Impact of Tax Incentives on Foreign Direct Investment Inflow in Kenya

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ABSTRACT

Foreign Direct Investment inflow plays a crucial role in fostering and maintaining economic growth in both the recipient country and the investor or the country investing. The significance of tax incentives in attracting Foreign Direct Investment (FDI) has been hotly debated, especially in least-developed and developing countries looking to boost economic growth. Tax incentives, such as corporate tax expenditures, tax holidays, and exemptions, are frequently utilised to boost a country's investment climate. However, the effectiveness of these incentives varies according to factors including political stability, regulatory measures, and overall economic conditions. The study's main objective was to assess the impact of tax incentives on foreign direct investment inflow in Kenya from 2002-2021. The Q-Theory of Investment and tax competition theory guided the study. Descriptive, correlation, and causal research designs were used for the study employing time series data. The data for the trend in FDI inflow was derived from World Investment Reports, World Bank, and IMF. The results showed that tax incentives ($t=4.811738$, $p<0.05$) and government recurrent expenditure ($t=2.402518$, $p<0.05$) had a positive significant effect on FDI Inflow while government external debt ($t=-3154145$, $p<0.05$) had a negative effect on FDI inflow in Kenya. To enhance the inflow of Foreign Direct Investment (FDI), the research suggested that policymakers should strategically optimize tax incentives, including Corporate Income Tax (CIT).

Keywords: Foreign Direct Investment, Inflow, Tax Incentives

I. INTRODUCTION

Foreign Direct Investment (FDI) is a category of investment that represents the purpose of creating an enduring stake by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor (United Nations Conference on Trade and Development, 2020). FDI inflows have become a pivotal factor in shaping the economic landscape of nations. The liberalization of trade and investment policies and globalization have created opportunities for cross-border investments, fostering economic integration and interdependence. (UNCTAD, 2020).

Developing nations depend increasingly on investment incentives to draw in capital and shape their actions. More than fifty per cent of 107 third-world nations offered national corporation tax holidays or favourable prices across industries. As of 2015, 46 per cent of them implemented new tax incentives or increased the size of already-existing ones between 2009 and 2015 (Andersen, et al, 2018). Corporate tax incentives are becoming a growing trend, in part because of the competition to draw in foreign direct investment (World Bank, 2015).

Developing countries have also emerged as attractive investment destinations, offering potential markets and abundant resources. Within the East African region, FDI inflows have been dynamic, with countries like Tanzania, Uganda, and Rwanda witnessing substantial investments (Azémar & Giroud, 2023). However, Kenya, despite its strategic location, skilled labour force, and diverse sectors, has faced challenges in attracting significant FDI inflows. The country's FDI landscape has been influenced by factors like political stability and infrastructural development, regulatory framework, market size and human capital. The country has witnessed fluctuations in FDI inflow over the years, influencing its economic development. (UNCTAD, 2022). The table shows the trends in FDI inflow in Kenya

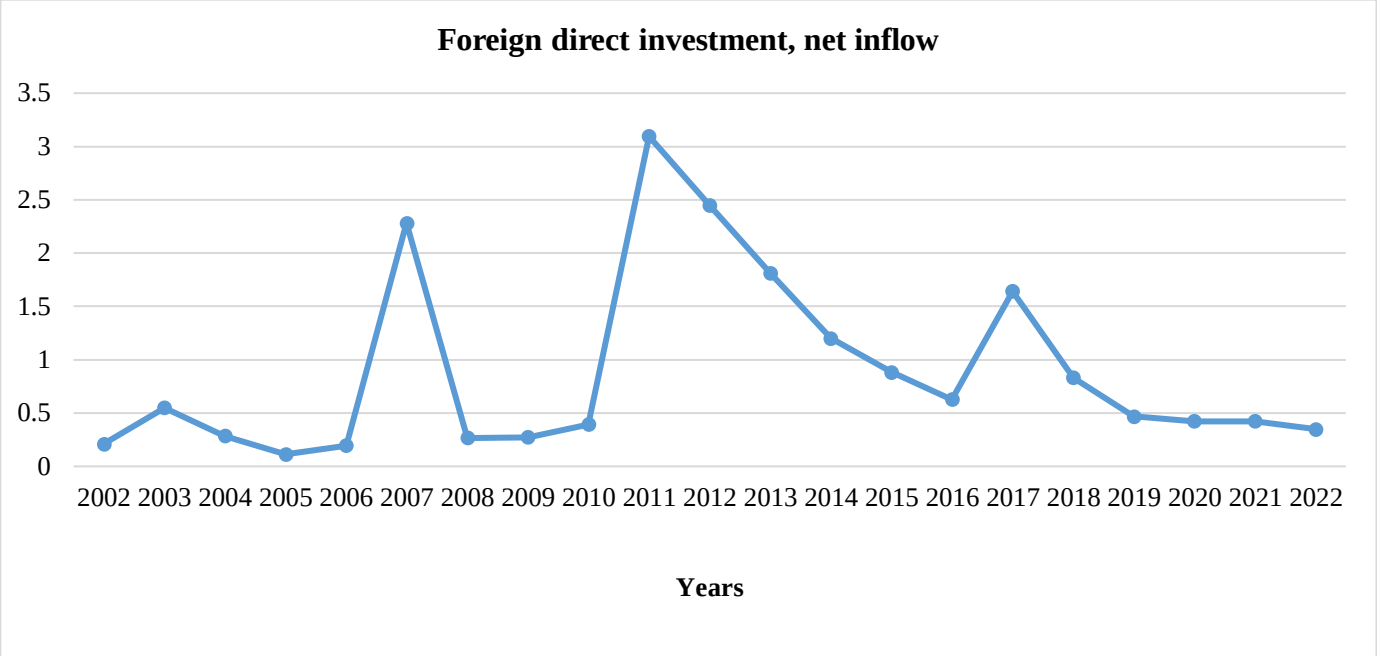

Figure 1

Trends of Foreign Direct Investment (FDI) Inflows in Kenya (2002-2022)

FDI in Kenya has had a tumultuous history, as depicted by the significant decline in 2005, followed by a gradual increase in 2006. Despite progress, the country is still vulnerable to external economic shocks, which have harmed the economy (UNCTAD, 2021). The Country continues to see relatively little foreign investment given the size of its economy and degree of development (UNCTAD, 2022). Kenya, however, is among the top recipients of FDI in Africa. FDI flows to Kenya rose by to $ 0.47 billion (0.42% of the Gross Domestic Product) in 2021 from 0.43 Billion in 2020 translating to the same percentage of GDP.

The Kenyan government has put in place policies and initiatives to encourage FDI inflow, including offering Tax incentives and improving the ease of doing business. Notably, Vision 2030, the country's long-term development strategy, emphasises FDI as a crucial driver of economic transformation (Kamau, 2020). Reforms aimed at improving investor safety, simplifying regulatory procedures, and enabling public-private partnerships (PPPs) have all helped to strengthen Kenya's status as an African investment hub (Kaburu, 2021).

The government has been providing a range of tax benefits. Nevertheless, recent research reveals that these tax incentives are resulting in substantial revenue losses and may not be necessary to attract FDI. The provision of tax incentives in Kenya is also driven by tax competition within the East African Community (EAC), where Member nations are inclined to raise incentives to draw foreign direct investment, which could result in detrimental tax competitiveness and possibly "race to the bottom." (Wachira, 2012; Baker et al., 2016). However, the effectiveness and impact of these incentives are not felt, considering their revenue implications and the overall welfare of the population (Wachira, 2018; Baker et al., 2016). Kenya's tax-to-GDP ratio stood at 15.2 percent in the 2021/22 period, this remains relatively high compared to regional benchmarks, with Uganda at 13.9 percent and Tanzania at 11.8 percent (African Union Commission, & African Tax Administration Forum (2023).

To attract investments, Kenya has implemented significant changes to its corporate tax policies over the years. Motivated by the necessity of competing for foreign investments, the main objective of these measures has been to lower the corporate income tax (CIT) rates and increase corporate tax expenditures. Consequently, CIT rates have been reduced from a high of 45 percent in 1989 to the current rate of 30 percent. Kenya also differentiates CIT rates between foreign-owned and locally-owned companies, typically imposing higher rates on foreign-owned firms to encourage domestic ownership. Kenya has used its CIT system to support an export-led industrialization strategy concerning tax incentives. This strategy involves creating an excise tax structure intended to encourage investments in the production of items that are competitive in export markets, as well as zero-rating or exempting raw materials from Value Added Tax (Wanjala, 2020).

1.1 Statement of the Problem

Foreign Direct Investment in Kenya has shown an unpredictable trend with the government failing to match the FDI inflow with the Gross Domestic Product. FDI flows to Kenya fell to Ksh 68,302 million ($455.34 million) in 2021 from Ksh 109,314 million ($728.76) in 2020, the lowest amount in the prior five years (UNCTAD, 2022). Reductions

in corporate income tax are frequently used to attract foreign direct investment inflow and stimulate economic growth. While lowering corporate tax rates can make Kenya more appealing to foreign investors by reducing their operational costs, this strategy also results in significant revenue losses for the government, raising questions about its effectiveness and sustainability.

Smith, (2022), studied the impact of tax incentives on FDI. The study based on a comprehensive analysis of data from multiple countries, suggesting that countries offering generous tax incentives attract higher levels of FDI. The findings indicate that lower tax rates and favorable tax treatment create a more attractive investment climate, leading to increased FDI inflows. In contrast, Study by Jones Jr (2020) presents conflicting evidence by suggesting that tax incentives have a limited impact on FDI inflows. It argues that other factors, such as market size, infrastructure, and political stability, play a more significant role in attracting FDI than tax incentives alone. A study conducted by Bartlett & Partnoy (2020). and Siregar and Patunru (2021) revealed that tax incentives had a significantly negative impact on FDI.

The constant change in tax rates makes it difficult to rely on the previous researches. Use of different methods and data types could have been the source of different conclusions. It is in the line of the above argument that this study intends to identify and understand more on the effect of tax incentives on foreign direct investment inflows in Kenya. Since FDI keeps changing from time to time, this study seeks to use the most recent data up to 2021.

1.2 Research Objective

The main objective of the study was to examine the effect of tax incentives (Corporate Income Tax) on foreign direct investment inflow in Kenya.

II. LITERATURE REVIEW

2.1 Theoretical Review

2.1.1 Q Theory of Investment

The study was guided by the Q theory of investment 1969, which states that an organization's investment decisions are a function of Q: the market worth of newly acquired additional investment items divided by their substitute cost. This study examines the impact of tax incentives measured as corporate income taxation expenditure on the allure of investment destinations (Bartlett & Partnoy, 2020). Marginal Q, the proportion of a unit of the capital market price to its market valuation, is the basis for all investment fluctuations. Tobin essentially says that shifts in the potential returns have an impact on investment choices (Tobin, 1969). Consequently, investors will raise their investment if they believe that the assets' value outweighs the replacement costs (Ishaq et al, 2021). Tobin's Q is predicated on market price and replacement value ideas, which Grunfeld and Griliches (1960) had previously suggested owners utilise to entice possible investors. Contrary to neoclassical investment theories, this theory bases investments on investors' assessments of the firm's growth prospects. Long et al, (2020) claim that Tobin's Q can forecast investment in advantageous business environments that offer significant returns, as well as assess the impact of incentives related to tax and regulations on firm performance. This theory is essential to comprehending how governments design tax policies, such as special economic zones and tax cuts, to draw in investment. By connecting this to the goal of evaluating how corporate income tax incentives affect foreign direct investment (FDI) in Kenya, Tobin's Q clarifies how tax breaks can enhance Kenya's appeal as an FDI destination. Such incentives can increase the number of foreign investors and create a climate that is more favourable for sustainable economic growth by raising the market value of investments in relation to their acquisition costs.

2.1.2 Tax Competition Theory

The study also employed the Tax Competition Theory, advocated by Hines Jr (2000). This theory focuses on how tax policies impact cross-border investment decisions. It suggests that countries engage in a competitive race to offer attractive tax regimes to multinational corporations, aiming to stimulate FDI inflows. In the context of fiscal policy, this theory highlights the significance of tax incentives as a tool to attract foreign investors.

2.2 Empirical Review

Studies that have examined the relationship between tax incentives and foreign direct investment inflow had different conclusions. Siregar and Patunru (2021), investigated the effects of tax incentives on FDI flows in Indonesia. The study used ordinary least squares to analyse data from 22 countries between 1999 and 2018 to evaluate the impact of tax incentives on foreign direct investment (FDI), among other factors. The conclusion showed that tax breaks and foreign direct investment had the opposite effect.

Abille et al. (2020) investigated the relationship between Ghana's fiscal incentives and foreign direct investment. They used data from 1975 to 2017 in their study utilizing the Autoregressive Distributed Lag (ARDL) bounds test method. According to their findings, tax laws and foreign direct investment inflows have a favorable short-term association.

Kyule (2018) aimed to determine the impact of tax incentives on foreign direct investment (FDI) inflows in Kenya. The study analyzed data spanning ten years (from January 2008 to December 2017) and employed a descriptive research design. Control variables included interest rates, economic growth, and inflation rates, measured every quarter by the Central Bank of Kenya. Multiple linear regression analysis was used to examine the relationship between the variables. The results showed that inflation rates are a significant determinant of FDI inflows, whereas individual tax incentives do not significantly affect FDI inflows.

Kariuki (2023), conducted a study to Analyse how Kenya's listed manufacturing companies attract investors in relation to corporate taxation. This study examined the relationship between corporate taxation and investor attraction in Kenya's manufacturing sector using panel data sets of listed manufacturing firms for the years 2009 to 2021. Regression using panel data was employed in the study. According to the survey, listed manufacturing companies in Kenya had challenges in attracting investors due to corporate taxation. Tax incentives had little impact on attracting investors when it came to the individual proxies for corporation taxation.

Linhartová (2018) examined the variables affecting foreign direct investment (FDI) into the Czech Republic, concentrating on the years 1998–2015. Panel data from public financial reports were used in the study, and multiple regression analysis was used to assess the data. The results showed that the amount of investment inflows was highly impacted by the corporate income tax rate. Since comparable incentives were offered throughout Europe, investment incentives had little effect on foreign direct investment (FDI). The study concluded that enacting a progressive tax system or raising the corporation tax rate would make the nation less appealing after noting that a 1% rise in the corporate tax rate caused some businesses to withdraw from the market. Additionally, other factors influencing FDI inflows included spending on science and research and GDP, both of which had a positive impact, whereas the Corruption Perceptions Index negatively affected the country's attractiveness as an investment destination.

Olaleye et al, (2016) investigated how income tax incentives affected Nigerian listed manufacturing companies' performance. Although there were 176 manufacturing enterprises in total, 174 were the target population for this study, which used a descriptive research approach. The findings showed a substantial positive causal link between foreign direct investment and lower corporate income tax incentives. Reduced corporate income tax incentives have a significant and statistically positive relationship with foreign direct investment. This relationship suggests that foreign investors are likely to increase their investments by utilising the fiscal incentives offered by the government, which will support a sustainable business environment.

Abdioğlu et al., (2016) investigated how tax laws in Organisation for Economic Cooperation and Development (OECD) nations affected foreign direct investment for the period 2003-2016. They divided the nations among those that have tax-cut programmes and those that don't. They looked at the connections between those two nations via time-series analysis sets. Their findings demonstrated that taxes have a big influence on foreign direct investment inflow. Furthermore, they discovered that different tax policies affected FDI differently in nations where there is a negative correlation between FDI and high tax rates.

A study was conducted by Etim et al. (2019) to determine the impact of tax incentives on foreign investors' decisions to engage in FDI (Foreign Direct Investment). The study utilized secondary data from the CBN bulletin and World Bank Development Database that spanned over 19 years (1999 – 2017). The study revealed that there was no significant relationship found between cost-based tax policy incentives, profit-based tax policy incentives and FDI in Nigeria.

Some of the studies by World Bank and the IMF have concluded that tax expenditures and exemptions have eroded Kenya’s tax base and contributed to underperformance in revenue. A revenue performance Technical Assistance (TA) by the International Monetary Fund (IMF, 2019) and previous World Bank (2020) tax studies have estimated exemptions under corporate income and VAT to account for up to 5 percent of GDP in foregone revenue.

In reviewing the empirical literature, it is clear that there are differing opinions and findings on the relationship between tax incentives and FDI inflow. While some studies suggest positive correlations, others highlight the importance of contextual factors and sector-specific considerations.

Therefore, the research aimed to contribute to this field of knowledge by critically evaluating the existing literature, addressing methodological flaws, and identifying gaps that informed the study's focus and methodology.

III. METHODOLOGY

3.1 Study Area

The study was done in Kenya since Vision 2030 identifies industrialization as one of the key sectors to spur the country into middle-income status. Kenya has had a persistent Foreign Direct Investment Shortfall leading to prolonged cycles of the balance of payment deficits (Ogero, 2023). Kenya is one of the East African Countries that is located between latitudes 5^0N and 4.5°S and longitudes 34^0E and 42^0E and covers an area of 580,367 square kilometres (224,081 square miles) with a population of 47,564,296 (Kenya National Bureau of Standards, 2019).

3.2 Research Design

Descriptive, Correlation and causal study designs were adopted for the study to establish the impact of tax incentives on foreign direct investment inflow in Kenya. The data for the trend in FDI inflow was derived from World Investment Reports, World Bank and IMF. Tax Incentive was derived from Budget and Review Outlook Papers, Government Tax Expenditure reports, KRA, KNBS, and CBK. The study used yearly data from 2002 to 2021 for the variables of interest. Tax Incentives were measured by Corporate Income tax expenditure as a percentage of gross domestic product (GDP), while foreign direct investment inflow was measured by growth rates.

3.3 Data Collection

Data were acquired based on secondary sources for a period of twenty years (from 2002 to 2021) and filled in the data collection tool. The data for the trend in FDI inflow was derived from World Investment Reports and data for tax incentives (Corporate Income tax) was derived from the Government Tax Expenditure reports and the Kenya Revenue Authority (KRA).

3.4 Data Analysis

Data analysis involved tabulation of means correlational analysis was done to determine the intensity and direction of the independent variable (increase in FDI inflow) and the Tax Incentives. Later inferential statistics was computed to test the study hypotheses. In addition, the linear regression analysis was conducted to demonstrate the impact of tax incentives on FDI in Kenya

3.5 Econometric Model Specification

Data was collected, cleaned, and sorted using an Excel spreadsheet and analyzed using EViews software version 10. A multiple regression analysis was employed in testing the hypothesized nexus between Tax incentive and foreign direct investment inflow.

The following regression model was employed;

$FDI_t = \beta 0+\beta 1TAX_t+\beta 2REX_{t2}+\beta 3EXTA_{t3}+\mu$

Where: FDI = Foreign direct investment inflow, REX = Recurrent expenditure, EXT = external Debt, t = time index, and μ= error term.

IV. FINDINGS & DISCUSSION

4.1 Descriptive Statistics

Table 1 displays the descriptive statistics for FDI inflow growth measured by growth rates and Tax incentives measured by Corporate Income Tax expenditure as a percentage of gross domestic product (GDP).

Table 1

Variables	FDI INFLOW	TAX INCENTIVES
Mean	534.0805	0.1455
Maximum	1450	0.2400
Minimum	21.21	0.0500
Standard Deviation	484.4778	0.0486
Skewness	0.6511	-0.1838
Kurtosis	2.1720	2.6250
Jarque Bera	1.9843	0..2298
Probability	0.3708	0.8914
Observations	20	20

As shown in Table 1, FDI inflow has a mean of 534.0805 this shows that foreign direct investments in Kenya remain relatively weak considering the size of its economy and the development level. However, Kenya is one of Africa's largest recipients of FDI (UNCTAD, 2023). This indicates greater potential when it comes to FDI Inflow. Additionally, the mean value of tax incentives (Corporate income tax expenditure as a percentage of GDP) in the country stands at 0.1455%. This suggests a somewhat modest approach, implying that while the government provides incentives, they are limited and do not account for a significant share of GDP. This balance might indicate a desire to ensure a consistent flow of tax income while also offering certain incentives for business investment.

4.2 Augmented Dickey-Fuller Unit Root Test

It is critical to establish the presence of a unit root before doing any statistical analysis to avoid erroneous results because most statistical models and procedures presume that the underlying data is stationary (Silva et al, 2021). This study used the Augmented Dickey-Fuller (ADF) test to check for unit roots.
Foreign direct investment inflow and Tax incentives were stationary at the first difference. Table 2 displays the ADF test results.

Table 2
ADF Unit Root Test

VARIABLE	ADF Test statistic @ level	Critical Value @ 5%	ADF Test statistic @ 1st difference	Critical Value @ 5%	Integration order
FDI	-2.4200	-3.6736	-4.8138	3.0403	1st difference
TAX	-4.7144	-3.6456	-4.5567	3.2869	1st difference

4.3 Regression Results

A multivariate regression analysis established the relationship between tax incentives and foreign direct investment inflow. Table 3 displays the output of regression analysis.

Table 3
Regression Results

Dependent Variable: FDI				
Method: Least Squares				
Sample (adjusted): 2002-2021				
Included observations: 20 after adjustments				
Variable	**Coefficient**	**Std. Error**	**t-statistic**	**Prob**
DTAX	0.290502	0.060373	4.811738	0.0002
DREX	0.257703	0.107264	2.402518	0.0288
EXT	-0.338091	0.107189	-3.154145	0.0061
C	0.102659	0.033371	3.077131	0.0072
R- squared	0.735668	Mean dependent var		53.40805
Adjusted R- squared	0.686106	S.D. dependent var		48.47782
S.E. of regression	2.714347	Akaike info criterion		14.22218
Sum squared resid	1.178828	Schwarz criterion		14.42132
Log-likelihood	-13.82217	Hannan- Quinn criter.		14.26105
F- statistic	14.84333	Durbin- Watson stat		1.959410
Prob (F-statistic)	0.000070			

Table 3 indicates that the adjusted R^2 value of 0.686106 and the probability value of the F- statistic was 0.00070< 0.05 implying that the regression model is fit and statistically significant at a 5% level of significance. Furthermore, R^2 of 0.735668 implied that 73.57% of variations in FDI inflow were predicted by the explanatory variables.
The regression equation obtained from Table 3 is;

$FDI_t = 0.102659 + 0.290502TAX_{t1} + 0.25703REX_{t2} - 0.338091EXT_{t3} + \mu$

Where; FDI = Foreign Direct Investment Inflow.
TAX_t = Tax Incentives (Measured as Corporate Income tax as a percentage of total GDP).
REX_t = Recurrent expenditure as a proportion of the total GDP (measure for recurrent expenditure)
EXT_t = External Debt as a proportion of total GDP (measure for External debt in the study)

μ = the error term
t = Yearly time series

4.4 Discussion

Tax incentives have a probability value of 0.0002<0.05, hence a confirmation that it was statistically significant in explaining Foreign Direct Investment Inflow. It had a positive sign as expected, which means that Tax Incentives and Foreign Direct Investment Inflow are directly related. Therefore, tax incentives showed a major impact on the influx of foreign direct investment in Kenya. 0.290502 coefficient for Tax Incentives implies that a 1% rise in tax incentives causes a 29.0502% increase in Foreign Direct Investment Inflow on average Ceteris Paribus. This finding implied that corporate income tax expenditure can as a tax incentive potentially increase Foreign Direct Investment Inflows by making the country more attractive for investors, enhancing competitiveness, and encouraging investment in specific sectors. Hence, this result aligns with the research done by Abille et al. (2020) on the relationship between fiscal incentives and foreign direct investment (FDI) in Ghana. Their findings indicate that there is a positive short-term relationship between tax policies and FDI inflows. This further supports Kariuki's (2023) findings that corporate taxation has a significant impact on the ability of listed manufacturing companies in Kenya to attract investors.

Abdioglu et al., (2016) examined how tax policies affect Foreign Direct Investment in countries that are part of the Organization for Economic Cooperation and Development (OECD). Their findings indicate that reductions in taxes have a considerable influence on Foreign Direct Investment.

The study conducted is not similar to Kyule's (2018) study which focused on assessing the effect of tax incentives on the flow of foreign direct investment (FDI) in Kenya. The results showed that FDI inflows are not significantly influenced by individual tax incentives, interest rates, and economic growth, but inflation rates are a significant factor.

This study also differs from those conducted by Etim et al. (2019) who sought to determine the impact of tax incentives on foreign investors' decisions to engage in FDI (Foreign Direct Investment). The results showed that tax benefits had a notable adverse impact on foreign direct investment. Nevertheless, this study focused on the Corporate Income Tax Expenditure.

4.4.1 Post-Estimation Diagnostic Tests

Multicollinearity Test

Table 4 indicates the Variance Inflation Factors Test output in checking for multicollinearity. Multicollinearity and error-prone variables in linear regression models impede parameter estimates and statistical analysis. When both issues are considered concurrently, it is clear that the error-prone variables disguise the multicollinearity. The variance inflation factor has been demonstrated to be the most prevalent diagnostic tool for multicollinearity (Gokmen, et al, 2022). The study utilized Variance Inflation Factors (VIF) as a measure to detect multicollinearity. The criterion stipulated that a VIF value below 10 indicates a lack of severe multicollinearity, necessitating no intervention. Conversely, a VIF exceeding 10 indicates a pronounced presence of multicollinearity in the model.

Table 4
Variance Inflation Factor Multicollinearity Test

	Coefficient	Uncentered	Centered
Variable	**Variance**	**VIF**	**VIF**
DTAX	1705723	10.84181	1.039383
DREX	437.5945	10.44543	1.158498
EXT	118.5193	26.46492	1.187403
C	111302.1	30.21361	NA

Table 4 shows that the VIF values of DTAX, DREX and EXT are 1.039383, 1.158498 and 1.187403 respectively. The above VIF values were less than 10, thus implying there was no multicollinearity in the regression model.

Breusch -Godfrey Autocorrelation Test

The study employed the Breusch -Godfrey Test in checking for autocorrelation. Table 5 displays the results of the Breusch-Godfrey Test for autocorrelation.

Table 5
Breusch- Godfrey Autocorrelation Test

Breusch-Godfrey Serial Correlation LM Test:			
Null hypothesis: No serial correlation at up to 2 lags			
F-statistic	0.173146	Prob. F(2,14)	0.8428
Obs *R-squared	0.482761	Prob. Chi-Square(2)	0.7855

The results of the Breusch-Godfrey test in Table 5 indicate that the p-value of Chi-square was 0.7855>0.05, implying no autocorrelation problem in the model.

CUSUM Model Stability Test

The CUSUM test is performed to assess the stability of the model at 5% level of significance (Dao, 2021). Figure 2 demonstrates that all variables in the model fall within the 5% threshold.

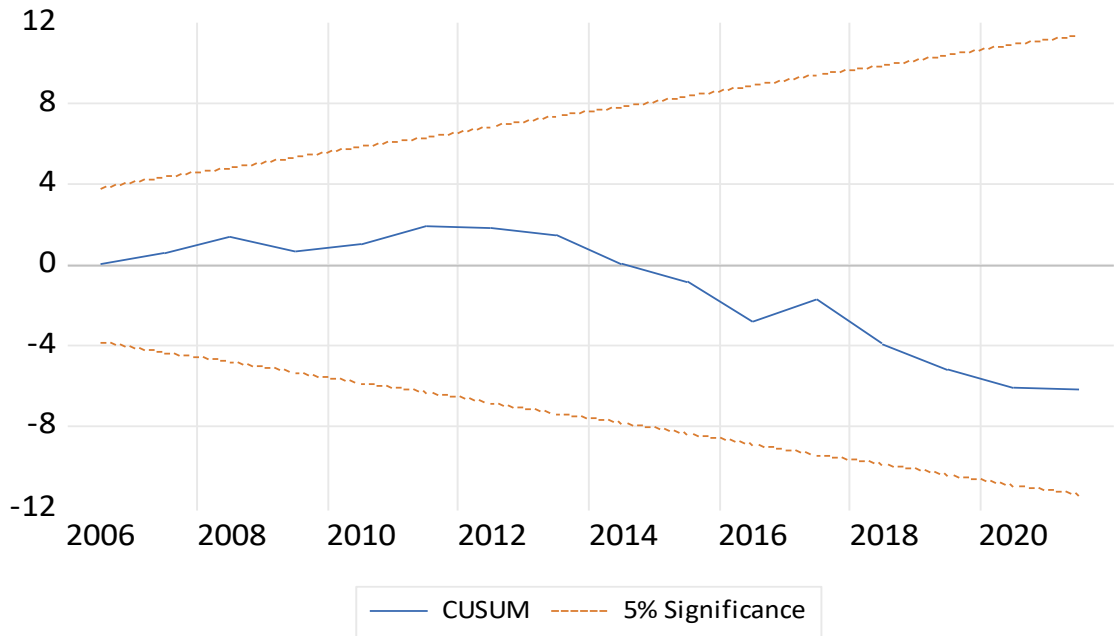

Figure 2
CUSUM Model Stability Test

V. CONCLUSIONS & RECOMMENDATIONS

5.1 Conclusions

The study examined the relationship between Tax incentives and foreign direct investment inflow in Kenya, employing yearly data from 2002 to 2021. The results revealed that Tax incentives had a positive significant effect on foreign direct investment inflow in Kenya, with a regression coefficient value of 0.290502 and a p-value of 0.0002<0.05. The research findings showed that Tax Incentives had a considerable favourable impact on Foreign Direct Investment.

5.2 Recommendations

Given the significant positive impact of tax incentives on foreign direct investment inflow, the study suggests that policymakers should strategically optimize tax incentives, including Corporate Income Tax (CIT). This entails revisiting tax structures, tailoring incentives for specific industries or regions, and prioritizing transparency in tax policies to foster investor confidence. By fine-tuning tax incentive programs effectively, authorities can create a more attractive investment climate, stimulating increased FDI inflows and supporting economic growth.

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