance the, dominance of Japan. This is in the automobile industry which was initiated in U.S. This necessitated action by the firms in US thus the expansion of US MNCs after World War II (Vernon 1966).

Clegg (1987) noted the shortcomings of the theory by claiming that the product cycle is not a complete theory of FDI since it fails to explain who owns the production. The theory is primarily one of new FDI and has not focused on the extensions of those investments that are already in existence in mature foreign investing countries. Dunning (1993) stated that the competitive advantage of companies was associated with firm – specific advantages and not by the factor costs. In conclusion, the theory states that most products usually follow a similar life cycle pattern where the product in its first stage is an innovation that is sold locally to satisfy the local demand. The product gets exported in stage two and in stage three, firms venture into FDI.

2.2.2 The Internalization theory

Development of the theory was done by Buckley and Casson (1976). This was enhanced further by Rugman (1981) and Hennart (1982). Coase (1937) originated it from a national perspective while Hymer (1976) originated it from an international perspective and established that there were two major FDI determinants. These were the advantages that companies possess while performing a certain activity and removal of competition. For Buckley and Casson (1976), transnational enterprises arrange their activities internally in such a way that they benefit from specific advantages that can be exploited. Internalization can happen in raw materials which have been concentrated geographically, intermediate products during manufacturing processes which are highly capital intensive and agricultural products that have high perishability. The theory clearly gives an explanation on the

motivation of these firms in making FDI and the growth of MNCs because they are able to take advantage of government fiscal policies.

Hymer (1976) noted some of the advantages of internalization include: application of transfer pricing, control of conditions and supply of inputs, control of markets, and avoidance of negotiation and search costs. Other advantages are avoidance of litigation and violated contract and avoidance of governmental intervention such as tariffs, quotas and price controls. Foreign direct investment occurs only when the benefits gained by exploiting the specific advantages are higher than costs of operations in other nations. The challenges that international firms face compared to local firms include information costs, different currency risks and different government fiscal policies.

To respond to any changes in a foreign nation such as exchange rates, government policy or tax structures, foreign investors through the change of direction in flow of resources may change their activities. The flow of these resources is what constitutes conditions for any competitive or location – specific advantages in the world economies. The theory aims to assess the extent by which tax incentives attract foreign investors into their nations. The assumption is that when a firm possesses the internalization advantages, it will exploit them by foreign direct investments rather than by exchange of contractual resources. For foreign investors to undertake activities that are within the multinational, it should be more attractive to them as compared to leasing or buying these from other companies. The unattractiveness or attractiveness of locations where investments can be undertaken by investors can be determined by the tax rate. When companies require input or intermediate products from various suppliers to enable them produce, they have to internalize the supplies so as to reduce the cost of transaction. The theory is backed by the premise that these enterprises only desire

to establish their own internal markets when the transactional costs are lower within the company. This in turn forces the MNCs to open subsidiaries in foreign nations instead of purchasing the inputs from other suppliers (Hosseini, 2005).

This theory gives an assertion that MNCs exert ownership over the knowledge based, intangible, proprietary control or specific advantages that firms possess. These advantages are based on efficiency. The firms have to integrate the new activities and operations that were done by intermediate markets under their governance and ownership. The internalization concept involves vertical and horizontal integration of FDI. The vertically integrated company will internalize an intermediate product market while a horizontal MNC will internalize proprietary assets markets (Caves, 1996). Rugman (1981) stated that as internalization happens, the MNCs will only grow when the benefits are more than the costs. He noted that this is what makes internalization the general theory of FDI.

2.2.3 Eclectic Paradigm Theory

Dunning (1979) developed this theory and it embraces all the existing theories of FDI. It is a blend of the three different theories that are based on these three advantages: Internalization (I), Location (L) - specific and Ownership (O) specific hence OLI framework name or theory. Hosseini (2005) opines that FDI occurs when a firm has all these three advantages. Ownership advantage occurs from management techniques, technology, economies of scale, different products and brands. Ownership advantage also includes tangible assets such as natural main power and capital endowment. Intangible assets include marketing, managerial, technology and information. Others include organization systems and entrepreneurial skill. These ownership advantages offer an advantage of profit over the local companies in foreign countries. Locational advantage is derived from infrastructure, natural resources availability,

political and macroeconomic stability and finally internalization advantage which comes from exploiting imperfections in the external markets. These include: transaction costs and uncertainty reduction so that knowledge is generated with efficiency that is better. For the state, the imperfections include: tariffs, foreign exchange controls and subsidies.

As opposed to franchising, these firms are motivated to do foreign production and take advantage of the social, political and economic characteristics of host countries. The desire for companies to invest in foreign nations will depend on those opportunities and any challenges that are present there. The factors are key in establishing the extent and pattern of foreign direct investment. Dunning (1979) suggested that for FDI to be successful, the firms need to possess ownership advantage over firms from other countries, location advantages where the firms use their ownership advantage in nations that are foreign rather than their own home nations and finally internalization advantages instead of using the market and passing them to the foreign firms.

Denisia (2010) noted that the theory builds up from the other theories and helps to cure their weaknesses. The theories such as internalization and product life cycle partly explained certain aspects that motivated foreign direct investment while the eclectic paradigm combined three aspects into one. She stated that countries can attract FDI by reducing inherent costs. When these countries grant tax incentives, they are able to derive maximum benefit as investors are attracted there. This theory is relevant as it explains why Kenya has been able to attract FDI from the tax incentives it offers. The OLI factors provide MNCs with great interest and confidence to invest their capital in foreign markets.

MNCs decisions to do FDI are complex since these involve strategic decisions. FDI will only be attractive when the OLI condition is actually met for those MNCs that aim to maximize

the value of the enterprises. These MNCs will have to enjoy the advantage of ownership relative to local enterprises ownership through its specific organizational knowledge, technical and tax issues. A condition of attractiveness has to exist for the MNC to produce in foreign nations due to its comparative location advantage since it could have as well chosen to do exportation rather than to invest. This will make it attractive to conduct activities within the MNC rather than leasing or buying from other countries. Taxes may influence OLI by having an effect on the tax treatment of foreign enterprises relative to domestically owned firms whereas the rates of tax can establish the location attractiveness for doing investments. Other factors that influence location include proximity to: markets and other businesses because of good knowledge workers availability, agglomeration, network and infrastructure that is good (Dunning, 1981).

Dunning (1981) posits that companies engaged in FDI should satisfy the three conditions: possess ownership specific advantage, more advantageous to use as opposed to selling or leasing the advantage, third is that it should be of more profit to combine the advantage with some of those factors that are located abroad. The reasons that determine the flow of FDI include search for resources, markets, new strategic assets and efficiency. Buckley et al. (2006) argues that all these advantages are interconnected and influence the decisions of 'why' (ownership advantages), 'how' (internalization advantages) and 'where' (location advantages).

Dunning (2011) made a suggestion that those factors that drive FDI inflows are political stability, market access, economic stability and opportunities which come with the processes of large scale privatization. Woldemeskel (2008) found that incentives such as low interest loans, special allowances of tax, tax exemptions, tax reductions, subsidies, capital repatriation

and transfer of profits influence FDI inflows. When a country has good infrastructure, it minimizes the transaction costs thus attracting investors. Athukorala posits that political instability hinders growth and FDI. This is because it lowers the country's attractiveness as an FDI location by disrupting the peace of a country and destroying the businesses.

Dunning (1979) noted that he was dissatisfied with international production existence theories such as internalization and product cycle theory hence the development of this theory as he considered them to only partially explain it. He thus integrated those theories into a general and eclectic model. Dadzie (2012) argues that a main theory's criticism is that it has various variables hence losing its relevance. Dunning (1988) concluded that OLI advantages were affected by factors like nature and market size, economic development level and industrialization. He also confirmed that the industry's nature where the investors operate in including the technology used, competition, size and age of firms also affected them.

2.2.4 Tax Discrimination Theory

The assertion in the theory is that the governments tend to charge tax at different rates depending on the sectors or regions. The tax rate more often than not is determined by the firms' demand to locate or situate in certain areas. The aim is to enhance greater development in those areas that are less developed in the economy such as towns away from major cities and rural areas. The lower rates of tax, exemptions and holidays of tax are offered to investors to entice them to locate businesses in those regions (Glaeser, 2001). In Kenya, the ID rates differ with regions. Expenditures of machineries and buildings exceeding Kshs. 200 million outside Nairobi, the investor can claim 150% allowance.

There are conditions to enable the effective application of tax discrimination. Availability of basic infrastructure such as good road and telecommunication network in the rural areas is key and the government needs to ensure this. The other important factor is the availability of labour force who will work in the firms of the investors (Glaeser, 2001). Manson (2006) noted that tax discrimination ensures that the non-residents and residents are subjected to different tax regimes while in those same jurisdictions. A resident taxpayer's global income is taxed. A non-resident's only income is that which is derived from the host nation. The European Court of Justice (2007) advocates for tax discrimination as it is important in promoting integration of European common market and economic efficiencies.

A critique of the theory is that some countries that offer tax discrimination do so to support local companies and discourage foreign investment. This is because lower tax rates are offered for the in state companies while foreign companies are taxed higher. Greece is a case example where the national banks are taxed at a 35% rate while a rate of 40% is taxed on foreign banks. The countries can also influence investments into particular foreign countries as opposed to the rest. This is because the government may exempt the foreign business income of its residents from taxation thus encouraging them to invest in only those nations with lower rates of taxes and discouraging them from investing where there are higher rates of tax (Manson, 2006). Different tax rates attract FDI into the country as investors benefit from lower tax rates. Tax exemptions encourage new investment to new firms and startups as their income earned is exempted from taxation. A disadvantage of such incentives is that at the expiry of their term, these investors relocate to other countries or shut down operations and open new firms so as to take advantage of the new incentives of tax (Glaeser, 2001).

2.3 Conceptual Framework

The diagram below shows the conceptual framework which is adopted in the study to snswer the research questions raised. It shows the relationship between the dependent variable and independent variables.

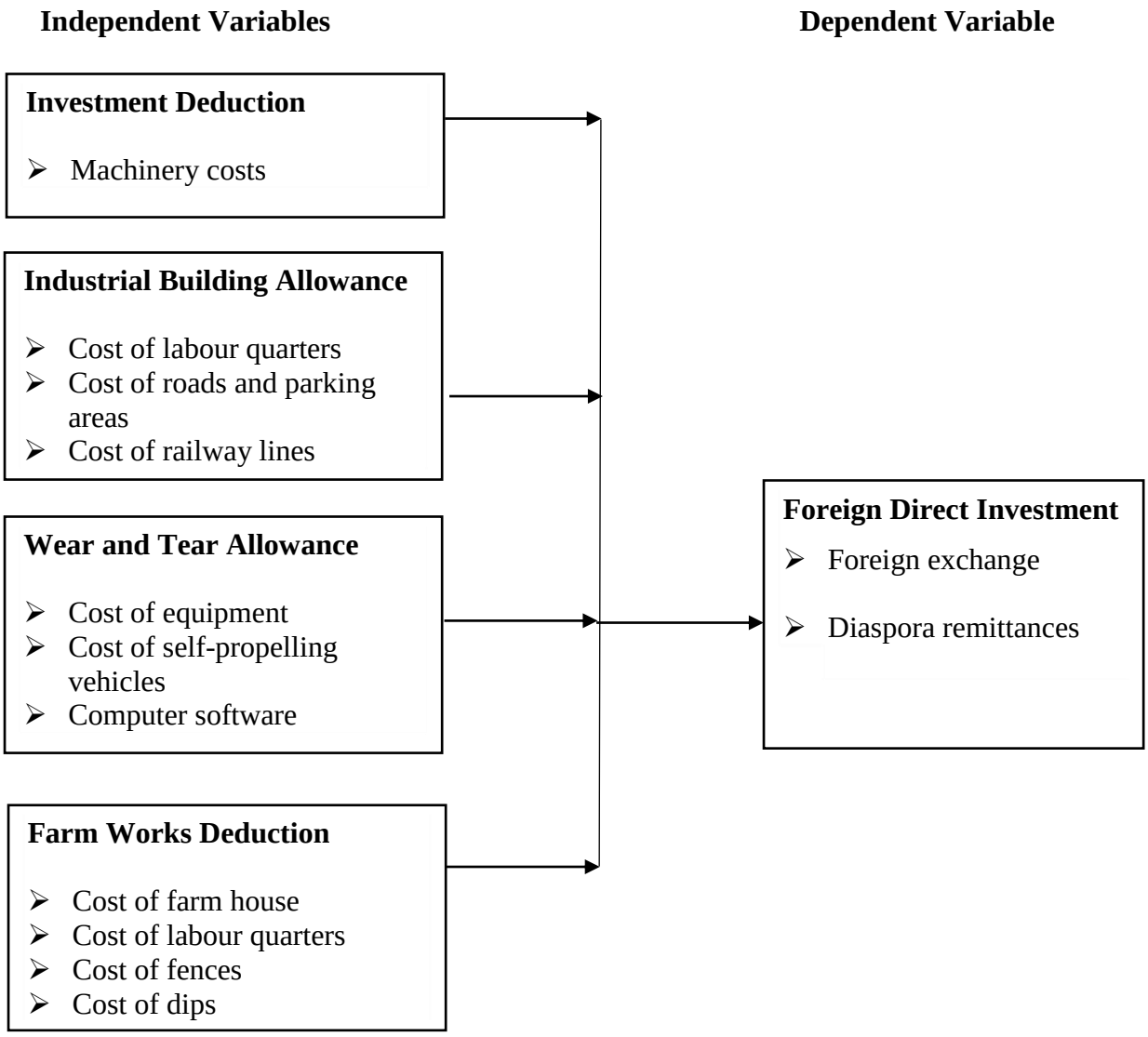

Figure 2.1- Conceptual Framework

2.4 Empirical Review

This section reviews critically the international and local empirical studies which include:

2.4.1 Investment Deduction

Investment deduction allowance was introduced in 1991 with the aim of encouraging investments in physical capital like machinery, equipment and industrial buildings (Budget Focus, 2012). The deduction is granted on the building cost and machinery installed as an incentive to investors. Any investor that has incurred capital expenditure on machinery and/or building used for manufacturing purposes or for use in an SEZ will be entitled to this allowance of 100% of entire cost. Where capital expenditure on machinery and/or buildings exceeds sh.200 million outside Nairobi, an investor is allowed to claim 150% of the cost (KRA website, 2019).

Klemm and Parys (2009) empirically studied the effect of tax incentives. They focused on answering these two questions of empirical nature; effectiveness of incentives in investments attraction and whether incentives are used as tools of competition of tax. Tax incentives data set was collected from forty seven (47) countries in Africa, Carribean and Latin America of twenty (20) years in 1985 – 2004. To answer the incentives as tax competition tools, spatial econometrics techniques for data which is panel in nature were used. Evidence was found for tax holidays strategic interaction and also the corporate income tax rate's well-known competition. There was no evidence found on competition for investment allowances and also tax credits. Dynamic panel data econometrics was used in answering the question on what the effectiveness was of incentives in investment attraction. Tax was the independent variable while FDI and gross private fixed capital formation were dependent variables. Evidence was found that longer holidays of tax and lower tax rates for corporate income were only effective in FDI attraction and not to promote growth or boost the capital formation.

Gumo (2013) studied the effect of the tax incentives on Kenya's FDI. A descriptive study was undertaken. In the study the research design used was descriptive. He collected data from KNBS, KRA and Treasury. The analysis done included: descriptive data, multiple linear regression models and correlation. He noted that the country has many incentives of tax like capital investment allowances: ID, MOA, FWA, IBA and shipping investment deduction. He established that the following investment incentives had a positive FDI effect with ID ($p = .047$) and MOA ($p = .038$) while a negative FDI effect was from industrial building allowance ($p = .054$). He further established that the following trade related incentives had a positive FDI effect with EPZ ($p = .008$) and TREO ($p = .009$) while a negative FDI effect was from manufacture under bond ($p = .004$). He made a conclusion that tax incentives would most likely positively affect FDI effect and recommended Government should make an evaluation on the tax incentives policies.

2.4.2 Industrial Building Allowance

In 1974, the Industrial building allowance was introduced to encourage investment in the industrial purpose buildings like manufacturing plants and hotels (Budget Focus, 2012). It is granted to those investors incurring expenditure of capital on an industrial building at 10% rate of cost, net of allowance on investment deduction if any. This allowance covers capital expenditure that is incurred by individuals on construction of buildings that are industrial to be used in a business that is either carried out by them or by their lessee. The building must be used for business purposes only so as to enjoy this allowance (KRA website, 2019).

Githaiga (2013) studied what impact tax incentives had on inflows of FDI for NSE listed firms. Focus was on impact of ID, W & TA allowance and IBA towards attracting FDI inflows for NSE listed firms. Time series data was collected for tax incentives and

investments during the 2008 -2011 period. The sample included ten (10) NSE listed firms. Data was secondary and was obtained from financial statements that were audited and annual reports. Correlation was undertaken to establish whether any relationship existed between incentives of tax and FDI inflows. Findings proved existence of a relationship that was strong between FDI inflows and wear and tear allowances. No significant relationship was in existence between IBA and ID on FDI inflows. An analysis was done further on the FDI inflows percentage change during that period where it was noted that there was an insignificant impact of these incentives on inflows of FDI.

2.4.3 Wear and Tear Allowance

It is granted to investors to cater for the wear and tear on machinery. The allowance is charged on the capital expenditure on equipment and machinery and is classified into five classes each with different rates: 37.5 % - Class I, 30% - Class II, 25% - Class III, 12.5% - Class IV and 20% - Class V (KRA website, 2019).

Musyoka (2012) studied relationship between incentives of tax and Kenya's FDI. Collected data included; exemptions of import duty, incentives that are trade related, incentives of investment and FDI flows. A ten (10) years period of study was conducted from 2002 – 2011. Three measures of performance were used in the study: loss of revenue due to trade related incentives, loss of revenue due to import duty exemptions, investment incentives and net FDI inflows. To analyze; mean, maximum and minimum measures of central tendency were used. Measure of dispersion (variation) used was standard deviation while calculations were undertaken for regression, correlation and significance tests. Correlation analysis was performed to establish whether any relationship was in existence between dependent and independent variables. Results of all the measures of performance were that there was no

significance difference when correlated with the FDI. Incentives that are trade related, incentives of investment and import duty exemptions showed a significance level of above 0.05. The research concluded that implementing them in Kenya did not cause a significant FDI improvement.

2.4.4 Farm Works Deduction

Introduced in 1985 its aim was investment promotion in the agriculture sector (Budget Focus, 2012). Farm work is any structure that has been constructed to enhance the farm operations. The deduction refers to the expenditure that is incurred on construction of farm works by agricultural land tenants or owners. It is granted to farmers at 100% cost rate with the farm house having an applicable rate of 1/3 on the expenditure that is incurred on one house. Employee houses also qualify for this allowance. For any other immovable buildings that are used for the proper operation of the farm, 100% is deducted (KRA website, 2019).

Sebastian (2009) studied effectiveness of incentives of tax in investment attraction with evidence of panel data for CFA Franc Zone Countries. Study purposed to investigate the extent of the effectiveness of these incentives in attracting the investments of Sub – Saharan Africa. Policy changes for these incentives and other investment climate variables were analysed. Twelve (12) nations were studied in 1994-2006. The neo – classical investment theory prediction of whether investment was raised when incentives of tax lowered user cost of capital was tested. The study also estimated the investment impact of other investment climate variables directly under Government control. Variables include: legal foreign investors protection, complexity and tax system transparency. Panel data econometrics was used to conduct the study. There was no robust positive relationship that existed between CFA Franc Zone investment and tax holidays. To aid in investment attraction, it was key to

increase the legal guarantees number or the foreign investors and to reduce the tax system complexity.

2.4.5 Foreign Direct Investment

It is an investment in businesses located outside nations or economies of investors and includes wholly owned subsidiaries, joint ventures, mergers & acquisitions (UNCTAD, 2002). It can also be defined as the investment by MNCs and consists of equity, debt and reinvested earnings (Mooij and Ederveen, 2003). A nation's investment level could be measured by the private gross capital and FDI inflows (Klemm and Parys, 2009). Dunning (2001) stated that FDI includes transfer of financial assets, technology, knowledge and intellectual capital abroad to other nations. FDI could foster linkages of local enterprises that are of benefit to host economies when the host nations are able to take an advantage of them (Alfaro et al., 2009). FDI flow consists of net transfers that are direct from parent companies to foreign affiliates by debt, equity and earnings reinvested by foreign affiliates. Mergers & acquisitions have accounted for more than 60% of all developing economies FDI (OECD,2000).

Joosung (1994) did a study on how taxation affects FDI (country – specific evidence). An empirical estimation was done on the home and host nations' tax systems and the degree to which they affected FDI. The author presented evidence that the capital FDI flow was significantly affected by tax rules. Taxes of home countries appeared to significantly influence FDI behavior. He identified various channels by which taxes affected FDI by identifying incentives that were associated with different parameters of tax in the host and home nations. The home country statutory rate of tax measures potential home nation surtaxes incentive effect on new FDI. The home nation effective rate of tax measures how

taxes affect the investment substitution in a nation for investment in another nation. The host countries effective rate of tax should either represent the FDI incentives in that nation or the foreign tax payments amounts that are creditable against the FDI's home tax liability. U.S investment data by ten (10) other nations in 1980 – 1989 showed that home nation statutory rates of taxes hurt FDI significantly when the nation made foreign source income a subject of taxation of the nation. This variable insignificantly affected FDI from nations which exempted foreign source income from taxation by home countries. He found that the coefficient of the home country's effective and statutory rates of tax take the opposite sign in the estimated equations which supports the different channels presence through which the tax systems of the home country influence FDI. Variable of tax weak performance of the host nation in the equations that were estimated suggested that it did not have an effect on the decisions of where FDI should be invested. This is how it is conventionally perceived therefore; the tax of the host nation largely represents credible foreign taxes for several investors.

Hansson and Olofsdotter (2010) evaluated the influence of agglomeration economies and corporate tax rates on FDI amongst the EU countries. Data used was on average and marginal effective corporate rates of taxes for twenty seven (27) EU member states in 1995-2006. Nations stocks and bilateral FDI flows panel data was used. Focus on the study was on: agglomeration forces and tax policies differences. It also focused on how differences of tax policies between old and new member nations could be explained. The model used viewed FDI in two steps: flow decision on the FDI amount to make investments and decision on investment location. They found that large differences exist in FDI determinants that go to old members compared to FDI that goes to new member countries. The flows of FDI to the

new member states were greatly influence by taxation. A greater impact on the investment amount made within old member states was by agglomeration economies.

Tomonori (2012) empirically analysed effect of corporate income tax on FDI. Study was on a panel of bilateral FDI flows amongst 30 nations in OECD during 1985 – 2007 period. He stated that the enhanced capital and labor liquidity by globalization had increased the global and efficient capital and human resources utilization. An argument was put across that many nations were aware of why to attract FDI in order to vitalize and economic growth promotion. These nations have developed and provided attractive investment environments. They have also reduced corporate tax rates one by one though he found that there were more elements that influenced FDI and that the effect of corporate tax on FDI failed to be apparent. This study also went ahead and analysed dynamic panel data. He expanded the static panel data analysis and found that the current FDI scale was affected by the investment level of the previous period. He found a significantly negative corporate tax impact on FDI.

Kimonye (2014) conducted an empirical analysis on taxation and FDI in Kenya. The objective was to investigate relationship of taxation and FDI in Kenya and establishment of trends of factors which affected Kenya's FDI. Period of study was 1980 – 2012. To estimate the time series data, ordinary least squares was used. The variables included taxation, exchange rates, GDP and trade openness which positively impacted FDI whereas another variable, inflation, had a negative FDI impact.

Imbayi (2013) did an investigation of the effects of taxation on Kenya's FDI which involved time series correlation. Secondary data was collected from KNBS and analyzed the information. 1992 – 2002 was the period of study with a descriptive research design. Industry

Investment Promotion Centre and Chamber of Commerce was the population target. Moderating variables - inflation, taxes, exchange rates, openness and GDP; dependent variable was FDI and independent variable – taxation. Model of regression analysis was used. Dependent variable was annual percentage FDI inflows to Kenyans. Conclusion was that taxation influenced inflow level and FDI location.

2.5 Critique of Existing Literature Relevant to the Study

Joosung (1994) studied taxation effect on FDI, (country specific evidence) with tax rate as the focus and not other taxation factors such as capital deductions. Klemm and Parys (2009) empirically studied effects of incentives of tax where they focused on Latin American, African and Carribbean countries. The study did not consider other regions such as Asia and European Union. Sebastian (2009) studied effectiveness of incentives of tax in investment attraction with evidence of panel data for CFA Franc Zone Countries. The study narrowed down the tax incentives to only tax holidays. An analysis was done on agglomeration economies and corporate tax rates impact on FDI for EU nations. It only focused on EU nations and corporate tax rates while there are other tax incentives (Hansson and Olofsdotter, 2010).

Tomonori (2012) empirically analysed corporate income tax effect on FDI where the last period was 2007. During the five years to the study, further developments could have taken place to distort study results. Githaiga (2013) studied these tax incentives and their impact on inflows of FDI for NSE listed firms. Focus was on only ten companies instead of all the sixty five firms in the NSE which would give a wider range of the impact of these incentives. Musyoka (2012) studied relationship of these incentives and Kenya's FDI. The research focused only on the variables relationship while in this study, the effect of tax incentives on

FDI was determined. Imbayi (2013) investigated the taxation effects on Kenya's FDI. 1992-2012 was the study period while the study was undertaken in 2013. Recent developments during the years not studied may have given different results in comparison to those conclusions made where it was found that taxation affected the inflow level and FDI location. Gumo (2013) studied these incentives and their effect on Kenya's FDI with focus on enterprises in the EPZ and Industrial Zones and not Kenya as a whole. Kimonye (2014) conducted an empirical analysis on FDI and Taxation in Kenya with focus on corporate and labour income tax and not tax allowances. The study was undertaken for this reason.

2.6 Summary of Literature Review

The chapter has presented the research gaps, conceptual framework, theoretical and empirical reviews. Four theories have been presented: Tax Discrimination, Eclectic Paradigm, Internalization and Product Life Cycle. The empirical review has demonstrated that taxation has an impact on FDI. Role of the empirical review was to identify the research gaps that this study aims to fill. FDI is influenced by factors other than taxation like market size and trade openness. Most of the studies in the global perspective focused on corporate tax rates and tax holidays. The studies found both negative and positive relationships of these incentives on FDI. They argued that these relationships vary however with the tax incentives types. The conflicting findings in the global and local perspectives show the gaps that exist in the factors of taxation that impacted FDI. Limited studies were done on the incentives and FDI impact. The tax incentives selected for the study are capital allowances: ID, IBA, W&TA and FWA. This study therefore aimed to fill the gap that existed and evaluated what effect tax incentives had on FDI in Kenya.

2.7 Research Gaps

Empirical review indicated that various studies had been undertaken on tax incentives and their effect on FDI. Research gaps have been explained in the matrix table below:

Table 2 - Matrix Table for Research Gaps

Author (Year)	**Title of The Study**	**Variable**	**Indicator**	**Findings**	**Research Gaps**
Joosung (1994)	How taxation affects FDI (country – specific evidence)	Ratio of FDI in US to US GDP	Residence tax system group Territorial tax system group	Home nation statutory rates of taxes hurt FDI significantly when the nation made foreign source income a subject of nation's taxation. This variable did not significantly affect FDI from nations which	Study only considered tax rate

				exempted foreign source income from taxation by home countries.	
Klemm and Parys (2009)	Empirical study on the effects of tax incentives	EIT rate Tax Holidays Tax credit Investment allowance FDI	Private gross capital formation Inflation rate Openness GDP General Government Consumption expenditure Population Size	Longer holidays of tax and lower tax rates for corporate income were only effective in FDI attraction and not to promote growth or boost the gross private fixed capital formation.	Study did not consider capital allowances

Sebastian (2009)	Effect of tax incentives on attracting investment: panel data evidence from the CFA Franc Zone Countries	Tax Holidays	Transparency Legal system complexity Legal protection of foreign investors	No significant positive relationship between the CFA Franc Zone investment and tax holidays	Study focused on tax holidays in Franc Zone Countries. This study will focus on tax allowances in Kenya.
Hansson and Olofsdotter (2010)	Impact of corporate tax rates and agglomeration economies on FDI amongst EU countries	Agglomeration economies Corporate tax rates	Agglomeration economies Corporate tax rates	Large differences exist in FDI determinants that go to old members compared to FDI that goes to new member countries. Taxation had a larger FDI flows influence to new member	The study was done in EU countries while this study will focus on Kenya

				states. A greater impact on the investment amount made within old member states was by agglomeration economies.	
Tomonori (2012)	Empirical analysis: effect of corporate income tax on FDI	Corporate tax	Previous year's investment level	Corporate tax effect was significantly negative on foreign investment	Focus was on corporate tax and not other tax incentives
Githaiga (2013)	Impact of tax incentives on FDI inflows of firms listed at the Nairobi Securities Exchange	W& TA ID IBA	Equipment used in the firms	There was a strong relationship that existed between FDI inflows and wear and tear allowances. No significant	The study only focused on ten NSE listed companies and not whole population

				relationship was in existence between IBA and ID on FDI inflows. An analysis was done further on the FDI inflows percentage change during that period where it was noted that there was an insignificant impact of FDI inflows and tax incentives.	

Musyoka (2012)	Relationship between tax incentives and FDI in Kenya	ID IBA W&TA FWA MOA	Import Duty Exemptions Trade Related Incentives	Implementation of Kenya's tax incentives did not significantly improve FDI.	The study was limited to the variables relationship
Imbayi (2013)	Investigation of the effects of taxation on FDI in Kenya	Openness Inflation Taxes GDP rates Exchange rates	Exchange Rates Inflation Taxes GDP rates Openness	Taxation affected inflow level of inflow and FDI location.	The period was old and limited to 2002 and study done in 2013
Gumo (2013)	Effect of tax incentives on FDI in Kenya	ID IBA	MOA EPZ TREO MUB	ID, mining operation deduction , tax remissions export office and export processing zones positively influenced FDI, IBA and MUB	The study only focused on enterprises in the EPZ and Industrial Zones and not Kenya as a whole.

				negatively affected FDI.	
Kimonye (2014)	FDI and Taxation In Kenya: An Empirical Analysis	GDP Exchange Rates Taxation Inflation Trade Openness	GDP Exchange Rates Taxation Inflation Trade Openness	Tax, GDP, openness to trade and exchange rate positively impacted FDI whereas inflation had a negative FDI impact.	The study focused on corporate and labour income tax and not tax allowances

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

Chapter explains the research methodology that was used in undertaking study. Research design details, data collection methods and analysis of data that were employed were provided. It includes the analytical method, tests of significance and reliability of data. It also describes the data presentation.

3.2 Research Design

Design explained by Mugenda and Mugenda (2003) as an outline, scheme or plan that can be employed to get answers for research problems. Kothari (2004) posits that it is an arrangement of various conditions for the data to be collected and analysed. The design provides an outline in detail on how to undertake the research and it specifies those procedures and methods that can be used in collection and data analysis (Gall et al. 2006). Descriptive research design was adopted in determining the effect of tax incentives on FDI in Kenya. Mugenda and Mugenda (2003) noted, this design is very applicable when the study aims to portray the characteristics and describe groups of people, communities, events, populations and situations. Babbie (2002) noted that the design fully portrays the characteristics of the population.

3.3 Target Population

Target population needs to have observable characteristics that a researcher can use in the generalization of the study results (Mugenda and Mugenda, 2003). The target population for the study was the FDI amount received in Kenya for the period 2008 – 2017. The study was a

census since it considered all the FDI inflows amounts received in Kenya over the ten year period.

3.4 Data Collection Procedure

Jensen (1976) found that collecting data is a process that requires gathering information of interest and systematically measuring it which enables the researcher answer the research questions. Ngechu (2004) found that collection of data can be done using numerous techniques. For the variables in this study, the researcher obtained secondary data for years 2008 - 2017. The information obtained consisted of amounts of capital allowances for ID, IBA, W&TA and FWA. Secondary data is usually applicable when the researcher has an interest in establishing relationships that exist amongst the variables in the study (Karoki, 2013). The data for tax incentives was collected from the Kenya Revenue Authority database while the data for foreign direct investment was from World Bank database.

3.5 Data Collection Instruments

The study used a data collection sheet.

3.6 Data Processing and Analysis

Macintosh (1996) determined that analysis of data is one scientific process of fact finding that is used to test the hypothesis and draw inferences that will contribute later to theories. It makes a complicated process simple and makes it useful to the information users. Saunders, Lewis and Thornhill (2009) noted that collected data should be processed to ensure that the information obtained will be more meaningful. As per Mugenda and Mugenda (2003), any data that is collected needs to be cleaned, coded and analyzed properly. Descriptive statistics were included in the study. Calculations of measures of central tendency were done. The

relationship that existed between the independent (tax incentives) and dependent (foreign direct investment) variables was established by use of multivariate regression analysis. An analysis instrument which was the statistical package for social sciences (SPSS) computer package version 20 was used.

In the study, the analytical model was established by the following regression model:

$$Y = \beta 0 + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + e$$

Where; Y = Dependent Variable. It was measured using the amount of net inflows in Kenya for the ten year period 2008-2017.

Y = FDI in Kenya

$\beta 0$ = Y-intercept (This is the constant term).

$\beta 1 - \beta 4$ = Regression Coefficients

$\beta 1$ to $\beta 4$ are the coefficients that were used to measure the sensitivity of Y (the dependent variable) to the unit change in the independent variables (X1, X2, X3 and X4). These coefficients provided an explanation on the change in Y amount that was associated with a unit change in X.

X1 = investment deduction amounts

X2 = industrial building allowance amounts

X3 = wear and tear allowances amounts

X4 = farm works allowance amounts

e = This is the error term that exists in the model which is assumed to influence the study variables. The error term measures the goodness of the model and captures the effect of all other unexplained variables that have an effect on FDI but have not been captured in the model.

3.7 Diagnostic Tests and Tests of Significance

Diagnostic tests established suitability of the collected data. The tests included normality, autocorrelation, linearity and multi-collinearity. These were measured as follows: normality using kurtosis and skewness, auto correlation by Durbin Watson test, linearity – Shapiro Wilk test, while multi-collinearity by Variance Inflation Factors and tolerance. The tests of significance were conducted by Analysis of Variance (ANOVA). The study findings were presented through tables.

CHAPTER FOUR

RESEARCH FINDINGS AND DISCUSSION

4.1 Introduction

The chapter describes how the data was analyzed, the findings, the interpretation and data presentation. Secondary data was obtained for ten years: 2008 – 2017 from World Bank and KRA databases. Data organization was done by use of excel spreadsheets and analysis was aided by the use of SPSS version 20. Correlation and multiple linear regression was tested on the data. It discusses the results obtained and provides the answers sought by the research questions. Presentation of data was in form of tables.

4.2 Data Analysis

The study's general objective was to examine the effect of tax incentives on FDI in Kenya. Data analysis was done by use of descriptive statistics which included mean, standard deviation, maximum and minimum values. These statistics showed the variables trends. A regression model was also done which provided information on the relationship that existed amongst the tested variables with the predictor variables being ID, IBA, FWA, wear and tear and the predicted variable being foreign direct investment.

4.3 Descriptive Data Analysis

The mean, standard deviation, maximum and minimum values of all the variables were obtained. The variables tested all had positive means. ID had a minimum value of 3,024, maximum value of 65,903, mean of 19,361 and standard deviation of 16,251. IBA had a minimum value of 148, maximum value of 24,031, mean of 3,602 and standard deviation of 5,050. WTA had a minimum value of 4,957, maximum value of 115,846, mean of 32,646 and standard deviation of 29,549. FWA had a minimum value of 234, maximum value of 5,795,

mean of 1,572 and standard deviation of 1,331. FDI had a minimum value of 7, maximum value of 816, mean of 180 and standard deviation of 203.

WTA had the highest mean while FDI had the lowest mean. ID had the second highest mean followed by IBA and FWA. In terms of variability, WTA varied the most then ID, IBA FWA and FDI. The findings explained that WTA had the highest variation over the ten year study period thus frequently changed. The statistics are described in table 3 below:

Table 3 - Descriptive Statistics

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ID	40	3,024	65,903	19,361	16,251
IBA	40	148	24,031	3,602	5050
WTA	40	4,957	115,846	32,646	29,549
FWA	40	234	5,795	1,572	1,331
FDI	40	7	816	180	203

4.4 Analytical Model

Diagnostic tests were performed to validate the set of data including tests of linearity, normality, auto correlation and multi-collinearity.

4.4.1 Correlation Matrix

Pearson correlation analysis was done to test the variables correlation. The correlation coefficient enables the researcher to quantify the strength of the linear relationship which

existed between the variables and should be between –1 and +1. The analysis was done at 95% confidence interval and 0.05 (2 – tailed) confidence level. All the correlations were found to be positive amongst each other and with the predicted variable. IBA and ID had a positive correlation of 0.779, ID and WTA a positive correlation of 0.927, WTA and FWA 0.975 while FWA and IBA 0.828. IBA and WTA had a positive correlation of 0.874 while ID and FWA had a positive correlation of 0.930. For correlation with the dependent variable, it was established that ID and FDI had a positive correlation at 0.690, WTA and FDI 0.565, FWA and FDI 0.627, IBA and FDI 0.302. Pearson correlation coefficient results are described in Table 4 below:

Table 4 - Correlation Matrix

Correlations

		ID	WTA	IBA	FWA	FDI
ID	Correlation	1				
WTA	Correlation	.927**	1			
	Sig. (2-tailed)	.000				
IBA	Correlation	.779**	.874**	1		
	Sig. (2-tailed)	.000	.000			
FWA	Correlation	.930**	.975**	.828**	1	
	Sig. (2-tailed)	.000	.000	.000		
FDI	Correlation	.690**	.565**	.302	.627**	1
	Sig. (2-tailed)	.000	.000	.058	.000	

**. Correlation was significant at the 0.01 level (2-tailed).
N - 40

It was established further that there was statistically no significant relationship between IBA and FDI at the 5% significant level: FDI and IBA (0.058, p>0.05). All the other variables had a significant relationship with the predictor variable: FDI and WTA (0.000, p>0.05), FDI and

ID (0.000, p>0.05) while FDI and FWA (0.000, p>0.05). None of the predictor variables were perfectly correlated with each other thus all of them were used in the model of study. As some of these variables had a high correlation, multi-collinearity test was done so as to ensure that they had no influence with each other.

4.4.2 Autocorrelation

This is a statistical problem which shows the similarity degree between a set of time series data and a delayed version of its own over time intervals that are successive. It refers to the correlation degree between same variables values across various data observations. If autocorrelation is found in research data, it will result in inconsistent findings of regression analysis. Table 5 presents the following results:

Table 5 - Test of Autocorrelation

Test of Autocorrelation

Model	Durbin-Watson
1	1.333

a. Predictors: (Constant), FWA, ID, WTA, IBA

b. Dependent Variable: FDI

The study used Durbin-Watson to test for autocorrelation. This statistic ranges from 0 to 4 where 0 values are positively auto correlated while values of 4 are negatively auto correlated. Values of 1 to 3 explain that the data set is not influenced by auto correlation. The DW statistic was found as 1.333 proving that the data was not auto correlated.

4.4.3 Multi-collinearity

This is a statistical problem and is described as states of very high inter – associations and inter – correlations amongst the independent or predictor variables. This was tested by use of Variance Inflation Factor (VIF) and Tolerance. Table 6 describes the findings:

Table 6 - Test for Multi - Collinearity

Test for Multi - Collinearity

Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	ID	.164	6.103
	IBA	.081	12.333
	WTA	.131	7.615
	FWA	.156	6.426

Tolerance is the reciprocal of VIF. A tolerance value of less than 0.1 shows the existence of multi-collinearity in the study. A VIF of 10 shows multi-collinearity. ID had a tolerance of 0.164 and VIF of 6.103. IBA had a tolerance of 0.081 and VIF of 12.333. WTA had a tolerance of 0.131 and VIF of 7.615. FWA had a tolerance of 0.156 and VIF of 6.426. On the tolerance statistics, the values of ID, WTA and FWA had greater values than 0.1. There was thus no multi-collinearity for ID, WTA and FWA but there was existence of multi-collinearity for IBA. On the VIF statistics, the researcher established that ID, WTA and FWA had values less than 10 hence no multi-collinearity but IBA value was greater than 10 thus multi – collinearity existed.

4.4.4 Measures of Normality

Normality aims at ensuring the set of data exhibits normal features and this was tested by skewness and kurtosis as described in table 7 below:

Table 7 - Testing for Normality

Testing for Normality

	N	Skewness		Kurtosis	
	Statistic	Statistic	Std. Error	Statistic	Std. Error
ID	40	1.158	.374	.457	.733
IBA	40	1.189	.374	.397	.733
WTA	40	1.566	.374	1.762	.733
FWA	40	1.459	.374	1.732	.733
FDI	40	1.785	.374	-1.274	.733

The acceptable normality level is $\pm$ 1.96 at the 5% level of significance. ID had a skewness level of 1.158 and kurtosis level of .457, IBA had a skewness level of 1.189 and kurtosis level of 0.397, WTA had a skewness level of 1.566 and kurtosis level of 1.762, FWA had a skewness level of 1.459 and kurtosis level of 1.732 while FDI had a skewness level of 1.785 and kurtosis level of -1.274. All these variables were within the acceptable $\pm$ 1.96 limits thus there was normality in the data collected and analysed.

4.4.5 Testing for Linearity

Linearity is a feature that is exhibited by sets of data and they generate a graph that is a straight line. The study used the Shapiro-Wilk test to confirm whether the data deviated from linearity. It is more useful when the observations are less than 50. This data set had 40 observations each for both the predictor and predicted variables. The statistic for ID was

0.923 and a significant value of 0.387. The statistic for IBA was 0.841 and a significant value of 0.046. WTA had a statistic of 0.874 and a significant value of 0.112. FWA had a statistic of 0.953 and a significant value of 0.704 while FDI had a statistic of 0.916 and a significant value of 0.325. The ANOVA test was at 95% with a p-value of 0.05.All the values were greater than 0.05 hence linearity was met. The findings are presented in table 8 below:

Table 8 - Tests of Linearity

	Shapiro-Wilk	
	Statistic	Sig.
ID	.923	.387
IBA	.841	.046
WTA	.874	.112
FWA	.953	.704
FDI	.916	.325

4.4.6 Regression Model Coefficients

Regression analysis was conducted where FDI was regressed against the four independent variables: ID, IBA, WTA and FWA. The study obtained a regression model from the set of data with results shown on table 9 below:

Table 9 - Model Summary

Model Summary[b]

Model	R	R Square (R^2)	Adjusted R Square (R^2)	Std. Error of the Estimate (SE)
1	.803[a]	.646	.605	127.792

a. Predictors: (Constant), FWA, ID, WTA, IBA

From the findings, the correlation coefficient of 80.3% shows that a strong linear relationship actually existed between the variables. R squared (R^2), the coefficient of determination was 64.6% which meant that of the FDI variation, 64.6% was explained by tax incentives changes. The adjusted R squared (R^2) was 60.5% which showed that the tax incentives contributed to 60.5% of FDI. The regression model, however, failed to explain 39.5% of the other variables that influence FDI.

ANOVA statistics were computed to determine the goodness of fit in the model and to establish whether the selected regression model was significant in making predictions of the relationships that existed between the factors which were being investigated. Obtained results are shown in Table 10 below:

Table 10 - ANOVA Statistics

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1,040,783	4	260,196	15.933	.000[b]
	Residual	571,580	35	16,331		
	Total	1,612,363	39			

a. Dependent Variable: FDI

b. Predictors: (Constant), FWA, ID, WTA, IBA

From the statistics presented, the F critical value at the 5% significance level is 2.64. From the findings, it was established that the F calculated was 15.933. For ANOVA interpretation, if the obtained F value is larger or equal to the F critical value, the results are said to be significant at that probability level. From the data shown, the F calculated is higher than the F critical value therefore the model was statistically significant. P value found in the data was 0.000. This was lower than the 5% significance level. It was hence concluded that the relationship in existence for the two variables was significant.

The regression model adopted in the study was:

$Y = \beta 0 + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + e$

The following regression model was established after fitting in the coefficients found;

$Y = -24{,}905 + 0.011X1 - 0.025X2 - 0.003X3 + 0.113X4$

Table 11 – Regression Model Coefficients

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B	
		B	Std. Error	Beta			Lower Bound	Upper Bound
1	(Constant)	-24,905	33.413		-.745	.461	-92.736	42.927
	ID	.011	.004	.903	3.171	.003	.004	.019
	IBA	-.025	.009	-.620	-2.899	.006	-.042	-.007
	WTA	-.003	.004	-.451	-.819	.418	-.011	.005
	FWA	.113	.074	.740	1.536	.134	-.036	.262

When all the factors were held constant, FDI was -24,905. It was further noted that a unit of ID increases FDI by a 0.011 factor. FWA causes FDI to increase by a 0.113 factor. It was also established in the study that a unit increase of IBA will cause a - 0.025 factor decrease in FDI. WTA was found to have a negative effect on FDI with a coefficient of -.003. On evaluation of the individual variables, the findings indicated that the y – intercept, WTA and FWA had p values of 0.461, 0.418 and 0.134 which was higher than the 5% significant level hence they were all individually statistically insignificant in predicting FDI. ID and IBA had p values of 0.003 and 0.006 which was lower than the 0.05 threshold thus they were individually statistically significant in predicting FDI.

4.5 Discussion of Key Findings

The study's general objective was to examine the effect of tax incentives on FDI in Kenya. ID, IBA, WTA and FWA were the predictor variables. The correlation tests done revealed that FDI was positively correlated with ID, IBA, WTA and FWA at 0.690, 0.302, 0.565 and 0.627 respectively. The findings on the correlation between WTA and IBA with FDI were in

tandem with the study done by Githaiga (2013), however, the results for ID were in contradiction as he found that ID and FDI were negatively correlated while this study found that they were positively correlated. Further there was a statistically significant relationship between the FDI and ID, WTA and FWA as the p values obtained were lower than the 5% level of significance, however, the relationship with IBA was statistically insignificant as the p value obtained was higher than 5%.

The correlation coefficient (R) was 80.3% depicting a relationship that was strongly linear between the predictor and predicted variables. R squared (R^2), was 64.6% which showed that of the FDI variation, 64.6% was explained by the tax incentives changes. Adjusted R squared (R^2), was 60.5% which meant that 60.5% of the total FDI variance was explained by the tax incentives whereas 39.5% of FDI variation was explained by other factors not explained in the model. From the ANOVA analysis, the overall model was found to be statistically significant evidenced by the p- value of 0.000 which was lower than the significance level was 5%. The F calculated was 15.933 which when compared with the F – critical value of 2.64, was high. These findings established that the results were significant at that probability level. Contradictory findings were noted by Hilda (2014) on her study of tax incentives effects on Kenya's economic growth. The data revealed F calculated of 2.376 against F critical value of 5.19 with a p value of 0.211. She concluded that none of the factors tested could significantly have an effect in GDP growth rate prediction. The factors were: investment levels, productive population percentage, global competitiveness index, tax incentives and population's literacy levels.

The following regression model was obtained:

Y= -24,905 + 0.011X1 - 0.025X2 - 0.003X3 +0.113X4

From the regression analysis, it was found that holding the tax incentives at constant zero, FDI will grow at -24,905. For the variables, IBA had a significant and negative effect on FDI with a – 0.025 coefficient. The p value was 0.006. For WTA, it was found that it had a negative effect on FDI. The coefficient was -0.003 with a p-value of 0.418. ID and FWA had positive coefficients of 0.011 and 0.113 and significant p-values of 0.003 and 0.134 respectively. An ID unit increase would result in a rise of FDI by a 0.011 factor. A FWA unit increase would cause FDI to increase by a 0.113 factor. The findings showed that only ID and IBA could significantly predict FDI flows in Kenya. ID can increase FDI by a 0.011 factor and a unit IBA increase will decrease FDI by a -0.025 factor.

The findings also indicated that the y-intercept, WTA and FWA were individually insignificant in predicting FDI while ID and IBA had p values lower than 5% level of significance, therefore, were individually statistically significant in predicting FDI. This shows that as per the study, offering high industrial building allowances and wear and tear allowances by the Government may be detrimental to FDI in Kenya. The results on the regression coefficients were in concurrence with the results of the study of Gumo (2013) on the effect of tax incentives on FDI in Kenya. He noted that ID and FWA had positive coefficients whereas IBA had a negative coefficient with FDI.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The chapter explains the findings summary and conclusions. It further gives a detailed explanation on the recommendations, study limitations and further study areas.

5.2 Summary of Findings

The project's purpose was to examine the effect of tax incentives on foreign direct investment in Kenya. Secondary data was obtained for ten years from 2008 to 2017 with information for FDI from World Bank Database and information for tax incentives from KRA database. Data analysis was done by use of descriptive statistics. It was also done through regression and correlation. Most of the variables did not violate the regression analysis assumptions thus were used in the model of study. The study had four specific objectives and the results were as follows:

To determine the effect of investment deductions on foreign direct investment in Kenya: the study established that a positive relationship existed between ID and FDI with a coefficient of 0.011. Thus, a unit increase of ID would increase FDI by a factor of 0.011. The level of significance was 5%. The p value of ID was found to be 0.003. ID was found to be significant as the p value was lower than 0.05. Therefore, ID could significantly influence FDI positively. From the descriptive statistics, the study found that ID had a minimum value of 3,024, maximum value of 65,903, mean of 19,361 and standard deviation of 16,251.

To establish the impact of industrial building allowance on foreign direct investment in Kenya: the study found that an inverse relationship existed between FDI and IBA with a coefficient of - 0.025. This meant that increasing IBA by a unit would result in a decrease of FDI by a factor of - 0.025. The level of significance was 5%. The p value of ID was found to be 0.006. IBA was found to be significant as the p value was lower than 0.05. Therefore, IBA could significantly influence FDI negatively. The descriptive statistics showed that IBA had a minimum value of 148, maximum value of 24,031, mean of 3,602 and standard deviation of 5,050.

To evaluate the influence of wear and tear allowances on foreign direct investment in Kenya: it was established that WTA had a negative effect on FDI as it had a coefficient of -.0.003. A unit increase in WTA would result in a decrease of FDI by a factor of 0.003. The level of significance was 5%. The p value of WTA was found to be 0.418. WTA was found to be insignificant as the p value was higher than 0.05. Therefore, WTA could not significantly influence FDI. The descriptive statistics showed that WTA had a minimum value of 4,957, maximum value of 115,846, mean of 32,646 and standard deviation of 29,549.

To determine the impact of farm works allowance on foreign direct investment in Kenya: the study found that FWA had a positive relationship with a coefficient of 0.113. This meant that an increase of a unit of FWA would increase FDI by a factor of 0.113. The level of significance was 5%. The p value of FWA was found to be 0.134. FWA was found to be insignificant as the p value was higher than 0.05. Therefore, FWA could not significantly influence FDI. Further, from the descriptive statistics, FWA had a minimum value of 234, maximum value of 5,795, mean of 1,572 and standard deviation of 1,331.

In summary, FDI had a minimum value of 7, maximum value of 816, mean of 180 and standard deviation of 203. The summary for the descriptive statistics was that WTA had the highest mean of 32,646 while FDI had the lowest mean of 180. For standard deviation, WTA had the highest variation of 29,549 followed by ID 16,251, IBA 5,050, and FWA 1,331 and FDI having the lowest variation at 203.

In summary, the correlation analysis showed that a statistically significant relationship existed between FDI with ID, WTA and FWA as the p values obtained were lower than the 5% level of significance, however, the relationship with IBA was statistically insignificant as the p value obtained was higher than 5%. The values were 0.000, 0.000, 0.000 and 0.058 respectively. A correlation coefficient of 80.3% was found which showed that there was a strong linear relationship which existed between tax incentives: ID, IBA, WTA, FWA and FDI. The coefficient of determination R squared (R^2), was found to be 64.6% meaning that 64.6% of the FDI variation was explained by tax incentives changes. The adjusted R squared (R^2), was 60.5% showing that only 60.5% of FDI was attributed to tax incentives while 39.5% of FDI was attributed to factors not tested in the model.

To determine the goodness of fit in the model, ANOVA statistics were computed. This also helped to identify whether the regression model selected was significant in predicting the relationships that existed between the investigated factors. F calculated was 15.933 which was compared to F critical value of 2.64. The results showed that F calculated was higher than the F critical value therefore the model was significant. The p value was 0.000 compared to the 5% significance level. The p value was thus lower hence it was concluded that the model was statistically significant in predicting the relationship between tax incentives and

FDI. To identify the association was in existence between tax incentives and FDI, regression analysis was done.

The model obtained from the study was:

$$Y= -24{,}905 + 0.011X1 - 0.025X2 - 0.003X3 + 0.113X4$$

5.3 Conclusions

The study sought to meet four objectives and further to the findings explained, the following conclusions were made; the research findings proved that both positive and negative relationships existed between the tax incentives and FDI in Kenya. The FDI's significance level was however low compared to the tax incentives provided during the study period of ten years. On the first objective: to determine the effect of investment deductions on foreign direct investment in Kenya, the study concluded that ID positively and significantly affected FDI in Kenya. Therefore, a rise in ID is likely to increase the FDI of the country. This may be because of the aim of ID which is encouraging investments in physical capital such as equipment, industrial buildings and machinery. Foreign investors are thus encouraged when ID is offered as it reduces their cost of capital and thus increases their income.

To establish the impact of industrial building allowance on FDI in Kenya: The study concluded that IBA negatively and significantly impacted FDI in Kenya. Therefore a rise in IBA was likely to decrease FDI in the country. On evaluating the influence of wear and tear allowances on FDI in Kenya: the study concluded that WTA had a negative and insignificant influence on FDI in Kenya. The data obtained indicated that the highest allowance given by government during 2008 - 2017 was wear and tear allowances. The government has to review

this allowance as though it was the highest offered, it resulted in decline in FDI flows. This will result in protection of the nation from leakages in revenue. Finally in determining the impact of farm works allowance on FDI in Kenya: the study concluded that FWA positively and non-significantly affected FDI in Kenya. This meant that though FDI would increase when FWA was increased, the effect in changing FDI inflows in the country would be minimal. The study concluded that the tax incentives selected as the independent variables influenced FDI by 60.5%. This showed that 39.5% of changes in FDI inflows in Kenya were explained by variables that were not included in the model.

5.4 Recommendations

The government should do a cost benefit analysis for these incentives which are available to various economy sectors. Any benefit that is accrued in terms of rise in investments level should exceed the revenue that is foregone through tax allowances, tax holidays and tax exemptions. Further, the government has to ensure that the environment for investments is highly conducive by improving infrastructure, tax issues, governance, ensuring political stability and security. As these incentives erode the tax base, the Kenyan government should continuously review them to ensure they are relevant, effective and to make an assessment on whether they have achieved the objectives they were set to.

From the analysis it was established that there other factors that have a greater impact on FDI apart from tax allowances. The government should identify these factors so as to ensure increase in FDI into the economy. Investment has been noted to be influenced by behaviors of investors. When these two factors are combined: financial and behavioral, an excellent input will be provided during the planning strategies for FDI attraction. This will ensure achievement of Kenyan's Vision 2030. The study found that there are some tax incentives

that had a positive influence on FDI inflows in the country. The study thus recommends that policy makers should encourage FDI by increasing tax incentives.

Countries have been noted to have tax competition behaviors where they offer lower taxes in order to entice these investments away from their neighboring nations. Since the nations may suffer from this competition, our country is encouraged to be the front runner in supporting EAC efforts for regional harmonization of tax. This will phase out needless competition and encourage investments across board. Nations are encouraged to offer lower but stable tax regimes and provide fewer tax exemptions. Governments are also encouraged to offer limited tax incentives and to eliminate tax holidays since they result in tax shopping where the foreign companies exit to other nations immediately the holiday expires. The Government should focus on placing systems that will ensure that the tax incentives are properly recorded and monitored. This is because data is unavailable for these incentives more so the influence of tax holidays and exemptions. Proper decision making will be ensured on these incentives offered in the country. This will be very important for the KRA as they will be able to identify those firms who are in the country for tax shopping and to tighten leakages in revenue.

5.5 Limitations of the Study

Study was limited to only four tax incentives whereas there are many incentives and factors that have an influence on FDI. This was shown by the obtained results where only 60.5% of FDI was explained by the factors researched while 39.5% remained unexplained by the adopted model of regression. Thus as described in the analysis, only ID and IBA significantly affected FDI. The allocated funds were insufficient in ensuring a study was conducted on all other FDI influencing factors. This study was done in a very short time

period where the researcher had to find a balance in the research and work engagements which was strenuous and could have had an effect on the input in the study.

The study relied on KRA database and World Bank database for the secondary data. This data was in existence already as opposed to primary data which is purely first hand. There might have been a possibility of inherent errors in the results while recording and organizing the data. Though the data was from reliable sources, it was thus limited to the precision degree. The study period was 2008 – 2017 where numerous changes occurred in Kenya that was not accounted for in the study. These were post-election violence that occurred in 2007 - 2008, new Constitution in 2010, elections in 2013, capital gains tax introduction in 2015, interest rate cap in 2016 and elections in 2017. Political stability and macro-economic factors of a nation have a significant influence on FDI therefore; these changes may have influenced the study's outcome.

5.6 Areas for Further Studies

Focus was on only four incentives in form of capital allowances: wear and tear allowance, investment deduction, industrial building allowance and farm works allowance to identify their effect on FDI in Kenya. Recommendation by the researcher is that investigation should be done on other factors including but not limited to tax holidays, tax credits, tax exemption and export promotion incentives. A further research can be undertake so as to establish specific factors that have an influence on the variables example determinants of tax incentives or factors that promote tax incentives. Another study can be done on the relationship amongst the tax incentives so as to identify their impact on each other.

Further research can be done on taxation impact on FDI or economic growth. This study did an investigation on FDI in Kenya as a whole without narrowing down to specific sectors. Other studies can therefore be done in sectors such as manufacturing, real estate, banking and insurance. Generalization was done on the entire country and it would be important to study influence of these incentives on FDI in various counties. The study used regression analysis and focused on Kenya alone. Another study can be done by use of analyzing panel data. Data comparison can be made from various countries instead of only one country as many nations in the world receive FDI. This would enable researchers to collect findings for various world markets and thus derive a universal result.

A research can also be done to establish the influence of factors such as inflation, interest rates, GDP, trade openness and exchange rates on FDI. Apart from these factors there are others such as political stability, infrastructure, raw materials availability and low cost skills which further influence FDI. These factors have a high influence on investors' decisions and should be studied. The data collected was in annual periods and analysis done in quarters while another research can consider breaking down the period into semi- annual timelines.

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APENDICES

Appendix A: Secondary Data Collection Sheets

ANNUAL DATA

Year	Investment Deduction	Industrial Building Allowance	Wear and Tear Allowance	Farm Works Deduction
2008	49,978,244,310	2,586,020,914	66,570,919,974	5,840,887,419
2009	48,389,821,266	2,375,716,522	79,318,999,383	4,747,753,962
2010	71,320,192,507	3,431,758,902	82,688,504,382	3,749,052,694
2011	71,941,041,720	5,083,961,590	84,718,362,795	4,792,327,822
2012	74,954,410,310	7,324,025,285	107,306,230,983	6,072,583,911
2013	83,948,939,547	9,667,713,376	121,256,041,011	6,315,487,267
2014	82,422,737,284	15,431,694,664	172,398,757,483	6,631,261,631
2015	86,760,776,089	22,693,668,623	183,402,933,492	7,161,762,561
2016	117,160,473,429	42,721,035,736	190,490,867,376	8,307,644,571
2017	87,558,855,047	31,977,382,121	205,948,730,103	10,301,479,268

ANNUAL DATA

Year	FDI Net Inflows
2008	95,585,680
2009	116,257,609
2010	178,064,607
2011	1,450,474,757
2012	1,380,173,662
2013	1,118,825,000
2014	820,937,598
2015	619,724,470
2016	393,359,421
2017	671,488,393

QUARTERLY RESEARCH DATA

2008 Q1	12495	647	16643	1460	24
Q2	3124	594	19830	1187	29
Q3	6247	858	20672	937	45
Q4	28113	1271	21180	1198	363
2009 Q1	12097	594	19830	1187	29
Q2	3024	148	4957	297	7
Q3	6049	297	9915	593	15
Q4	27219	1336	44617	2671	65
2010 Q1	17830	858	20672	937	45
Q2	4458	214	5168	234	11
Q3	8915	429	10336	469	22
Q4	40118	1930	46512	2109	100
2011 Q1	17985	1271	21180	1198	363
Q2	4496	318	5295	300	91
Q3	8993	635	10590	599	181
Q4	40467	2860	47654	2696	816
2012 Q1	18739	1831	26827	1518	345
Q2	4685	458	6707	380	86
Q3	9369	916	13413	759	173
Q4	42162	4120	60360	3416	776
2013 Q1	20987	2417	30314	1579	280
Q2	5247	604	7579	395	70
Q3	10494	1208	15157	789	140
Q4	47221	5438	68207	3552	629
2014 Q1	20606	3858	43100	1658	205
Q2	5151	964	10775	414	51
Q3	10303	1929	21550	829	103
Q4	46363	8680	96974	3730	462
2015 Q1	21690	5673	45851	1790	155
Q2	5423	1418	11463	448	39
Q3	10845	2837	22925	895	77
Q4	48803	12765	103164	4028	349
2016 Q1	29290	10680	47623	2077	98
Q2	7323	2670	11906	519	25
Q3	14645	5340	23811	1038	49
Q4	65903	24031	107151	4673	221
2017 Q1	21890	7994	51487	2575	168
Q2	5472	1999	12872	644	42
Q3	10945	3997	25744	1288	84
Q4	49252	17987	115846	5795	378

Appendix B: Capital Allowances

a. Investment Deduction Rates

Item	Rate
Investments situated within Nairobi, Mombasa and Kisumu	100%
Investments worth Ksh.200 Million situated outside Nairobi, Mombasa and Kisumu	150%
Investment deduction – Manufacturing Under Bond: For production of export goods under bonded warehouses	100%
Investment deduction – Export Processing Zones	100%
Shipping allowance - New or power driven unused ships of more than 125 tons.	100%

b. Industrial Building Allowance Rates

Item	Rate
Industrial Building	2.5% capital deduction applicable within the first Forty (40) years of operation.
Hotels	10% capital deduction applicable within the first 10 years of operation
Hostels and Educational Buildings certified by the commissioner	50% capital deduction for the first 2 years of operation. These buildings include; Laboratory, Workshops, Accommodation halls, classrooms, dining halls/cafeteria, other halls for use by the students, administration building, sporting facilities and staff quarters.
Building in uses for training of film producers, actors or crew	100% capital deduction.
Rental residential building approved by the minister in a planned developed area	25% capital deduction.
Commercial building	25% capital deduction in a developed area

c. Wear and Tear Rates

Class	
Class I @ 37.5%	Heavy earth moving self-propelling equipment such as: Caterpillars, tippers, lorries of 3 tonnes and above, tractors (heed, Train, Engine head, buses and coaches, loaders, rollers and graders, transport trucks, combine harvesters, mobile cranes and forklifts etc.
Class II @ 30%	Office electronic machinery and equipment e.g. computers and its peripherals, computer printers, scanners and processors, calculators, mobile phones, photocopiers, stamping and franking/fax machines, duplicating machines, photo printers, cash registers, tax registers.
Class III @ 25%	Other self-propelling machines such as motor bikes, saloon cars and hatchbacks, tuktuk, pick-ups and delivery vans, aircrafts, minibuses (nissans included), lorries < 3 tonnes.
Class IV @ 12.5%	Other non-self-propelling machine such as; Ship, Bicycles, Wheelbarrow, lifts & conveyor belts, carpets and curtains, partitions in a building, shelves, safes, sign boards and advertising stands, furniture and fittings, plant and machinery, security and alarm systems fixed in a car, tractor trailer, train coaches, milking machinery, beds in a hotel, a plough and lawn mowers, refrigerator, T.V, non-self-propelling forklifts and cranes, boats and petroleum pipeline.
Class v@20%	Computer Software and for Telecommunication equipment its 20% for five years on a straight line basis

Appendix C: Cost Budget

Item	Amount(Kshs)
Proposal Writing	
i. Traveling expenses	2,000.00
ii. Formatting & printing	500.00
iii. Photocopying	400.00
iv. Binding	400.00
Data Collection and Analysis	
i. Computer data entry and analysis	5,000.00
ii. Internet costs and Stationery	4,000.00
Report Writing	
i. Formatting and Printing	2,300.00
ii. Photocopying	1,000.00
iii. Binding	400.00
Total Budget of the Study	**16,000**

Appendix D: Time Budget

The Gantt chart below shows the duration of activities on a timeline. The Gantt chart is scheduled for three months, that is, twelve weeks.

Activity	**Week 1-4**	**Week 5 - 6**	**Week 7-8**	**Week 9**	**Week 10 - 12**
Proposal Writing					
Proposal Presentation					
Data Collection					
Data summarizing					
Data analysis					
Report Writing and Presentation					
Project Submission					