

**FACTORS INFLUENCING FOREIGN DIRECT INVESTMENT:
THE CASE OF KENYA, 1967-2004**

Masters of Arts(Economics) Thesis

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degree in Economics*

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DECLARATION

I, the undersigned, declare that this thesis is my original work and has never been presented for any academic award at this or any other University. Work of others used in this study has been duly acknowledged. Any errors contained herein are entirely mine.

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CERTIFICATE OF APPROVAL

We, the undersigned declare that this thesis is from the student's own work and effort. Where she has used other sources of information, she has duly acknowledged. This thesis is submitted with our approval.

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DEDICATION

**This thesis is dedicated to my husband Gerald and my children Mercy, Eugene,
Oliver and Christian.**

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TO GOD BE THE GLORY AND PRAISE.

ABSTRACT

Private investment, both domestic and foreign is one of the key players in economic development in Kenya. While developing countries as a whole attracted an annual average of \$41 of Foreign Direct Investment(FDI) per capita in the period 1996-2003, Kenya only drew average annual inflows of \$1.3 per capita, thereby missing out on the global surge in FDI that affected most of the world in the 1990's.

On the one hand, FDI liberalization is a means of promoting competition among firms while on the other hand, inorder to benefit fully from FDI liberalization, countries need to ensure that, as statutory obstacles to contestability are reduced, these are not replaced by anticompetitive practices of firms, be they foreign or domestic.

This study attempts to analyse some of the factors influencing FDI inflows into Kenya and of particular interest is the impact that the presence of competition policy has on FDI inflows both in the long and short run. The method of estimation employed was Ordinary Least Squares taking into consideration times series properties of the data.

The results of the study is mixed and shows that in long run market size, macroeconomic stability, credible macroeconomic policies and presence of competition policy play a significant role in influencing FDI inflows. While in the short term corporate tax rates, market size, macroeconomic stability, credible macroeconomic policies and presence of competition policy will influence FDI inflows. An important implication is that FDI inflows in Kenya is not driven by openness of the economy.

This implies that determinants of FDI in Kenya, is dynamic and mixed. This calls for the government of Kenya to put in place policies aimed at promoting investor confidence by providing a competitive and efficient investment framework, improving macroeconomic stability geared towards enhanced economic growth, improving governance and also putting in place the necessary legal framework to speed up completion of anticompetitive cases.

ACRONYMNS

AERC	African Economic Research Consortium
COMESA	Common Market for Eastern and Southern Africa
CUTS-C-CIER	Consumer Unity Trust Society Centre for Competition, Investment and Economic Regulation
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IPR	Investment Policy Review
KIA	Kenya Investment Authority
M&As	Mergers and Acquisitions
MNCs	Multinational Corporations
MPC	Monopolies and Prices Commission
RTP	Restrictive Trade Practices
UNCTAD	United Nations Conference on Trade and Development
WIR	World Investment Report
WTO	World Trade Organization

CHAPTER ONE

INTRODUCTION

1.0 Background

Kenya's economy has been characterized by two decades of poor economic policies, low domestic and foreign investment and slow growth. An Investment Policy Review¹ (IPR) found that the deterioration in economic performance together with rising problems of corruption, governance, inconsistency in economic policies, structural reforms and deterioration of public services and infrastructure generated a long period of low Foreign Direct Investment (FDI) that started in the early 1980's and continues to date (UNCTAD 2005). When Kenya attained its independence in 1963, the government opted for an economy that was more market oriented. There was already an existing private sector dominated by European settlers and the economy was open to foreign investment. Being a predominantly foreign owned economy the government was faced with the challenge of regulation of the economy due to its monopoly character. There was colonial capitalism which gave exclusive powers to branches of large transnational companies in various sectors of the economy. This signalled to the government to nationalize most of the companies and state interventions of all kinds was done by the government to increase its hold over the national economy.

However, in the 1980s, there was a remarkable process of liberalization of FDI policies worldwide which has been part of a broader liberalization of international trade in goods and services and flows of finance, technology and knowledge. FDI is therefore becoming increasingly important to developing countries and in particular to Kenya. In the fiscal environment, a high tax regime will act as an impediment to FDI inflows while tax incentives and tax holidays will have the resultant effect of attracting FDI inflows. For instance, Kenya has a special tax incentive in the Export Processing Zones (EPZ) for exporters over an initial period of ten years and this has resulted in an increase of FDI

¹ UNCTAD Investment policy reviews are intended to help countries improve their investment policies and to familiarize governments and the international private sector with an individual country's investment environment.

inflows in manufacturing, services and commercial; the three activities in the EPZs. Therefore an efficient tax regime which is not burdensome is key to the functioning of the economy with resultant effect of attracting FDI inflows.

Several studies have found that countries that are more open will attract more FDI. However liberalizing FDI regimes is expected to contribute to the contestability of host country markets for goods and services. With the removal of restrictions and establishment of standards of treatment, these markets can now be freely entered by foreign firms by establishing production operations or affiliates (as well as entering contractual arrangements), including those serving local markets. The entry of Multinational Corporations (MNCs) and the activities of their affiliates can influence the structure of host country markets for the products of the industries in which MNCs participate, and, given appropriate conditions including the presence of other firms and the openness of markets to competition by domestic and foreign firms, can strengthen competition. However, market structures in host countries might sometimes become more concentrated after MNC entry, providing greater scope for anticompetitive behaviour by firms, both domestic and foreign. Therefore it remains an empirical issue if openness of the economy will attract FDI inflows for the case of the Kenyan economy.

Governments are sometimes so anxious to attract FDI, or to obtain the highest possible price for the assets they sell to MNCs as part of privatization programmes, that they agree to offer MNCs various kinds of arrangements that grant market power with legal protection against competition in exchange for investment. Market-power inducements in effect restrict competition, typically creating monopoly situations or market structures that provide scope for anticompetitive behaviour. Therefore government policies and actions that are meant to exclude certain investors or monopoly-type inducements that grant legally protected market power given to MNCs, may undermine the pro-competitive effects of FDI. Further, government policies that protect certain segments of the economy may be more attractive to certain investors than a fully competitive market because of the potential benefits for abnormal profits resulting from imperfect competition in that sector.

A synergy exists between investment liberalisation and the effective application of competition policy. FDI can increase competition in local markets, particularly in investments of the greenfield type since investment in new production activities will necessarily add to the number of firms engaged in the production of a good or service and, if the production is for sale in the host country market, to the number of sellers in the market for the good or service. This could have a positive impact for investors who value a level playing field. Further, the entry and subsequent activities of MNCs interact with the structure of markets for goods and services in developed and developing host countries in several different ways. Traditionally, the aspect of market structure that has attracted most attention has been that of market concentration.²

Recent years prior to 2001 have experienced a very rapid increase in FDI with an increasing share of it coming through Mergers and Acquisitions of existing firms in the host country (CUTS-C-CIER, 2005). According to WIR (1997), about half of FDI inflows worldwide during 1989-1996 period is estimated to have taken place through M&As, with 90 percent of cross-border deals being made in developed countries. Until 1992, entry of MNCs into the developing world through M&As was almost entirely confined to transactions in Latin America and the Caribbean. Since 1992, the practice has extended to Asia and Central and Eastern Europe. Privatization during the 1990s has contributed to increasing entry through M&As in developing countries and economies in transition. The acquisition and rejuvenation of local companies can also increase competition in local markets. There is also a possibility that over time such acquisitions may make markets increasingly concentrated and become characterized by one or a small number of dominant players. Conceptually MNCs activities are more pronounced in industries that are more highly concentrated since MNCs possess special advantages that are typically generated in industries with relatively high cost-related barriers to entry which make it conducive to their entering such industries in host countries. The proper application of competition policy and law is believed to be vital in ensuring that the

² However high concentration need not be equated with lack of competition but it can also facilitate the exercise of market power and anticompetitive behaviour.

potential benefits of FDI for a host country are maximised. This study will therefore assume that the presence of competition policy implies having a competition law in place.

Competition policy is now squarely on the menu of issues to be tackled within the multilateral trading system. Most competition laws contain merger control provisions and this implies that FDI has to undergo the scrutiny of the competition agency of the host country before being allowed to start operations in economies where a competition law is in place. From an international viewpoint, even where competition laws do exist, they differ considerably in terms of their content, sectoral scope and in terms of the entities they cover. Competition is important to a sound investment climate and competition laws therefore could be expected to play a key role. Competition policies should therefore be given increasing attention because of the need to balance the benefits of globalization against possible anti-competitive effects.

Although UNCTAD (2005), has tended to be descriptive, especially with analyzing trends, incentives, motivations and distribution of FDI but virtually no empirical work aimed at statistically evaluating the determinants of FDI in Kenya exists. This study has the object of going beyond intuitive and descriptive analysis by providing an empirical estimate of determinants of FDI using time series analysis. The analysis focusses on FDI in all industries combined. An attempt which entailed disaggregated approach of FDI into new investments and Mergers and Acquisitions is complicated by absence of such data.

1.2 Problem Statement

In a liberalized environment, markets play a major role in determining how economic performance is influenced by FDI. Kenya under-performed in attracting FDI over the past two decades. Instead of benefiting from global shifts in FDI as a result of liberalization of FDI regimes, the evidence is that Kenya is losing ground as potential investors stay away from the country and existing investors relocate elsewhere. For instance, in 1999 Procter & Gamble moved its detergent production line from Kenya to Egypt and in 2000, Johnson & Johnson moved its production to Zimbabwe from Kenya. This trend of foreign investors moving out and consolidating out of Kenya, with few new investors coming in is a worrying trend.

In the 1980s there was a remarkable process of liberalization of economies worldwide. With the wave of liberalization, Kenya also embarked on liberalization of its policies, which were aimed at opening up the Kenyan market. Complete liberalization of the trade regime was achieved in 1995, with one of them being the introduction of the Kenyan Competition law in 1989 which saw the Kenyan economy move away from price control regime (with significant state intervention) towards a market economy. However, what is not known is how these policy changes have affected FDI inflows in Kenya. The question that the study seeks to answer is what are the relevant factors that determine FDI inflows in Kenya. Most studies in Kenya on what determines FDI have tended to be descriptive however there have been no studies in Kenya, which have empirically tried to examine the determinants of FDI. Therefore this study attempts to empirically determine the factors influencing FDI inflows in Kenya and the influence that the presence of competition policy will have on FDI inflows.

1.3 Significance of the study

In Kenya, there has been a worrying trend of foreign investors moving out and consolidating business outside Kenya with few new investors coming in. On the other hand, Kenya also missed out on the global surge in FDI that affected most of the world in the 1990s (UNCTAD, 2005). FDI inflows into Kenya is deemed to be beneficial if it acts as a source of government revenue, skills or technology improvement and also for employment creation. The desire is to establish what attracts FDI inflows in Kenya as this is relevant for the country's strategic economic policy. The motivation of this study is therefore the desire to investigate the factors influencing FDI inflows that will shed more light on the appropriate policy formulation to attract and retain FDI inflows. The study is important as it is expected to enrich the literature on government responses to FDI inflows and open new avenues for further studies.

1.4 Objectives of study

The overall objective of the study is to examine the factors influencing foreign direct investment inflows in Kenya. This overall objective will be achieved by considering the following specific objectives;

- To investigate if openness of the economy has an influence on FDI inflows
- To examine if corporate tax rates determine FDI inflows
- To find out if market size has an influence on FDI inflows
- To investigate if macroeconomic instability has an explanatory power on FDI inflows
- To investigate if the presence of Competition Policy has an influence on FDI inflows.

1.5 Hypotheses

The hypotheses to be tested to achieve the above objectives are:

- Openness of the economy does not influence FDI inflows in Kenya.
- Corporate tax rates does not determine FDI inflows
- Market size does not influence FDI inflows
- Macroeconomic instability has no explanatory power on FDI inflows
- Competition policy has no influence on FDI inflows

1.6 Organization of the study

The study will be organized in six chapters. Chapter two will highlight an overview of FDI inflow trends and interface of FDI and Competition Policy. Chapter three will review both theoretical and empirical literature. Chapter four will look at the methodology of the study. Chapter five will display the results, analysis of the results and discussions of the results. Chapter six will consist of summary of findings, conclusions and policy recommendations.

CHAPTER TWO

2.1 OVERVIEW OF FDI AND COMPETITION LAW IN KENYA

This section gives an overview of entry and establishment of FDI, trends of FDI inflows in Kenya and also the establishment of competition law in Kenya. It also reviews the interface of FDI and Competition Policy and further outlines some cases on FDI and Competition in Kenya.

2.1.1 Entry and establishment of FDI

For decades, Kenya had one of the most open regimes for FDI in Africa. The principal restrictions were contained in the Trade Licensing Act (1968) with subsequent amendments. Apart from this Act, the only formal limits on foreign ownership were in telecommunications and insurance (in which foreign ownership of a business was limited by policy to 70 percent and 77 percent respectively) and for companies listed on the Nairobi Stock Exchange which are required to have at least 25 percent national ownership. Moreover, FDI did not require screening for approval. The nature of restrictions that existed under the Trade Licensing Act of 1968 are:

- There was no restriction of access to foreign investors
- Trade license were obtained free of charge and without delay from the Ministry of trade and Industry.
- Foreigners were allowed to operate in all sectors of the economy and throughout the country.
- Licenses were valid for periods of one to three years.

A new FDI entry regime introduced in 2004 saw one of the most liberal regimes replaced by more restrictive one. The Investment Promotion Act (2004), introduced a mandatory investment threshold and restrictive screening procedure for all foreign investments. It further required foreign investors to apply to newly established Kenya Investment Authority (KIA) for an investment certificate. Some of the new requirements stipulated in the Investment promotion Act (2004) are:

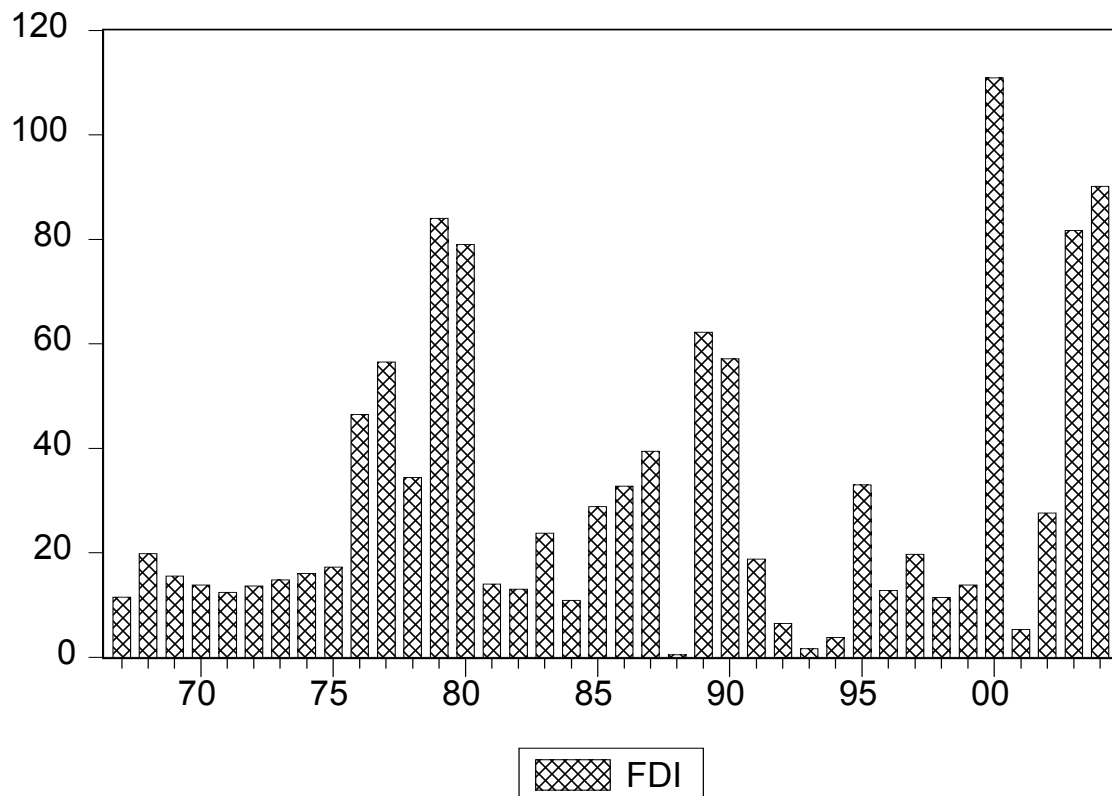
- There is a mandatory investment threshold . The amount to be invested by a foreign firm must be at least \$500,000 or the equivalence in another currency while for domestic firms the minimum capital invested is \$65,000.
- Foreign investors are required to apply to the newly established KIA for an investment certificate and that a foreign investor shall not invest in Kenya unless it has been issued with an Investment Certificate.
- Investment must be deemed by KIA to be to the benefit of Kenya, that is, must lead to the creation of jobs for Kenyans, acquisition of new skills or technology and must contribute to tax revenues or other government revenues.

Source: UNCTAD (2005).

2.1.2 Trends in FDI inflows

Foreign Direct Investment (FDI) grew steadily through the 1970's as Kenya was a prime choice for foreign investors since it was more open to FDI than other countries in the region. FDI started at a low of \$10 million a year in the early 1970s before reaching a peak of \$80 million during 1979-1980. In the period 1989-1999 FDI inflows averaged only \$22million a year. Although the sale of mobile phone licences to Kenyan-foreign joint ventures pushed FDI to over \$100million in 2000, inflows fell again to around their average of the 1980s and 1990s before rising again in 2003 because of textile investments in Export Processing Zones(EPZs). While developing countries as a whole attracted an annual average of \$41 of FDI per capita in 1996-2003, Kenya only drew average inflows of \$1.3 per capita. Kenya thus missed out on the global surge in FDI that affected most of the world in the 1990s (UNCTAD, 2005).

Figure 1: FDI inflows to Kenya, 1967-2004 (million dollars)



Source: *Data from International Financial Statistics, various issues.*

2.2 Establishment of Competition Law in Kenya

In the 1980s, there was increasing debate of liberalization of the economy which saw the Kenyan economy move away from price control regime towards a free market economy. The government therefore put in place the Kenyan Competition law, The Restrictive Trade Practices, Monopolies and Price Control (RTP-MPC) Act³, Cap 504 of the Laws of Kenya which came into force on 1st February , 1989. The Act is implemented by the Monopolies and Prices Commission (MPC) which is a department of the Ministry of Finance. However, the economy was still characterized by incomplete price decontrol since the petroleum sector remained under price control until 1994 when the economy

³ The Act provides for the control of restrictive trade practices, price fixing, collusive tendering, monopolies and concentrations of economic power and for control of mergers and acquisitions and was meant to be a provisional one. Currently an amended draft is awaiting the approval of the Attorney General.

was completely price decontrolled. During the period 1989-2004, MPC handled a total of 234 M&As cases with 58% of the cases being handled in the last five years. The highest percentage of 15.8% was handled in the year 2000 alone. However during 2001-2004 there has been a decline in the number of M&A cases handled by MPC (see table 1 below).

Table 1: Cases considered by the Monopolies and Prices Commission from 1989-2004

Year	Restrictive Trade Practices cases	Merger and acquisitions Cases
1989	7	6
1990	6	9
1991	6	10
1992	7	9
1993	7	7
1994	13	9
1995	15	14
1996	15	11
1997	10	11
1998	15	12
1999	18	24
2000	18	37
2001	18	23
2002	15	35
2003	35	19
2004	15	22

Source: Various issues of Monopolies and Prices Commission Annual reports, Kenya.

2.3 FDI and Competition Policy

The liberalization of FDI policies can lead to an increase in competition in national markets. Most countries, in particular developing countries, are indeed liberalizing the entry of inward FDI and have gradually extended this process to traditionally closed industries, such as telecommunications, public transport and other public utilities. The reduction of barriers to entry has an immediate effect in terms of reducing market-entry costs and increasing, at least in principle, the contestability of markets. The gradual abandonment of many FDI restrictions has been complemented by the adoption of standards of non-discrimination, national treatment and most-favoured-nation treatment for FDI (WIR 1997).

Some of the barriers to FDI entry are due to government measures, such as the granting of exclusive rights (including state monopolies), privatization, technical standards, public procurement practices and licensing requirements (WIR 1997). These are receiving increasing attention due to concern about anticompetitive private business practices, which include many restrictive business practices. Some of these practices are prohibited per se for their anticompetitive effects, including various kinds of horizontal cartel agreements. The situation becomes more difficult when the practices may have anticompetitive effects but are not considered illegal under the laws of the countries in which they occur. While such practices do not discriminate between domestic and foreign firms, they may constitute barriers to competition. Therefore in their eagerness to attract FDI, governments should not end in situations where they agree to inducements which, by their very nature, restrict competition.

According to CUTS-C-CIER (2005), the entry and subsequent activities of MNCs interact with the structure of markets for goods and services and may lead to market concentration. While high market concentration does not necessarily imply a lack of competition or contestability, high concentration and a large market share may make it easier for firms to undertake anticompetitive practices, especially where entry barriers exist through brand dominance; intensive and extensive advertising; high investments;

control over distribution systems among others. Where this happens, the lack of competition law, or of merger review provisions in competition law, can reduce the investor-friendliness of the environment by allowing concentration to rise. It may also make it difficult for domestic entrepreneurs in developing countries to succeed.

The main interface between competition law and FDI occurs when a foreign affiliate is established by means of a significant merger, acquisition or joint venture. Such transactions may be examined by competition authorities under merger-control review, especially when they occur between competing firms, such as when the acquiring foreign investor was competing through exports with the domestic firm it plans to acquire. They may also be subjected to anti-monopoly provisions if they are viewed as a means to achieve or preserve a dominant market position. Furthermore, joint ventures may involve a market-allocation investment cartel to restrict FDI. Countries are therefore increasingly adopting merger-control regulations (WIR 1997).

At the regional level, too, merger control is also gaining increasing attention. The Common Markets for Eastern and Southern Africa (COMESA) currently has a draft competition law in place to help in regulating anticompetitive practices among member countries. However, it has not been ratified by the member states.

2.4 Some cases on FDI and Competition in Kenya⁴

2.4.1 Carbonated soft drinks sector

The Coca-Cola soft drink case in Kenya has an interesting history and shows how the presence of an appropriate competition law may reverse an intended monopoly situation. The Coca-Cola Company, Atlanta, the franchisor of all Coca-Cola companies across the world, had a consolidation plan of having Anchor-bottling⁵ companies in the world. This led to the taking over of bottling companies in Kenya one at a time by Coca-Cola South Africa Bottling Company Limited (Coca-Cola Sabco) in an attempt to have only one bottling company in Kenya. Coca-Cola Sabco acquired majority stake in Nairobi Bottlers Limited, which was one of the eight bottling plants, all franchisees of Coca-Cola Company, Atlanta. In 1997, Coca Cola Sabco acquired total shareholding in another bottling plant, Flamingo Bottlers, and there was an express proviso by the then Commissioner, that it would not acquire any other plant at any time so as not to have a tight hold on the market. In 2001, Coca-Cola Sabco acquired yet another bottling plant, East Kenya Bottlers based in Machakos against the recommendation of MPC.⁶ After the acquisitions it renamed itself to Coca-Cola Holdings and this gave it control of about 70 percent of the market which is a concentration of economic power.⁷ Concentration of economic power per se is not bad but the abuse of that dominant position is anti-competitive.

In 2003, further investigations⁸ in the carbonated soft drinks sector revealed that due to the dominance of Coca-Cola Holdings it was abusing its dominant position by engaging in several restrictive trade practices like resale price maintenance, territorial allocation, exclusive dealership arrangements and tied selling against the provisions of the

⁴ See UNCTAD, (2005), Voluntary Peer Review on Competition Law in Kenya, at <http://www.ditcclp20056en.pdf>.

⁵ One big bottling company which supplies to the whole region.

⁶ MPC is not autonomous. The final decision lies with the Minister who can either approve or reject the recommendation of the Commissioner.

⁷ RTP-MPC Act stipulates the threshold for concentration of economic power as market share of 33.33% and market share of 40% is considered as concentration of economic power.

⁸ Gazette Notice number 1020 of 10th February, 2003.

competition law. This was addressed in a draft consent order. However the Commission suspended its investigations before the Consent order could be signed when the complainants took the matter to the High Court. The High Court proceedings have not been concluded.

2.4.2 Cement sector

There are three cement manufacturers in Kenya: Bamburi Cement Limited (BCL), East African Portland Cement Limited (EAPC) and Athi River Mining Company Limited (ARM). BCL is the largest with a market share of 57 percent, followed by EAPC with 37 percent and ARM with only 6 percent. However, there is cross-ownership within the industry. BCL has a shareholding in EAPC and also in ARM. The largest shareholding in BCL in turn is held by French Multinational Lafarge, the largest cement producer in the world. BCL supplies ARM with all its requirements of clinker, a major raw material in cement production. EAPC and BCL sell their products through appointed distributors and also directly to large contractors, but ARM sells through general dealers. BCL's distribution agreement has a restrictive clause that prohibits the distributors from selling competitors' products. BCL has leased and developed two berths at Mombasa port which results in the company being charged a port tariff of \$1.5 per ton by Kenya Ports Authority. However, their competitors must pay a port tariff of \$15 per ton when they use the other general berths, and this does not result into a level playing field for all the players.

In 2004, the Minister for Finance directed the Commissioner to investigate the Cement sector as he believed the sector might feature one or more factors related to unwarranted concentrations of economic power under Section 23 of the Act.⁹ The Commission did not find any need to recommend a disposal of interests in the sector.

⁹ Gazette Notice of 23 January, 2004.

2.4.3 Alcoholic beverages sector

Investigations was launched by MPC in this sector after receiving complaints from the distributors of Kenya Breweries Limited (KBL). Currently, KBL has a monopoly of the beer market. In 1998, Castle Brewing Limited (CBL), a South African company, entered the beer market but exited in 2002. Several other beer companies have entered the market but none have been able to stay on course. KBL manufactures , exports, imports and distributes beer and spirits all over the country. It sells its products through appointed distributors located across the country and also sells directly to retail outlets. The Commission conducted oral interviews and obtained questionnaires during its investigations. The Commission found that KBL's agreement with the distributors contain clauses which contravene the Act, that is, territorial allocation, exclusive dealership and price fixing which contravenes sections of the RTP-MPC Act.¹⁰ The Commission noted the absence of adequate provisions in the Act to control dominance in the market. This case shows how lack of adequate provisions in the competition law can lead to situations of concentration of economic power and the abuse of it which can deter potential entrants into the market and impede FDI.

2.5 Emergence of Competition Policy

Competition policy refers to a body of policies intended to prevent collusion among firms and to prevent individual firms from having excessive market power. The main objective of competition laws is to preserve and promote competition as a means to ensure that efficient allocation of resources in an economy, resulting in the best possible choice of quality, the lowest prices and adequate supplies for consumers.

Developed countries were the first to adopt competition laws and to set up regulatory agencies. In the U.S. it is called the 'anti-trust policy'. The origin of the competition policy is in the 19th century USA Sherman Antitrust Act and from there it spread to Germany and Japan. The European Community (EC) incorporated a competition policy

¹⁰ See Sections 6(1)(i), 6(1)(a)(i) and 6(1)(d) of RTP-MPC Act.

in articles 85 and 86 of the Rome Convention and in Regulation 17 of the Council of Ministers, 1962 (Vaknim, undated). In 1914, another Act, the Clayton Act was passed by USA to supplement the Sherman Act and this further increased government's power but also allowed for lawsuits against anti-competitive practices. Since then more developing countries and economies in transition have adopted competition laws as well as agencies to administer them. In 1980, less than 40 countries had competition laws. The pace of adoption increased rapidly after 1989, when formerly centrally planned economies in Central and Eastern Europe introduced comprehensive programmes of investment liberalization, deregulation, privatization and competition-law enforcement. Currently, over 70 countries worldwide have competition laws (WIR 1997). Some developing countries have followed developed countries models. For most developing countries, based on UNCTAD's Model Law on Competition, have adopted different models to suit their needs while taking into account their judicial systems since 'one size fits all' competition law is not advisable.(WIR, 2003).

2.6 Enforcement of Competition Law

Competition laws apply to all firms in the national territory and supplying a particular market, whether through domestic sales, imports, foreign affiliates or non-equity forms of FDI. They do not, in principle, discriminate between national and foreign firms or between foreign firms from different national or regional origins when it comes to competition analysis (WIR 1997).

Most competition laws deal with enterprise behaviour by prohibiting such restrictive business practices as competition-restricting horizontal¹¹ agreements, acquisitions and abuses of dominant positions,¹² as well as substantially restrictive vertical¹³ distribution

¹¹ Horizontal agreements are concerted practices among competing enterprises and include practices like price fixing, restraint of output, market allocation, exclusionary practices, collusive tendering/bid-rigging and other restraints on competition.

¹² Competition laws, in general, do not consider the possession of a dominant (or monopolistic) position per se unlawful but, rather, the abusive exploitation of that position.

agreements. Most competition laws deals with alterations to the structure of markets, through the control of M&As, as well as joint ventures (merger control) aimed at avoiding the creation of dominant positions, monopolies, or even oligopolies. Most Competition laws also contain exceptions (basically sectoral) and exemptions to the application of their provisions, for example, in regulated industries like telecommunications, defence or even in cooperative arrangements. It is therefore the task of the competition authority or courts to consider business practices, and focus on those that have the highest probability of anticompetitive effects and the least justification based on efficiency (WIR 1997).

¹³ Vertical restraints include exclusive dealing, reciprocal exclusivity, refusal to deal, resale price maintenance, territorial restraint, discriminatory pricing, predatory pricing, tied selling, premium offers or royalty rebated, full-line forcing and transfer pricing

CHAPTER THREE

CONCEPTUAL FRAMEWORK AND LITERATURE REVIEW

This section reviews the economic arguments for FDI and the findings on the determinants of FDI. It also reviews findings on the link between competition policy and FDI by other studies that have been conducted.

3.1 Review of Theoretical Literature

The arguments for FDI largely stem out of the traditional neo-classical and new growth theory analysis of the determinants of economic growth. FDI refers to the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset(Sodersten & Reed, 1994). FDI can be of the greenfield type or through M&As. Greenfield investments are direct investments in new facilities or the expansion of an existing facility. M&As occur when a transfer of existing assets from local firms take place.

3.1.1 Neo Classical Approach

According to Todaro (1997), the arguments for FDI stem out of the traditional neo classical analysis where FDI is seen as a way of filling in the gaps between domestically available supplies of savings, foreign exchange, government revenue and human capital skills and the desired levels to achieve growth and development targets. First, FDI contribution to national development is in filling the resource gap between targeted or desired investment and locally mobilized savings and only if this translates to growth in GDP. Second is the foreign exchange gap which is the gap between targeted foreign exchange requirement and those desired from net export earnings plus net public foreign aid. The belief is that private foreign capital cannot only alleviate part or all of the deficit on balance of payments current account but can also function to remove that deficit overtime if the MNCs can generate a net positive flow of export earnings. Third, it is

argued that the tax revenue gap is filled by taxing MNCs profits and also by them participating financially in local operations, making host governments better able to mobilize public financial resources for development projects. Lastly, there is the gap in management, entrepreneurship, technology and skills presumed to be partly or wholly filled by the local operations of private foreign firms (Todaro 1997). MNCs not only provide financial resources and new factories to host countries, but also supply various resources, for example, by educating managers and on-the-job trainings, they provide the entrepreneurship and management skills.

In a perfectly functioning Heckscher-Ohlin (H-O) world with incomplete specialisation and no factor-intensity reversals there would be a few incentives for international factor movements, since free trade will equalise relative factor prices (Sodersten & Reed, 1994). This implies that the failure of factor prices to equalise could provide an incentive for migration and establishment of foreign subsidiaries to take advantage of lower costs in other countries. A common cause of differences in factor prices that may generate FDI is the violation of the assumptions of identical production function (technologies) and universal perfect competition central to the H-O model.

According to the Product Life-cycle Hypothesis by Vernon (1966), it is argued that in the initial stages of a product cycle, initial expansion will be through exports, but as the product evolves and competing products are developed, the firm may decide to look overseas for the lower cost locations and new markets due to considerable scale economies from longer production. New markets could also be established by price reductions or in an oligopolistic market structure through product differentiation. This explains the concentration of innovations in developed countries and growing and integrated intra-industry trade and FDI (Sodersten & Reed, 1994).

Dunning's 'eclectic theory' of FDI, uses the Ownership advantages, locational considerations, and internalization gains (OLI) paradigm as an explanation to FDI. MNCs have advantages in technology, management, organizational skills, size and diversification, access to finance and ease with which they can shift production between

countries which makes them able to exploit opportunities across borders. In some countries locational considerations still impede FDI but with debate of eliminating barriers to entry and giving MNCs tax holidays, explains the presence of FDI. All these conditions must be met before there will be FDI but there is no one condition which is sufficient (Sodersten & Reed, 1994).

Taxation policies in source and host countries may affect the flow of FDI. Differences in such policies between countries may also encourage MNCs to engage in activities designed to maximise their post-tax profits on a global basis. Other things being equal, comparatively high tax rates on profits will encourage firms to look outside their home country for a base in which they will pay lower taxes. Special provisions in policy on profits earned externally, such as those allowing firms to defer tax payments until the profits are repatriated, will offer further encouragement. Similarly, a country with low taxes on profits will tend to attract FDI inflows. This may be reinforced by other incentives like a 'tax holiday' (Sodersten & Reed, 1994).

3.1.2 Neo-Marxist theories

Marxists saw FDI as a natural consequence of a maturing capitalism due to the need for new markets (Sodersten & Reed, 1994). On the extreme they believe that capitalist countries derive profits from FDI abroad and also highly depend on the territories and their economies may collapse without them. In most cases, FDI occurs because the investing enterprise has technological, managerial, capital and skills advantage which they want to exploit in foreign markets apart from the profitability drive.

3.1.3 Market Failure

Governments concern with implementation of competition policy is due to market failures. The economic argument is the concern over market failures resulting from monopolies or oligopolies and the resultant effects of concerted practices. There is need therefore of formulating policies that would prevent one firm or a few firms acting in concert to gain control over a market. Oligopolistic interdependence may lead to intense rivalry which may result in collusion. In cartels, firms meet with the objective of replacing competition with cooperation so that they all benefit (Dolan & Lindsey, 1988). Competition policies are therefore put in place by governments to regulate such markets with the objective of bringing fairness to all players.

The aims of competition (anti-trust) laws are to ensure that consumers pay the lowest possible price (the most efficient price) coupled with the highest quality of the goods and services consumed. This, according to current economic theories, can be achieved only through effective competition. Competition not only reduces particular prices of specific goods and services - it also tends to have a deflationary effect by reducing the general price level. It pits consumers against producers, producers against other producers (in the battle to win the heart of consumers) and this everlasting conflict does the miracle of increasing quality with lower prices and achieves the two main objectives of competition policy, that is, efficiency and fairness (Vaknim, undated).

3.2 Empirical Literature

Most of the studies on FDI have concentrated on the determinants of FDI in developing countries or Sub-Saharan Africa but comparatively no empirical work exists on what determines FDI inflows in Kenya. Further very few studies look at the broader link between FDI and competition policy.

A study done by Asiedu (2003), on what determines FDI to Africa, in particular the role of government policy, governance and political instability found out that macroeconomic stability, efficient institutions, political stability and a good regulatory framework have a positive impact on FDI. In using a panel data for 22 counties in Sub-Saharan Africa (SSA) over the period 1984-2000 she concluded that Africa is not solely driven by natural resource endowment but that governments can play an important role in promoting investments to the region. A further study by Asiedu, (2003) on policy reform and FDI to Africa found that despite Africa's improved infrastructure, liberalized investment framework and reformed institutions, it still experienced a decline in FDI globally. An implication of the results is that in a competitive global economy, it is not enough to just improve one's policy environment: improvements need to be in both absolute and relative terms.

Due to decreasing trends of FDI to low-income developing countries, Oluyele (2003), tried to find out why middle-income countries benefited from FDI more than low-income countries. He concluded that a combination of high per capita GDP, high rate of return on investment, outward-orientation to international trade and the level of infrastructure development are the significant and important decision parameters in choosing whether or not to locate investment in a developing country. Other determinants of FDI inflow include political risk, taxes on income, profits and capital gains, the level of inflation, the level of financial sector development and availability of solid minerals and petroleum resources.

A study by Bevan and Estrin (2000) on the determinants of FDI in Transition Economies of Eastern and Central Europe found that FDI inflows are significantly influenced by risk, unit labour costs, host market size and gravity factors. In using a detailed panel data set covering the periods 1984-1998 they perceived that private sector development, industrial development, government balance, gross reserves and corruption are significant determinants of country risk, which may impede FDI inflows.

Chakrabarti (2001) used a variant of Extreme Bound Analysis (EBA) to determine which coefficients of the explanatory variables studied in the existing cross-country studies on the determinants of FDI are “*robust*” and which are “*fragile*” to small changes in the conditioning information set. He ranked the estimated coefficients of potential explanatory variables of FDI in terms of their *likelihood* of being correlated with FDI by assigning each of them a level of confidence. The EBA showed a strong support for the explanatory power of market size of a host country in its FDI but revealed that the relations between FDI and many of the controversial variables that have been reported in the empirical literature (namely, tax, wage, openness, exchange rate, tariff, growth rate of GDP, trade balance) are highly sensitive to small alterations in the conditioning information set. The variables are termed controversial because depending on the choice of variables in a model, one would get completely different results. He argues that while it is encouraging to find that a vast number of empirical literature not only exists but continues to grow around the issue of identifying the forces attracting FDI, it is not exactly clear *whether* one can have any confidence in the conclusions reached by FDI regressions.

Chakrabarti (2003) argues that today’s process of globalization is neither complete nor irreversible. While it is easy to exaggerate the extent of globalization it is only prudent for policy-makers to recognize that at any point in history there are many powerful forces at work driving countries apart at the same time as other powerful forces working to integrate the world. There is also a growing discrepancy between the integration of international capital markets and the limited capacity at the national and multilateral level to control and regulate these markets. There is need therefore to systematically evaluate the partial correlations between FDI and a wide assortment of economic indicators.

Obadan (1982) found that market size, growth rate, tariff barriers and need for raw materials stimulate demand for FDI. He concluded that when dealing with policy issues related to FDI in Nigeria, it is important to take cognizance of such factors as the country’s market size or growth and, to some extent tariff policy. Although the analysis supports the hypothesis that the desire to acquire raw materials for their industries back

home has induced foreign investors to invest in the country, the variable representing it is virtually outside Nigeria's control.

An endeavour to find the link between competition policy and FDI focused on the channels through which government policies, private practices and FDI could interact (Norland, 1999). Norland's analysis was concerned about the impact of government policy on FDI, particularly the possibility that those policies may encourage firms to engage in anticompetitive private behaviour that may impede FDI. His data focused on the US and Japan and his results imply that there is little evidence to support the notion that industrial or private practices impede FDI. Generally, he argues that informal barriers do not appear to be an impediment to FDI. Although as formal restrictions are liberalized there may be some attempts by incumbents to use anticompetitive practices to impede new entry. He further argues that competition policies per se may be the general trend toward deregulation and liberalization in both goods and factor markets with the consequent elimination of anticompetitive practices facilitating devices.

A study carried out by Clarke (2003) concentrated on trying to find the broader link between FDI and competition policy by using data from a panel containing FDI for 98 countries over the years 1985-1999. He used data before and after the competition law was put in place and examined whether there was a systematic deviation of the amount of FDI before and after the changes took place in all the big economies of the world. The results infer that there is a positive relationship between the existence of a competition law, the enforcement of competition law and FDI.

In exploring the possible implications of competition policy on FDI, Horn and Francois (2000) used a general equilibrium model. Their analysis proposes that differing competition policies result in different cost structures across countries, and assert that beggar-thy-neighbour competition policies may be undermined by FDI. This is based on their observation that a strategic competition policy that increases profits of domestic firms by permitting larger markups than would prevail under perfect competition will also enhance the competitive position of those firms by lowering their marginal costs.

They further hypothesize that the reduction in marginal costs in the country pursuing an export oriented strategy will actually attract FDI by encouraging overseas manufacturers to invest in the more competitive factors of production there. In their model, FDI is disadvantageous for the recipient country because it suffers a loss of income.

Horn and Francois therefore float the question of whether some countries will be worse off as a result of the increased FDI that results from the competition policy and surmise that countries pursuing a beggar-thy-neighbour competition policy may oppose any international accord which attempt to set minimum standards for a multilateral framework on competition precisely because it will have a negative impact on their national welfare. Thus, the literature concerning the link between FDI inflows and the existence of competition policy has yielded varying results. Therefore the net effect of factors influencing FDI inflows in Kenya remains an empirical issue.

CHAPTER FOUR

METHODOLOGY OF STUDY

This section displays the model employed in the study, description of variables used and also data sources. It further gives the data analysis technique and the various diagnostic tests underlying time series analysis.

4.1 THE MODEL

This study will employ a model similar to the one by Clarke (2003) who did a study on competition policy and foreign direct investment. However the model employed in this study differs from Clarke's in the method to be used. Clarke used a general least squares method with random effects due to the fact that he dealt with panel data. This study will use Ordinary Least Squares (OLS) method.

The model to be estimated is therefore given as:

$$LnFDI_t = \beta_0 + \beta_1 LnOp_t + \beta_2 LnCtx_t + \beta_3 Lnfer_t + \beta_4 Lnrgdp_t + \beta_5 LnInfl_t + \beta_6 CDum + \mu_t$$

Where

t = time

Ln = natural logarithm

FDI = Aggregate FDI inflows

Op = Measure of the openness of the economy to trade

$Ctax$ = Corporate tax rates

Fer = foreign exchange rate

$rgdp$ = real gross domestic product

$Infl$ = Annual inflation rates

$CDum$ = competition law dummy variable

μ_t = error term

4.2 Definition of Variables and Sources of Data

This study will employ secondary annual data from 1967-2004 and this will show the post independence trend. The following variable definitions will apply (as tabulated in Table 2 below):

Table 2: Definition of variables and Sources of Data

Variable	Definition	Source
FDI	Aggregate annual foreign direct investment inflows	International Financial Statistics (IFS), various issues
Op	Measure of openness of the economy which will be proxied by share of trade to GDP (total imports plus total exports divided by GDP in real terms)	International Financial Statistics (IFS), various issues
Ctax	Corporate tax rates for non-resident companies	Kenya's Economic Surveys, various issues
Fer	Foreign exchange rate (Kenya shillings to the US dollar)	International Financial Statistics, (IFS), various issues
Rgdp	Real Gross Domestic Product, deflated by GDP deflator, which is a proxy for market size	International Financial Statistics,(IFS), various issues
Cdum	Competition Law dummy variable, a value of one from 1989 onwards and zero otherwise	
Infl	Annual inflation rates will be used as proxy for macroeconomic instability	Central Bureau of Statistics, Kenya

4.3 Expected signs

4.3.1 Openness of the economy

As countries liberalize their FDI regimes, it is expected that a more open economy will attract more FDI inflows. Therefore openness of the economy to trade is expected to carry a positive sign.

4.3.2 Corporate tax rates

Multinational Enterprises always try to minimize the total taxes they pay and will locate their affiliates in countries offering low tax rates on profits. Therefore high taxes on profits tend to discourage investment. The relationship between FDI inflows and corporate tax rates is expected to be negative.

4.3.3 Foreign exchange rate

Credible macroeconomic policy management positively influences inbound FDI but on the other hand lack of credibility in macroeconomic policy management can have a negative impact on FDI inflows. Foreign exchange rate, *fer*, will be employed to find out how it impacts on FDI inflows. The relationship is expected to be negative.

4.3.4 Market size

A large market implies a greater demand for goods and services and therefore makes the host country more attractive for inbound FDI. All else equal, FDI should be positively related to domestic income. Therefore total GDP in real terms will be included as a proxy for market size. This is postulated to have a positive relationship with FDI inflows.

4.3.5 Competition Policy

An effective competition policy removes barriers to entry and also provides a predictable legal and regulatory framework. The proper application of competition law can attract and retain FDI inflows for investors who value a level playing field. Kenyan competition law came into force on February 1, 1989, therefore the data will be assigned a value of one from 1989 onwards and zero otherwise. In this way, the presence of competition law and its attendant effect on FDI may be measured. Competition policy is expected to be positively related to FDI inflows.

4.3.6 Inflation rate

Inflation rates will be used as proxy for macroeconomic instability. Holding other factors constant, a higher inflation rate should be negatively related to FDI inflows.

4.4 Data Analysis Technique

The analysis of the data will be carried out by OLS (Ordinary Least Squares) method. The data will be exposed to various diagnostic tests to confirm the assumptions of OLS. Dummy variable approach to test for structural breaks will be employed in this study because it enables us to use a single regression equation to represent the multiple groups unlike the Chow test which is tedious because of fitting different regressions. To explain whether the variables are stationary or not, a test of stationarity will be carried out by both the unit root and the Dickey Fuller (DF) test methods. The Econometric views package (E-views 3.1) will be used to obtain the results of the study.

4.5 Diagnostic Tests

Reliability of the estimated parameters of the equation and the interpretations thereof depends on whether the underlying assumptions of the estimation method, in this case OLS, are met. A brief discussion of underlying assumptions and diagnostic tests that were conducted to ascertain whether the underlying assumptions of OLS were met or not follows.

4.5.1 Normality of the random variable

OLS assumes that the random (disturbance) variable μ_i in any of the econometric models is normally distributed around the zero mean and constant variance. If this does not hold, OLS estimates will be unbiased and best but we cannot assess their statistical reliability by the classical tests of significance (i.e. t-statistic, F-statistic, and standard errors) because the latter are based on normal distributions. The Jarque-Bera (JB) test was employed when testing for normality. The null hypothesis for the JB test is that the random variable series is normality distributed.

4.5.2 Multicollinearity of the Explanatory Variables

The term multicollinearity originally meant the existence of a perfect or exact, linear relationship among some or all explanatory variables of a regression model. If there is perfect multicollinearity, the regression coefficients remain indeterminate and their standard errors are infinite. On the other hand, if multicollinearity is imperfect but high, estimation of the regression coefficients may be possible (determinate) but could possess large standard errors (in relation to the coefficients themselves), which implies that the coefficients cannot be estimated with great precision or accuracy. According to Gujarati (2003), multicollinearity becomes a serious problem if the pair-wise or zero-order correlation coefficient between two regressors is in excess of 0.8. Explanatory variables correlation matrices was utilized to test the presence of multicollinearity in the regression equation (see Appendix A3.1).

4.5.3 Autocorrelation of the Disturbance terms

OLS assumes that there is no serial or auto-correlation in the error terms entering the regression functions. Autocorrelation may be defined as correlation between members of a series of observations ordered in time (as in time series data) or space (as in cross-sectional data). OLS estimates, in the presence of autocorrelation are still linear unbiased as well as consistent and asymptotically normally distributed, but no longer efficient. They do not have minimum variance among all linear unbiased estimators. The Breusch-Godfrey(BG) Lagrange Multiplier(LM) test was used to test for autocorrelation. The null hypothesis of the test is that there is no serial correlation.

4.5.4 Heteroscedasticity of the Disturbance terms

One of the important assumptions of OLS is that the variance of each disturbance term conditional on the chosen values of the explanatory variables are homoscedastic i.e. they have the same or equal variance. Violation of the assumption of homoscedasticity (problem of heteroscedasticity), although the estimates will still be unbiased and consistent, but they will not be efficient. They do not have a minimum variance as well. White heteroscedasticity (no cross terms) test was employed to test for heteroscedasticity. The null hypothesis is that the error term is homoscedastic.

4.5.5 Auto-Regressive Conditional Heteroscedasticity (ARCH)

ARCH occurs when the error (disturbance term) variance is related (autocorrelated) to the squared error term in the previous period. ARCH in itself does not invalidate standard OLS inference. However, ignoring ARCH effects may result in loss of efficiency. To test for the presence of ARCH, ARCH LM test was employed. The test runs against the null hypothesis that there is no ARCH.

4.5.6 Correct Specification of the Model

The following are common specification errors: omission of relevant variable(s), inclusion of an unnecessary variable(s), adopting wrong functional form, errors of measurement bias or incorrect specification of the stochastic error term. If the regression model is not correctly specified, OLS estimates are biased and inconsistent. To test for correct specification of the models we utilized the Ramsey Regression Specification Error Test (RESET). The null hypothesis of the test is that the model is correctly specified.

4.6 Test for Stability and Structural Breaks

Over the study period Kenya experienced some shocks. These shocks may have caused structural breaks between the regressand and the regressors in the function. By structural break we mean that the values of the parameters of the model do not remain the same through the entire time period. The commonly used tests for structural breaks or stability of the model are dummy variables and Chow tests. A dummy variable is a qualitative variable used in regression analysis to represent subgroups in a single regression. The statistical significance of a dummy variable implies that there was a structural break. While under the Chow test the idea is to fit the equations separately for each sub-sample and to see whether there are significant differences in the estimated equation. A significant difference indicates a structural change in the relationship. In this case regression results from a single, pooled regression (i.e. regression that combines sub-samples) obtains dubious results. A dummy variable approach is preferred to the Chow test because apart from testing for structural breaks, dummy variables enable us to use a single regression equation to represent the multiple groups without producing dubious results (Gujarati 2003). We have therefore used dummy variables in this study. However, recursive coefficient plots were obtained to validate stability of the coefficients(see Appendix 5). Further, the Cumulative Sum (CUSUM) and Cumulative Sum of Squares(CUSUM Sq) of the residuals at 5% level of significance, confirm that the model is stable (see Appendix 4).

4.7 Unit Root Test for Stationarity

Time series data is associated with the problem of non-stationarity of the series, that is, they exhibit time characteristics. Stationarity, denoted as $I(0)$ series in econometrics, implies that the mean and variance computed from such variables would be unbiased estimates of the unknown population mean and variance. However, this does not hold for those series that are non-stationary. Using one or more non-stationary series in a regression equation could therefore produce spurious (nonsense) results.

Unit root test for stationarity and regression equations cointegration tests was performed in order to avoid spurious results. This involved Dickey- Fuller (DF) test which is a test against the null hypothesis that there is a unit root series integrated of order one { i.e. $I(1)$ }. The DF test was used instead of Augmented Dickey Fuller test, which is an extension of DF test because the series were not serially correlated of any order. Eviews gives options whether to include an intercept in the equation, or to include both intercept and linear time trend or none. The right options were chosen by plotting line graphs for each of the variables and observing their characteristics and appropriate options were applied in the tests (See Appendix 1 for graphs for each of the variables). The test was run at 5% significance level. The DF Unit root test results in levels and in first differences are reported in Table 3 below.

Table 3: DF Unit Root Test Statistics for the variables at 5% significance level

Variable	DF Test statistic -in levels	5% DF critical value	DF test statistic - 1st diff.	5% DF critical value	Inference from DF
FD1	-6.335	-2.9446	-9.612	-1.9504	I(1)
OP	-1.539	-2.9446	-6.748	-1.9504	I(1)
CTAX	-1.579	-2.9446	-5.916	-1.9504	I(1)
FER	0.282	-2.9446	-4.049	-1.9504	I(1)
RGDP	-1.904	-2.9446	-6.225	-1.9504	I(1)
INFL	-0.305	-2.9446	-5.720	-1.9505	I(1)

It is evident from DF test results in Table 3 above that all variables are integrated of order one { i.e. $I(1)$ }. Line graphs of all the variables in levels and in first difference are provided in Appendix 1. The graphs show stochastic movements around the zero mean confirming that the variables are indeed stationary in first difference. After establishing that the variables are $I(1)$), we proceed to test for cointegration.

4.8 Cointegration Analysis

The statistical concept of equilibrium centres on a stationary process. Although economic variables may be individually non-stationary, they may be co-integrated. Non-stationary series are said to be cointegrated if a linear combination of these variables yields a lower order of integration, rendering the linear combination stationary {ie. $I(0)$ }. The existence of a cointegrating relationship implies that the regression of non-stationary series in their levels yields meaningful, not spurious results. However, for cointegration to exist the non-stationary series must be integrated of the same (or higher) order. Testing for co-integration in this study involved the Engle and Granger (1987) two-step method. The first step was to estimate the co-integrating static (long run) models using

OLS method. In the second step, the residuals generated from the static model were individually evaluated in terms of their order of integration using the ADF unit root test. However, for this test, the usual ADF critical values are not appropriate. The appropriate critical figures can be found from several sources including Charemza and Deadman (1997). Graph of the errors (see Appendix 2) show that the residuals have an intercept. The ADF test statistics were tested against critical values from Charemza and Deadman (1997). The results are as shown in Table 4 below:

Table 4: Engle- Granger Two Step Cointegration Test

Residual	ADF test statistic	5% critical level	Inference
Ecm	-5.377	3.92	I(0)

From table 4 above, it can be seen that the residuals are stationary in levels. Stationarity of the residuals in levels { i.e. $I(0)$ } supports the existence of cointegrating relationship in all the estimation equations. After establishing that the regression equations are cointegrated, the study applies Error Correction Mechanism (ECM) to the short run cointegrating equation. A cointegrated series implies that there is a long term or equilibrium relationship between the variables. However, in the short run there may be disequilibrium. This relationship between cointegrated variables is expressed as ECM, which corrects for disequilibrium between the long and short run relationship, and also ties the short run behaviour to its long run behaviour. The ECM or equilibrium error is therefore a means of reconciling the short run behaviour of an economic variable to its long run behaviour, by correcting for the disequilibrium.

CHAPTER FIVE

EMPIRICAL ANALYSIS

This sections gives the results and the interpretation of the results. Descriptive statistics of the variables used in the model is given in Appendix 6.

5.1 Regression Results and Interpretations

5.1.1 Long Run Regression Results for Aggregate FDI inflows

Table 5: Aggregate FDI Inflows Long Run Regression Results

<i>Dependent Variable: Ln (FDI)</i>				
<i>Method: Least Squares</i>				
<i>Sample: 1967 2004</i>				
<i>Included observations: 38</i>				
<i>White Heteroskedasticity-Consistent Standard Errors & Covariance</i>				
<i>Variable</i>	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-Statistic</i>	<i>Prob.</i>
C	-3.893	3.251	-1.198	0.2401
LnRGDP	2.491	0.732	3.402	0.0019**
LnCTAX	-0.200	0.752	-0.266	0.7917
LnINFL	-0.330	0.185	-1.791	0.0830*
LnOP	0.793	0.599	1.322	0.1959
LnFER	-1.088	0.553	-1.969	0.0580*
CDUM	1.857	1.091	1.702	0.0988*
<i>R-squared</i>	0.386	<i>Akaike info criterion</i>		2.925
<i>Adjusted R-squared</i>	0.268	<i>F-statistic</i>		3.254
<i>S.E. of regression</i>	0.962	<i>Prob(F-statistic)</i>		0.013
<i>Durbin-Watson stat</i>	2.182			

NB: *, **, ***, shows significance at 10%, 5% and 1% respectively

Diagnostic tests results

BG LM test	0.485(0.492)	ARCH test	0.392(0.535)
White (Het.)	2.273(0.042)	Ramsey RESET	0.066(0.799)
JB(Normality)	0.456(0.796)		

Table 5 above reports regression results for the long run cointegrating equation and the associated diagnostic tests. The White Heteroscedasticity (no cross terms) test indicates that the residuals have no constant variance. This problem was overcome by using the White Heteroscedasticity-Consistent Standard Errors and Covariance estimation

procedure which provides correct estimates of the coefficient covariances in the presence of heteroscedasticity of unknown form. It improved probability values of the regressors.

Although in Table 5 above the R-squared which is a measure of the goodness of fit of the model of 0.39 is quite low, and implies that only 39% of the variation in the dependent variable is explained by the explanatory variables, overall the model fits well. The computed value of the F-statistic is significant as its p-value is 0.013. Therefore the results obtained are meaningful.

Regression results show that in the long run the coefficient of market size (*RGDP*), is significantly different from zero and is positive. This implies that national incomes exert a positive influence on FDI inflows especially for market seeking FDI. Results show that a one percent increase in national incomes will lead to approximately 2.5% increase in FDI inflows. Therefore a large market will positively influence FDI inflows.

The coefficient of foreign exchange rate (*fer*) is significantly different from zero and negative. This magnitude of change shows that that a one percent depreciation of the foreign exchange rate will lead to approximately one percent (1%) reduction in FDI inflows in the long run. A depreciation of the foreign exchange rate negatively affects FDI inflows if the exchange rate is highly volatile. However, if FDI is market seeking (producing for the domestic market), an appreciation of the currency will increase FDI inflows due to higher purchasing power of the local consumers. On the other hand, a depreciation might as well increase FDI since it increases the relative wealth of foreign firms and hence their capacity to invest (through reduced cost of capital). Therefore the net effect of the changes in the exchange rate in influencing FDI inflows will depend on the objectives of the foreign investor. The coefficient of corporate tax rates (*Ctax*) is insignificant but has the expected negative sign. High taxes on profits will therefore have a negative impact on FDI inflows.

Competition policy dummy variable (*CDUM*) has a positive coefficient which is significantly different from zero. This implies that the presence of competition policy will

exert a positive influence on FDI inflows in the long run. The results reveal that the presence of competition policy will lead to approximately a two percent (2%) increase in FDI inflows in Kenya. Due to liberalized entry regimes for FDI, the entry and subsequent activities of MNCs interact with the structure of markets for goods and services in different ways. With liberalization of trade and FDI regimes, the entry of MNCs will lead to a high market concentration. Therefore lack of competition law or of merger review provisions can reduce the investor-friendliness of the environment by allowing concentration to rise. It may also make it more difficult for domestic entrepreneurs in the host country to succeed. The implementation of competition law can play a significant role of removing anticompetitive practices that act as entry barriers thereby facilitating the retention of more investment in the economy. Competition policy is a means by which governments hope to improve the competitive environment in which firms operate, in order to enhance the overall performance of the economy. Further, due to increased merger activity in an economy, which may result in a few dominant firms in an industry and coupled with high contestability of markets, the result might be anticompetitive practices by firms in an endeavour to gain a larger share of the market. Therefore there is a need to regulate such markets so that unfair trade practices are eliminated or minimized. It is expected that competition policy will play a key role in bringing efficiency and fairness in the marketplace.

The coefficient of inflation rates, *Infl*, is negative and significantly different from zero. A one percent rise in inflation rates will lead to 0.33% reduction in FDI inflows. This implies that macroeconomic instability has a negative influence on FDI inflows and will impede FDI inflows. The coefficient of openness of the economy, *Op*, is insignificant but carries the expected positive sign. In the long run, a more open economy will not influence FDI inflows in Kenya but will exert a positive pressure on FDI inflows. For decades Kenya had one of the most liberal regimes in the region which was replaced by a more restrictive one in the year 2004. Being that the period under review falls within the period that the country was more open to FDI inflows could be reason why the variable of openness of the economy is insignificant and therefore is not an influencing factor.

5.1.2 Short Run Regression Results for Aggregate FDI inflows

In the long run, market size, macroeconomic stability, foreign exchange rate and presence of competition policy will influence FDI inflows. In the short run we employ the error correction mechanism since there is a long run cointegrating equation.

Table 6: Short Run Regression Results for Aggregate FDI inflows

<i>Dependent Variable: DLnFDI</i>				
<i>Method: Least Squares</i>				
<i>Sample(adjusted): 1971 2004</i>				
<i>Included observations: 34 after adjusting endpoints</i>				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.726	0.293	2.476	0.0207
DLnRGDP	1.776	0.967	1.836	0.0788*
DLnCTAX	-0.203	0.101	-2.010	0.0551*
DLnFER	-5.135	1.576	-3.257	0.0033**
DlnOP(-1)	0.106	0.194	0.548	0.5888
DLnINFL	-0.904	0.310	-2.920	0.0075***
CDUM	2.522	0.991	2.543	0.0178**
ECM(-1)	-0.787	0.260	-3.027	0.0058*
AR(2)	-0.454	0.138	-3.299	0.0030*
MA(1)	-0.990	0.001	-1304.9	0.0000*
<i>R-squared</i>	0.814	<i>Akaike info criterion</i>		2.626
<i>Adjusted R-squared</i>	0.745	<i>Schwarz criterion</i>		3.075
<i>S.E. of regression</i>	0.798	<i>F-statistic</i>		11.692
<i>Durbin-Watson stat</i>	2.499	<i>Prob(F-statistic)</i>		0.0001

NB: *, **, ***, shows significance at 10%, 5% and 1% levels respectively

Diagnostic tests results:

BG LM test	0.039(0.845)	ARCH LM test	5.501(0.025)
White(Het.)	1.279(0.293)	Ramsey RESET	0.008(0.929)
JB Normality	0.674(0.713)		

Table 6 above reports the dynamic short run regression results for aggregate FDI inflows and the associated diagnostic test statistics. The ARCH LM test shows that there is a problem of ARCH. The correlogram of squared residuals showed significant spikes at lag two in the autocorrelation (AC) function and one significant spike of the partial correlation (PAC) which confirmed further the presence of ARCH. This therefore

justified the inclusion of Second Order Autoregressive {AR(2)} and First Order Moving Average {MA(1)} terms to correct for the ARCH effect. Since the series are integrated of order one {I(1)}, the error correction mechanism lagged once was included in the regression as a means of reconciling the short run behaviour of the economic variables to their long run behaviour. The ECM is included in the short run regression equation so as to correct for disequilibrium that exists between the short run and long run relationships.

In the short run, the Adjusted R-squared of 0.74 shows that 74 percent of the variability in the dependent variable is explained by the explanatory variables. Overall, the model also fits well since the p-value of the computed F-statistic is quite significant (0.001).

Regression results show that in the short run the coefficient of openness of the economy is insignificant. This implies that in Kenya, FDI inflows is not driven by openness of the economy. The coefficient has the expected positive sign both in the short run and long run signifying a positive relationship. The coefficient of market size (*RGDP*) has a positive sign which is significantly different from zero both in the long and short run. In the short run, a one percent increase in national incomes will lead to approximately two percent (2%) increase in FDI inflows. This implies that market size is an important factor that foreign investors will consider when making decisions of where to invest. Therefore national income has a positive impact in terms of influencing FDI inflows.

The coefficient of foreign exchange rate (*FER*) is negative and statistically significant. Results show that a one percent depreciation of the foreign exchange rate will lead to a five percent (5%) reduction in FDI inflows. The magnitude of change is quite high as compared with the long run results (1%). A fall in the value of a currency will bring about a change in the prices of exports (cheaper) and imports (more expensive). Changes in export and import prices will in turn cause changes in the quantity of exports and imports demanded and consequently the balance of payments position in the current account. Exports will be cheaper and this will lead to an increase in quantity of exports demanded while quantity demanded of imports will decline. Therefore if FDI aims at producing for re-export, then a depreciation will increase FDI inflows by increasing

wealth of foreign investors and stimulating their demand for investment while an appreciation of local currency reduces FDI inflows due to high costs. Therefore the net influence of foreign exchange rate on FDI inflows will depend on the aims of the foreign investor. However, a highly volatile foreign exchange rate will negatively influence FDI inflows.

The coefficient of corporate tax rates ($Ctax$) is significantly different from zero and has a negative sign. This implies that high taxes on profits will exert a negative influence on FDI inflows. From economic theory, it is expected that an increase in taxes on profits will impede inbound FDI since firms look for locational advantages which are not found domestically but can be exploited across borders. The negative sign implies that high taxes on profits will impede FDI inflows. The magnitude of change shows that a one percent increase in corporate tax rates will lead to a reduction in FDI inflows by 0.2 percent in the short run.

Competition policy dummy variable ($CDUM$) has a positive coefficient which is significantly different from zero. This implies that the presence of competition policy in Kenya plays a role in influencing FDI inflows. The magnitude of change shows that in the short run the presence of competition policy will lead to a 2.5% increase in FDI inflows. FDI inflows in the form of mergers and acquisitions of existing firms in the host country means that such FDI has to undergo the scrutiny of the competition agency before they start operations hence the importance of competition law. There is also a possibility that overtime such acquisitions may make markets increasingly concentrated and become characterised by one or a small number of dominant players. From a narrow national market perspective, a cross-border acquisition may seem to have no effect on competition. But if the acquirer has been a major exporter to the country, then the acquisition may lead to lessening of effective competition in the market. Therefore the proper application of competition policy or law can be vital for ensuring that the potential benefits of FDI for a host country are maximised.

The coefficient of inflation rate has the expected negative sign which is significantly different from zero. Results show that a one percent increase in the inflation rate will lead to 0.9% reduction in FDI inflows. The negative coefficient implies that macroeconomic instability will exert a negative pressure on FDI inflows. Therefore macroeconomic stability is a key factor that will influence FDI inflows while macroeconomic instability will impede FDI inflows. The coefficient of the error correction mechanism (ECM) lagged one period is significantly different from zero and negative. Its coefficient of -0.787 shows that 78.7% of the discrepancy between the actual and equilibrium value of FDI inflows is corrected each period. Thus there are economic forces in the economy which operate to restore the long run equilibrium position of FDI inflows following the short run disturbance.

Competition policy is important as its objective is to regulate markets where there are concerted practices, abuse of a dominant position due to monopoly or increased merger activities and the resultant restrictive business practices. Therefore the reduction of barriers to entry of FDI and the establishment of positive standards of treatment for MNCs need to go hand in hand with the adoption of measures aimed at ensuring the proper functioning of markets, including, in particular, measures to regulate and control anticompetitive practices by firms, which is the work of competition agencies.

Most MNC activity is dominant in industries where entry barriers exist through brand dominance, high investments, intensive and extensive advertising and where they also enjoy advantages in technology, management and size. This explains why corporate tax is insignificant in the long run. In the long run, firms will be engaged in expansion activities so as to increase their market shares by re-investing the profits made. Secondly, most FDI are involved in the production of goods and services. An increase in corporate tax rates will result in the burden of this tax being shifted to the final consumers of these products. The resultant effect is increase in profits by these firms which can be re-invested. Third, most MNCs use transfer pricing and other devices to report more of their profits in low-tax countries, even though the profits were actually earned in high tax countries. For instance, to lower its corporate income taxes, the MNC can have its unit in high-tax

country be overcharged (or underpaid) for goods and services that the unit buys from (sells to) an affiliate in a low tax country. Therefore the unit in the high-tax country does not show its tax officials much profit, while the unit in low-tax country shows high profits. In this way, the MNC reduces the net tax paid and the profits can then flow in for re-investment purposes.

The results from this study are mixed and dynamic and is consistent with the results obtained in similar studies for developing countries. For instance, Chakrabarti (2001) found out that there is a strong support for the explanatory power of market size of a host country in its FDI but reveals that the relations between FDI and many of the economic variables that have been reported in the empirical literature (namely, tax, wage, openness, exchange rate, tariff, growth rate of GDP, trade balance) are highly sensitive to changes the conditioning information set. Blonigen (2006) found that one cannot simply conclude that factors as exchange rate or tax policies have a general impact on FDI patterns but that each factor should be modelled depending on the hypothesis to be tested for a country.

The results by Clarke (2003) infer that there is a positive relationship between the presence of competition policy, the implementation of competition policy and FDI, which is consistent with the results obtained in this study. Further, results from a study by Asiedu (2003) found that market size influences FDI inflows while macroeconomic instability impacts negatively on FDI inflows, is also consistent with the results in this study.

CHAPTER SIX

CONCLUSION AND POLICY IMPLICATIONS

6.0 Summary of findings

The objective of the study was to determine the factors influencing FDI inflows in Kenya and of interest was the impact the presence of competition policy has on FDI inflows. The study employed secondary annual time series data covering 1967-2004. Quantitative estimation procedure utilized both cointegration and Error Correction Models (ECM). The variables used were found to be integrated of order one and the model was therefore cointegrated.

The salient conclusions drawn from the empirical analysis are that :

- In the long run market size, macroeconomic stability, foreign exchange rates and presence of competition policy are significantly different from zero. Therefore national incomes, macroeconomic stability, foreign exchange rate and presence of competition policy play an important role in influencing FDI inflows in the long run. Corporate tax rates and openness of the economy to trade will not influence FDI inflows in Kenya in the long run.
- In the short run, market size, macroeconomic stability, corporate tax rates, foreign exchange rate and presence of competition policy will influence FDI inflows in Kenya. An important implication is that FDI inflows to Kenya is not driven by openness of the economy both in the long run and short run though it has a positive influence. Descriptive analysis of the determinants of FDI in Kenya by Investment Policy Review (2005) found out that Kenya has a mixed and dynamic record in FDI determinants.

The dynamic nature of the results obtained in this study is consistent with results obtained from a study by Chakrabarti (2001). He found that there is a strong support for the explanatory power of market size of a host country in its FDI but revealed that the relations between FDI and many of the economic variables, namely, tax, wage, openness, exchange rate, tariff, growth rate of GDP, and trade balance are highly sensitive to changes in the conditioning information set. Therefore in trying to identify the factors attracting FDI inflows, a 'one size fits all' conclusion cannot be reached at with confidence and therefore the results of this study cannot be taken as conclusive.

6.1 Policy Implications

In every economy, government has a significant influence on industry and commerce and thereby play an important role in promoting investment in a country. In the short and medium term, the government can influence FDI inflows by streamlining the investment framework, implementing policies that act as incentives to investors and also policies that promote macroeconomic stability. The government should also work towards proper management of the macroeconomic environment with the objective of achieving enhanced economic growth.

There is a direct, necessary and enlarging relationship between liberalization of FDI regimes and the importance of competition policy. Therefore competition policy needs to be effectively implemented and this requires a strong competition law and an effective autonomous competition-enforcement agency. The enforcement agency should in turn act as a 'watchdog' to discover potentially anticompetitive situations and to deal with them at an early stage.

The necessary legal framework should also be put in place to speed up the completion of anticompetitive cases. Good governance is a key to a well functioning system, therefore the government should improve on governance so as to be able to influence inbound FDI.

6.2 Limitations of the Study

The main limitation of the study was that disaggregated data of FDI inflows into new investments and Mergers and Acquisitions (M&A) was not available. Consequently, disaggregated analysis of FDI inflows into new investments and through M&As could not be undertaken.

6.3 Future Research

This study could not encompass everything. The current study did not analyse FDI inflows through new investments and due to M&As and the likely influence of each category. The influence of other economic variables not employed in this study can also be undertaken in future.

This study did not analyse empirically FDI inflows by sector. Therefore a sector by sector study is worth undertaking to see the direction of FDI inflows and which sectors are more competitive and also modelling the effectiveness of competition law in each sector is worth undertaking in future.

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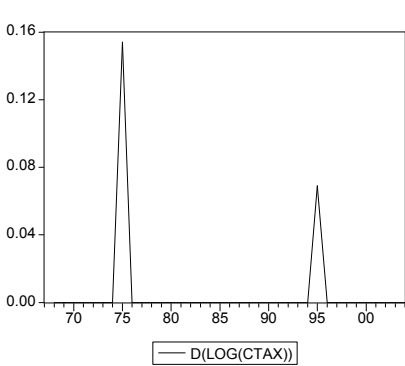
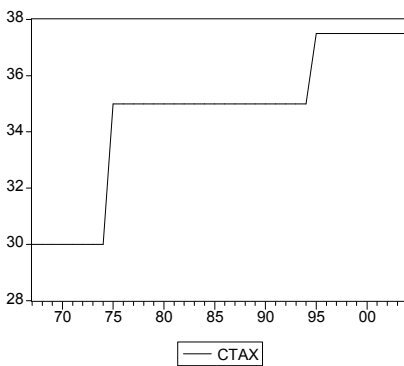
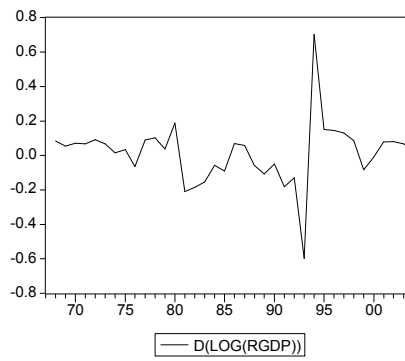
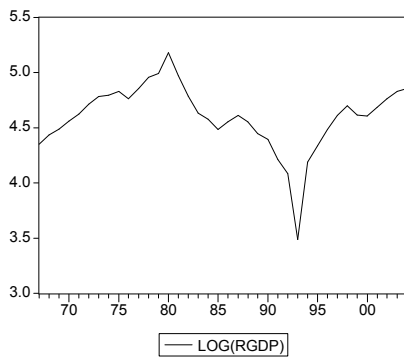
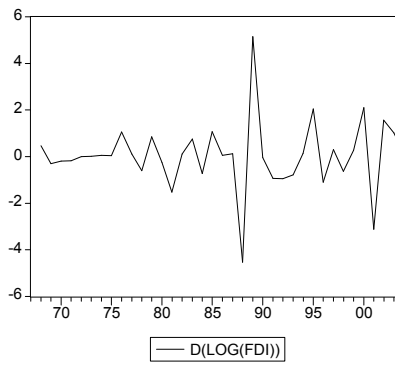
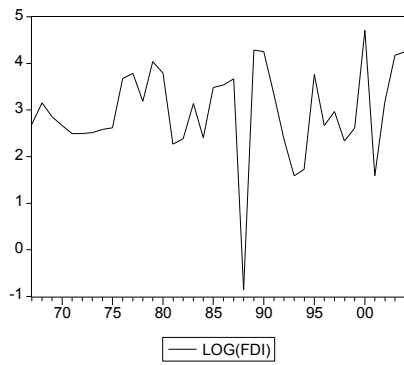
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APPENDICES

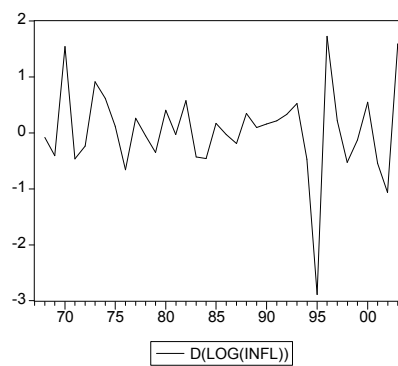
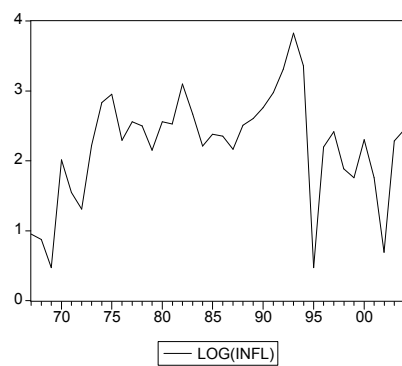
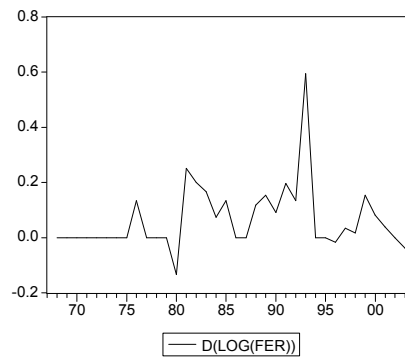
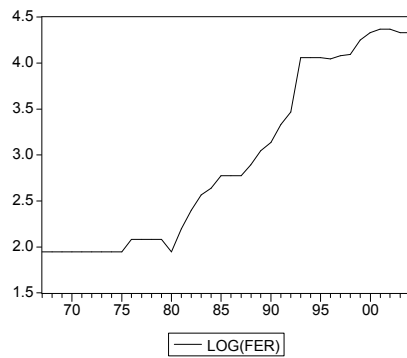
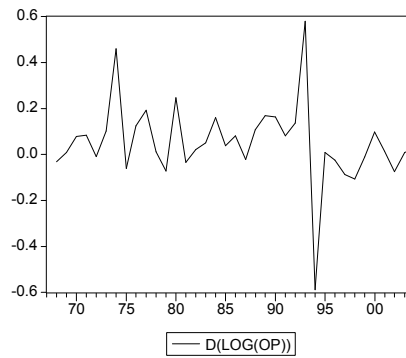
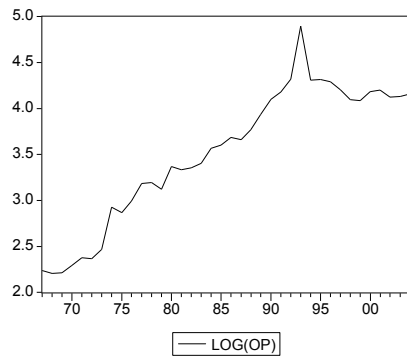
Appendix 1

Appendix A1.1: Line Graphs, in Levels and in First Difference of Variables Used



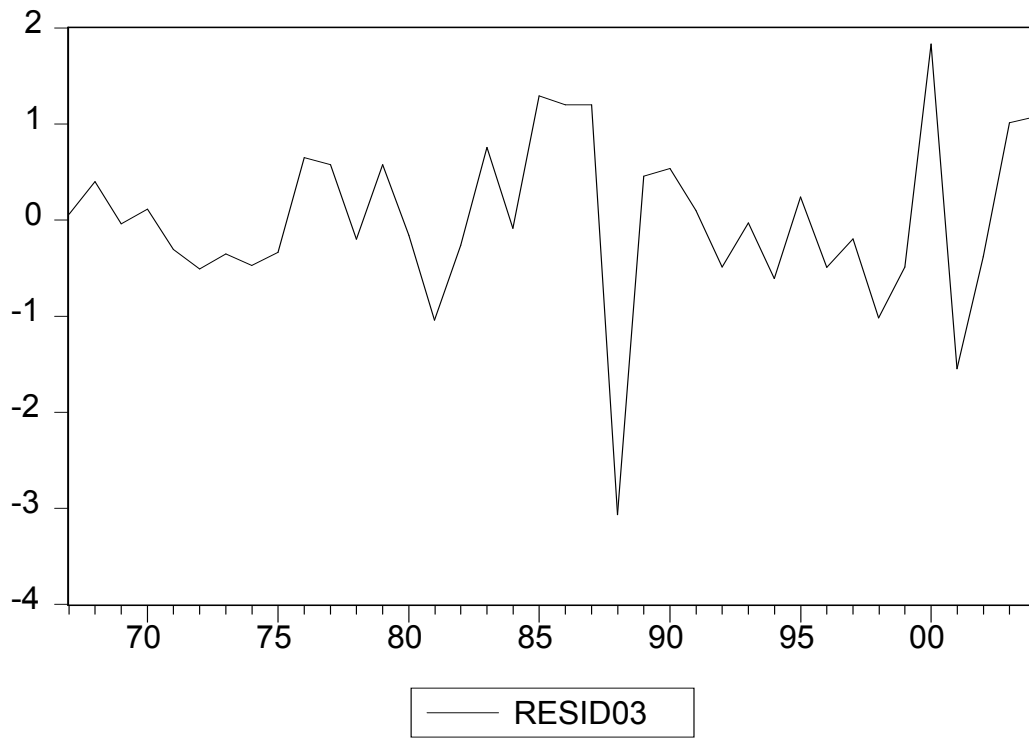
Appendix 1

Appendix A1.1: Line Graphs in Levels and in First Difference, of the variables used (Contd)



Appendix 2

Appendix A2.1: Line Graph for Long Run Errors (Residuals)

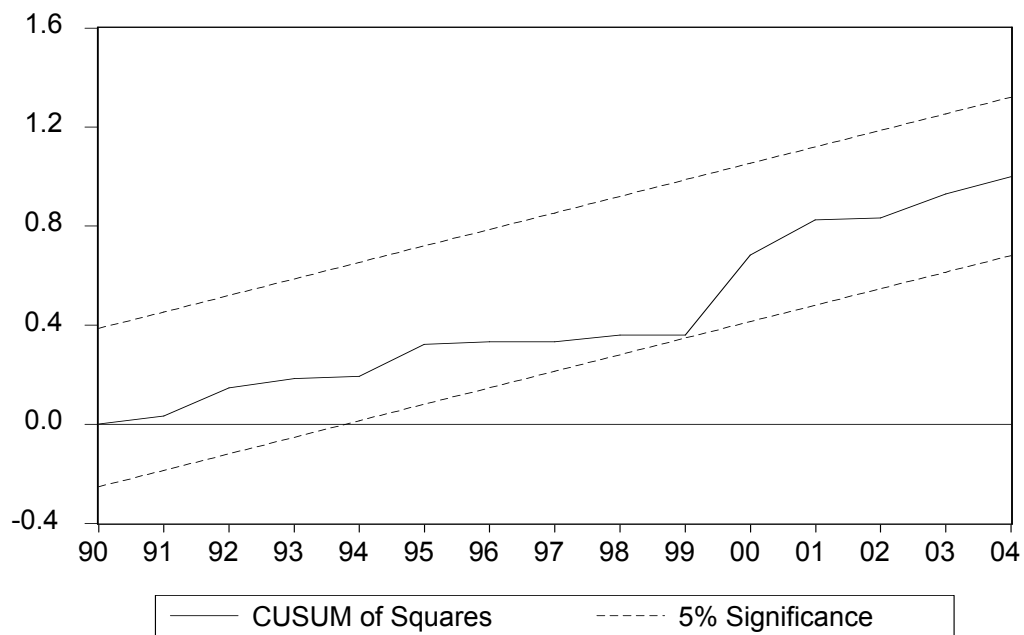
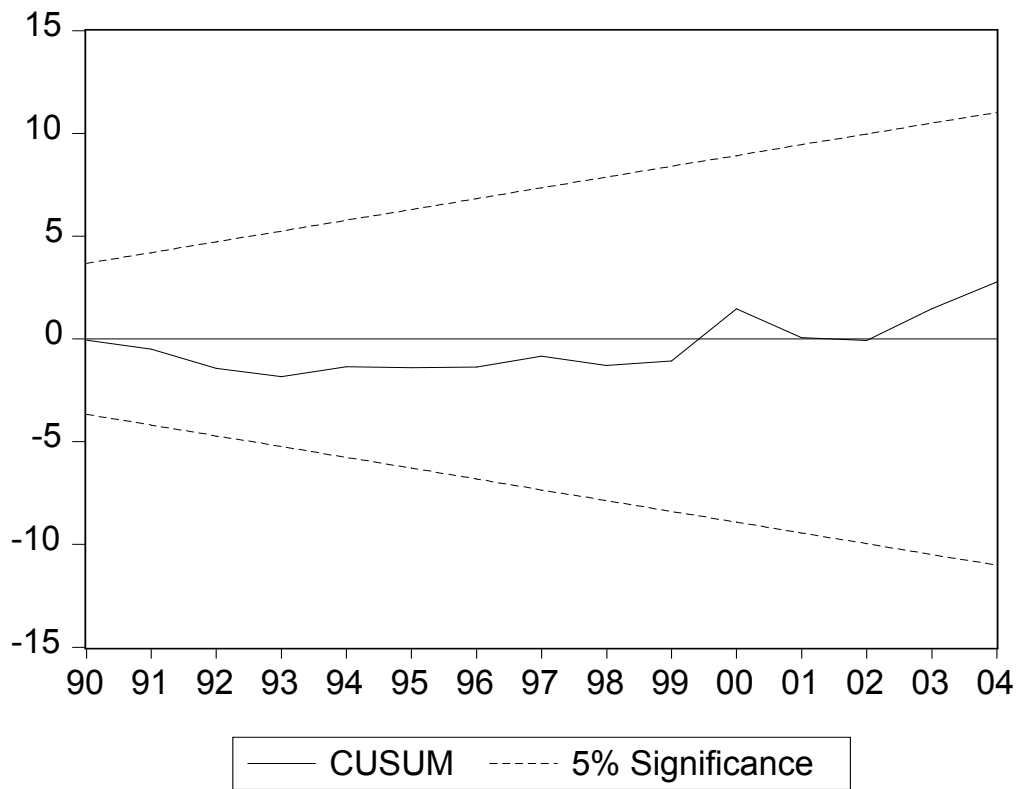


Appendix 3

A3.1 Correlation Matrix for Explanatory Variables for Aggregate FDI inflows Model

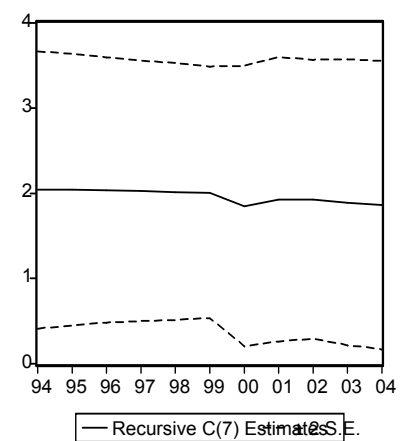
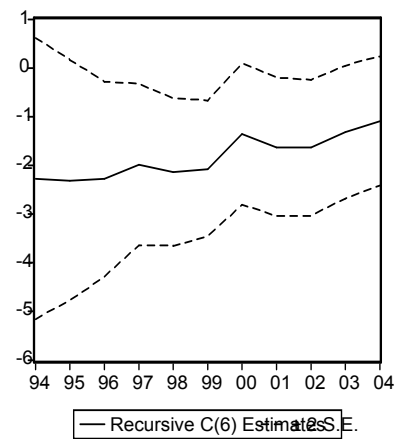
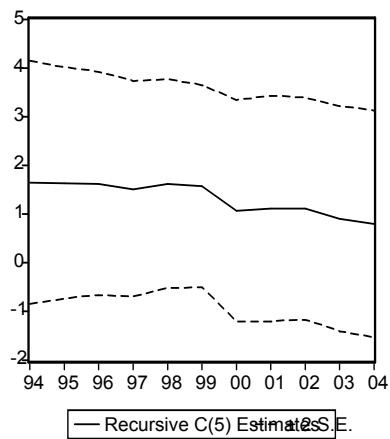
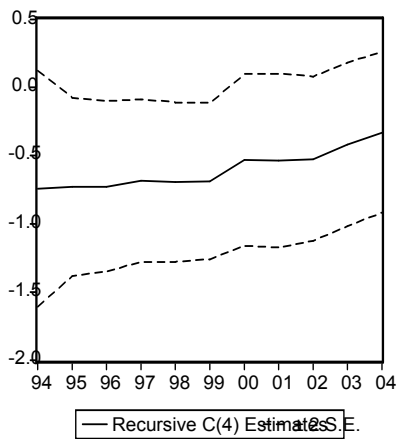
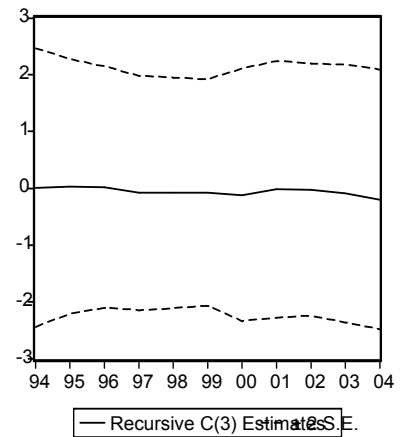
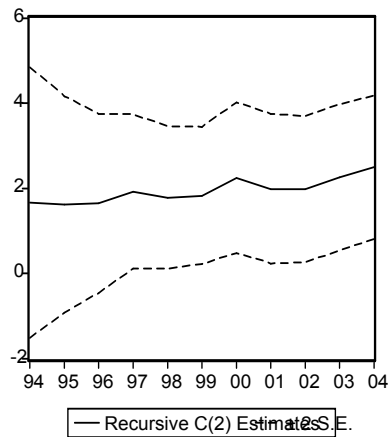
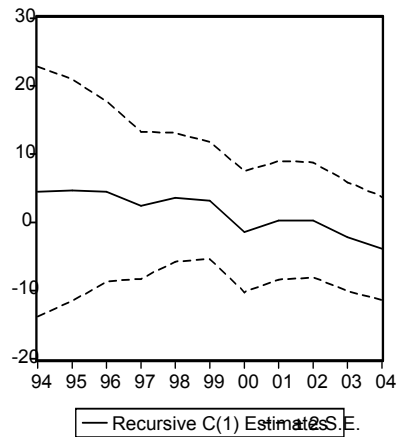
	FDI	CTAX	RGDP	FER	INFL	OP
FDI	1.00	0.211	0.435	0.167	-0.145	-0.024
CTAX	0.211	1.000	-0.215	0.621	0.163	0.486
RGDP	0.435	-0.215	1.000	-0.215	-0.357	-0.506
FER	0.167	0.621	-0.215	1.000	0.054	0.682
INFL	-0.145	0.163	-0.357	0.054	1.000	-0.327
OP	-0.024	0.486	-0.506	0.682	-0.327	1.000

Appendix 4



Appendix 5

A.5.1 Recursive coefficients of the variables used in the equation



Appendix 6

A6.1 Descriptive Statistics of the Variables used in the equation

	FDI	RGDP	CTAX	Op	INFL	FER
Mean	30.361	103.454	34.605	0.407	11.821	29.605
Maximum	110.9	177.99	37.5	1.276	46.0	79.0
Minimum	0.4	32.713	30.00	0.087	1.6	7.0
Std. Dev.	27.869	27.199	2.633	0.261	8.611	27.018
Skewness	1.32	0.12	-0.806	0.874	1.901	0.777
Kurtosis	3.757	3.819	2.482	4.143	7.985	1.908
Jarque-Bera	11.942	1.154	4.541	6.902	62.239	5.716
Probability	0.002	0.561	0.103	0.032	0.00	0.057

Appendix 7

A7.1 Data used in the Study

Year	cdum	ctax	fer	fdi	infl	op	rgdp
1967	0	30	7	11.5	2.6	0.089438	77.62102
1968	0	30	7	19.8	2.4	0.086579	84.29474
1969	0	30	7	15.5	1.6	0.087298	88.94112
1970	0	30	7	13.8	7.5	0.094416	95.50713
1971	0	30	7	12.4	4.7	0.102631	102.05
1972	0	30	7	13.6	3.7	0.101601	111.7122
1973	0	30	7	14.8	9.2	0.112505	119.3417
1974	0	30	7	16	17	0.178081	121.1168
1975	0	35	7	17.2	19.1	0.167608	125.2519
1976	0	35	8	46.4	9.9	0.18984	117.2971
1977	0	35	8	56.5	12.9	0.230102	128.3462
1978	0	35	8	34.4	12.2	0.232546	142.2131
1979	0	35	8	84	8.6	0.216188	147.5218
1980	0	35	7	79	12.9	0.276673	177.9899
1981	0	35	9	14	12.5	0.267144	144.4385
1982	0	35	11	13	22.2	0.272972	119.9512
1983	0	35	13	23.7	14.4	0.287072	102.8311
1984	0	35	14	10.8	9.1	0.337006	97.19227
1985	0	35	16	28.8	10.8	0.350109	88.70083
1986	0	35	16	32.7	10.5	0.37948	95.0372
1987	0	35	16	39.4	8.7	0.371313	100.6793
1988	0	35	18	0.4	12.3	0.41348	95.04336
1989	1	35	21	62.2	13.5	0.489167	85.28728
1990	1	35	23	57.1	15.8	0.575735	81.13574
1991	1	35	28	18.8	19.6	0.624352	67.60567
1992	1	35	32	6.4	27.3	0.715459	59.41264
1993	1	35	58	1.6	46	1.276104	32.71307
1994	1	35	58	3.7	28.8	0.708386	65.9369
1995	1	37.5	58	33	1.6	0.714556	76.62098
1996	1	37.5	57	12.7	9	0.69732	88.52799
1997	1	37.5	59	19.7	11.2	0.639066	100.8122
1998	1	37.5	60	11.4	6.6	0.574123	109.8964
1999	1	37.5	70	13.8	5.8	0.567953	101.181
2000	1	37.5	76	110.9	10	0.625987	99.99997
2001	1	37.5	79	5.3	5.8	0.635068	108.1544
2002	1	37.5	79	27.6	2	0.589476	117.1032
2003	1	37.5	76	81.7	9.8	0.594237	125.1339
2004	1	37.5	76	90.1	11.6	0.609373	128.6375