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TAX INCENTIVES AND FOREIGN DIRECT INVESTMENT ELATIONSHIP IN THE EAST AFRICA COMMUNITY PARTNER STATES

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Abstract

The relationship between tax incentives and Foreign Direct Investments (FDI) is one of the unresolved issues in public finance. The existing studies on the effectiveness of tax incentives in attracting foreign investors differ depending on jurisdiction of research and the methodological approach employed. This study was to establish the relationship between tax incentives and FDI in East Africa Community Partner States. A panel descriptive study design was used to determine the relationship between tax incentives and foreign direct investment in East Africa Community Partner States, which included Tanzania, Rwanda, Kenya, Burundi, and Uganda. The study used panel secondary data, which covered a period of 16 years from 2002 to 2017. The study revealed that tax holidays and period of losses carried forward did not have statistically significant influence on FDI inflow. However, investment allowances had a positive statistically significance influence on and FDI inflow in EAC. The study concluded that the investment allowance had a significant influence on FDI inflows among the East African community partner states. The study recommended that the leadership of East Africa community partner states should encourage use of investment allowances to attract FDI. The study also recommended that tax holidays and period of losses carried forward should not be used as a means of attracting FDI since the empirical evidences shows that the two are not significant in attracting FDI.

Keywords: Tax Incentives, Foreign Direct Investments, Tax holidays, investment allowance, period of losses carried forward.

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Introduction

Foreign Direct Investment (FDI) is considered a pivotal driving force of global economic integration. It is regarded as one of the factors developing and transitioning economies use to enhance their economic development and a country not attracting FDI is at risk of not accessing the main sources of economic growth (Estrin & Uvalic, 2014; Bhensdadia & Dana, 2004). Foreign investment is associated with skills transfer and creation of employment. Due to the critical role, FDI plays in promotion of economic growth many countries have come up with different tax incentives to attract foreign investors (Fletcher, 2002). According to World Bank (2012) FDI is the flow of investments to a nation state different from the investor's home nation state with the objective of having lasting interest in the host country. Easson (2004) argues that there are two types of investments affected by international fiscal policies, foreign direct investment and portfolio investment.

FDIs takes a number of forms among them Greenfield investments (real investments in factories or production plants), joint ventures (creating global strategic alliances), brown field investments (acquiring existing manufacturing facilities to start a new production line) and cross border mergers and acquisition (Zolt, 2015). Each of the four forms of FDI can take any of the following four major objectives namely: strategic assets acquisition, natural resources exploitation, efficiency seeking and market exploitation (Dunning, 1977). Market seeking firms consider horizontal strategy to penetrate the host country domestic markets. The aim is to serve the surrounding markets with locally produced commodities. Therefore, host countries' economic growth prospect, market size, openness and accessibility to neighboring markets are key considerations in deciding whether to invest in the host country (Vijayakumar, Sridharan & Rao, 2010).

Efficiency seeking multinationals employs vertical integration strategy to minimize cost of production especially in developing countries. Most of the activities are moved to where the production takes place and seeks to minimize cost by controlling the entire process from production to marketing. A resource seeking Multinational Corporation (MNC) invest in countries with rich natural resources, which they use as raw materials and take advantage of cheap labor force and physical infrastructure (Kinoshita & Campos, 2006). The objective of strategic asset seeking MNC is to take advantage through strategic location, which helps it take advantage of foreign networks, advanced technology, organizational abilities, market intelligence, management expertise innovation as well as access to research and development (Cleeve, 2008).

Tax incentives on the other hand entails are all forms of unique tax dealings targeted to particular sectors or activities only, unlike universal tax treatment applied to all (Klemm, 2010). Tax incentives are also referred to as fiscal incentives. Bolnick (2004) defines tax incentives as fiscal action by governments to attract both domestic and international investment in particular to key sectors of the economy. Tuomi (2011) further defines tax incentives as a facility by government that awards investors' advantageous environment that departs from the normal tax legislation.

UNCTAD (2000) classifies tax incentives into twelve different ways: investment allowances, tax holidays, losses carried forwards, reduced corporate income tax rate, investment tax credits, deductions for qualifying expenses, tax credits for value addition, zero or reduced tariffs, preferential treatment of long capital gains, credits for foreign hard currency earnings,

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employment based deductions and reduced taxes on dividends/ interest paid abroad.

Provision of tax holiday is a situation where new foreign investments are exempted either partly or completely from payment of corporate tax income for a specified number of years mostly five years (UNCTAD 2000). In spite of criticism, tax holidays are the most popular form of tax incentive in EAC and in most jurisdictions around the world. Its popularity emanate from the fact that it is easy to implement and does not involve actual cash out flow payment by the host nation. However, it has been opposed because of its several shortcomings. James (2013) identified some drawbacks associated with the tax holiday. Firstly, it is a blanket benefit not related to the amount of capital investment or growth of the investment. Secondly, companies with foreign subsidiaries are able to use tax holiday for transfer pricing practices. That is channeling profits from another jurisdiction to where tax holiday is being enjoyed. Thirdly, firms enjoying tax holidays for a specified number of years have incentives to close and relocate to another country after the expiry of the tax holiday period.

Investment allowances takes the form of special zones investment allowances, accelerated depreciation, Investment tax credit, timing differences (Klemm & Parys, 2012; James, 2013). Investment allowances have various advantages. Firstly, they are only offered when the actual investment has occurred which in actual sense is the real aim of permitting the fiscal incentives and secondly they are not complicated to implement. However, they have been criticized because they cause distortions between old established investment and new investments (Klemm, 2010).

The East African Community (EAC) is an intergovernmental regional bloc formed by six countries namely Tanzania, Rwanda, Kenya, Burundi, South Sudan and Uganda headquartered in Arusha, Tanzania (Penev & Marusic, 2014). EAC is among eight other regional economic communities (RECs) in Africa that are duly recognized by African Union (AU) and the only one with a stated vision in its founding treaty of creating a political federation (Tharani, 2017). According to EAC Secretariat (2016), the population of EAC partner states excluding Southern Sudan was 150 million people by the end of 2015. The bloc was initially founded in 1967 but collapsed in 1977; however, it was resuscitated on seventh, July 2000 by signing of a treaty by the original three partner states Tanzania, Kenya and Uganda with a vision to generate wealth and boost the global competitiveness of the region by improved production, trade and investments. The collapse of initial EAC in 1977 was attributed to several factors including: inadequate political will, non-involvement of private sector, not engaging civil society, issues around sharing of EAC benefits among the Partner States and lack of proper procedures to solve grievances (Penev & Marusic, 2014).

The community established a custom union in 2004, which encompassed common external tariffs and a free trade area and in July 2010, a common market was ratified by the member states. A common market enables members states to operate a single market for goods, capital, labour, services, free movements of citizens, enacting of common trade and revenue laws. This greatly advantages the member states by allowing them to take advantage of economies of scale through large-scale production (Gastorn & Masinde, 2017). Notwithstanding coming up of EAC's common market there still, exists barriers on free movement of goods capital and services negatively affecting its FDI attractiveness (Penev & Marusic, 2014). Currently, the member states are working on establishing monetary union. The East Africa Assembly in April 2018

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passed a bill creating East Africa monetary institute. The institute is charged with preparatory works for establishing East African Monetary Union (EAMU). According to (Union & UNECA, 2016) the EAC is the most integrated and ambitious regional economic community bloc among the eight regional economic communities in Africa. However more work need to be done on integration process as it was noted by Reith and Boltz (2011).

Literature Review

Dunning (1977) provided theoretical justification as to why firms find it necessary to locate their manufacturing business abroad instead of exporting. Using eclectic theory, he observed that for a company to make a decision to invest in a foreign country it must poses some advantages over and above the local companies. Some of these factors include labour costs, government incentives and raw materials. The advantages will make the products of the company competitive. One of factors, which can help to reduce the cost of production of foreign companies, is tax incentives. Neoclassical investment theory by Jorgenson (1963) argues that reduction in cost of production leads to accumulation of investment. Countries which offers tax incentives reduces cost of production for Multinational Enterprises (MNCs) resulting to more investment by multinational companies in such countries (DeMooij & Ederveen, 2003).

Evidence from empirical studies on the influence of tax incentives on FDI flows is inconclusive and most studies have produced results oscillating from significant to insignificant effect. Studies explored indicating tax incentive have a significant effect on FDI are: (Olaleye, 2016; Ahmed, 2015; Munongo, 2015; Lee, 2012) while those showing insignificant effects include: (Peters & Kiabel, 2015; Tuomi, 2011; Chai & Goyal, 2008).

Olaleye (2016) carried a study on the effect of tax incentives on FDI in Nigeria for period of 10 years (2005 to 2014). The study used descriptive research design targeting 74 listed manufacturing companies. Stratified purposive sampling technique was used. The study established that FDI in manufacturing sector in Nigeria was greatly influenced by provision of tax incentives.

A study exploring the relationship between taxation and FDI in Bangladesh from 2001-2010 was carried out by Ahmed (2015). The data was analyzed using regression, correlation and descriptive statistic. The dependent variable FDI was measured using FDI net inflow (% of GDP) while corporate taxation which was the independent variable was measured using corporate tax rate (CTR). The study used inflation, GDP and exchange rate as the control variables. There was negative significant relationship between FDI and CTR. There was however negative statistically insignificant relationship between FDI and exchange rate. FDI was positively insignificantly related to GDP whilst FDI had positive significant association with inflation.

A study on the effectiveness of fiscal incentives in luring foreign investments in Southern African Development Community (SADC) was carried out by Munongo (2015) for the period 2004 to 2013. The study used panel data model. The study found that tax incentives were important in attracting FDI in the SADC region. A study by Lee (2012) in the export sector of the People's Republic of China (PRC) found that tax incentive influences location decisions of investors. The study used Resource flow model and comparative advantage analysis and established that by reducing corporate tax and value added tax investors were attracted to invest in Taipei, China and Hong Kong processing trade sector. Conversely, a study by Peters and Kiabel

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(2015) to established influence of tax incentives in an investor's decision to locate business in Nigeria found that increase in tax incentives do not lead to corresponding increase in FDI. The study used error correction modelling model. Using micro data and firm interviews to determine drivers of FDI in South Africa Tuomi (2011) found that tax incentives play a negligible role in influencing location of FDI. Chai and Goyal (2008) carried out a study in Eastern Caribbean Currency Union on the relationship of tax concessions and FDI. The study established that the revenue foregone due to the tax concessions was very huge while on the other hand FDI did not seem to depend on the tax incentives.

Methodology

A longitudinal descriptive survey was used in this study. The design was appropriate since it involved data relating to a period of time. The study was carried out in the five states in the East Africa Community: Tanzania, Rwanda, Kenya, Burundi, and Uganda. South Sudan was excluded because of lack of data. The main source of the data were published Ernst and Young worldwide tax data, UNCTD, EAC secretariat; World/African Development Indicators of the World Bank, World Resource Institute, tax and finance Acts of the individual countries and Partner states tax Authorities and OECD The unit of analysis was the individual partner states. The data covered a period of 15 years from 2002 to 2016 and the analytical tool use was the multiple linear regression. The model was formulated as follows

$$FDI_{ct} = \beta_0 + \beta_1 X_{1ct} + \beta_2 X_{2ct} + \beta_3 X_{3ct} + \varepsilon$$

FDI_{ct} = Tax incentives in country (c) at time (t)

X_{1ct} = Tax holiday in country (c) at time (t) measured using the maximum tax holiday given to investors in a given year i.e. the length of the tax holiday

X_{2ct}= Investment allowances in country (c) at time (t) measured using the average rate investment allowances offered in various economic sectors per annum per country

X_{3ct} = Losses carried forward in country (c) at time (t) measured using the maximum number of years granted for a loss carried forward

β_0 = Constant

β_1 - β_3= Regression coefficients

ε = Error term

Results

Table 1 shows a descriptive statistics summary of the results from the five East African partners states from 2002 to 2016.

Table 1: Summary of Descriptive Statistics for the Study Variables

Variable	Obs	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
FDI inflows (Ratio of FDI to GDP)	78	0.0220	0.02	0.00002	0.06	0.21	1.86
Tax holiday (No of years)	75	7.9733	3.92	0.00	10.00	-1.47	3.25
Investment allowances (Rate in percentage)	80	31.2815	8.99	16.73	46.07	-0.02	1.66
Period of losses carried forward (no of years)	74	7.7297	2.58	4.00	10.00	-0.29	1.15

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The pooled results for the five countries show that FDI inflows to GDP had a mean of 0.0220. The minimum and maximum values were 0.00002 and 0.06 respectively an indication that some countries had very little FDI inflows during the study period. The average number of years for tax holiday was 7.97. The results also depict that the average rate of investment allowances for the five nations was 31.28% with minimum and maximum values being 16.73% and 46.07% respectively while the average number of years for carrying losses forward was 7.73 with minimum and maximum values of 4 and 10 years respectively.

Correlation analysis was carried out to determine the strength and the nature of the relationship between the study variables. The Karl Pearson correlation coefficient was used in this study to determine the correlation among the study variables. Table 2 shows the results

Table 2: Correlation Analysis

	FDI inflows	Tax holiday	Investment allowances	Losses carried forward
FDI inflows	1			
Tax holiday	0.078	1		
Investment allowances	-0.240*	0.663*	1	
Losses carried forward	0.279*	0.466*	0.130	1

The results show that there is a very weak and positive correlation (0.078) between tax holiday and FDI while investment allowance has a weak and negative correlation (-0.240) with FDI. On the other hand, there is a weak and positive correlation between the period of losses carried forward (0.279) and FDI inflows.

To determine the relationship of tax incentives on foreign direct investment in East Africa Community Partner States a pooled OLS regression model was used. Tax incentives were measured using three indicators, which included tax holidays, investment allowances and the period of losses carried forward. On the other hand, foreign direct investments (FDI) was measured using the ratio of FDI inflows to real GDP. The study hypothesis was formulated as follows: *H1: The relationship between tax incentives and FDI in EAC partner states is not significant.*

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Table 3: Effect of Tax Incentives on FDI

Variables	Coefficients
Tax holiday	-0.0001
	(0.0005)
Investments allowances	0.0008***
	(0.0002)
Period of losses carried forward	-0.0001
	(0.0008)
Constant	0.0029
	(0.0053)
Observations	65
R-squared	0.0501
F (3, 61)	5.16***

Robust standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1

The results of the effect of tax incentives on FDI on Table 3 shows that the R square value (R^2) was 0.0501, which indicates that the independent variable indicators, comprising of tax holiday, investment allowances and the period of period of losses carried forward account for about 5% of the variation in foreign direct investments. The other percentage 95% was accounted for by other factors not considered in the model. The results further show that F statistic value of 5.16 was statistically significant an indication that jointly, tax holiday, investment allowances and the period of period of losses carried forward influences foreign direct investments.

The results further shows that the effect of tax holidays (B = -0.0001) on FDI inflow was negative and statistically insignificant at 5% level of significance while the relationship between investment allowances (B = 0.0008) was positive and statistically significant at 1% level of significance. In addition, the results show that the period of period of losses carried forward (B = -0.0001) had a negative and statistically insignificant at 5% level of significance. These results indicate that tax holidays and period of losses carried forward as indicators of tax incentives do not have a statistically significant influence on foreign direct investment while the investment allowances had a statistically significant influence on FDI inflows among the East Africa Community partner states. Table 4 summarizes the results of hypothesis one and the sub hypotheses.

The results on the relationship between tax incentives and FDI inflows established that tax holidays had a negative and statistically insignificant effect on FDI inflows. Similarly, the findings revealed that the period of period of losses carried forward had a negative and statistically insignificant relationship with FDI inflows. Theoretically, these results are

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supported by the new economic geography theory by Krugman (1991) which challenged the key assertion of neo-classical investment theory regarding the importance of taxes in influencing investments and states that FDI flow can be determined by geographical location of a country and not necessarily tax incentives advantages, which may be inconsequential. However, the findings do not support the neoclassical investment theory by Jorgenson (1963) which states that the relationship that exists between tax incentives and foreign investment is positive in nature. The findings also do not support the eclectic paradigm which states that investors will prefer countries with locational advantages as Tavares-Lehmann (2012) argues that locational advantages include provision of tax incentives and tax incentives reduces cost of doing business making a country internationally competitive therefore attracting more FDI.

The above results are consistent with previous empirical studies. A study by Cleeve (2008) using tax concessions as an indicator of tax incentives found that tax concessions were statistically insignificant in attracting FDI in Sub Sahara Africa. Fahmi (2012) found that tax holiday is not a significant factor in attracting FDI in Indonesia. A study by Oleksiv (2000) established that provision of tax holidays in Ukraine did not result to attraction of FDI in the country and concluded that though tax matters in attraction of FDI tax holidays do not. Porcano and Price, (1996) found that reduction on corporate taxes do not have a significant effect in attraction of FDI. Further, the above findings are consistent with those of Munongo (2015) who found that period of losses carried forward was an insignificant factor in attracting FDI in the SADC region. In addition, the above findings support the IMF and World Bank, which have been discouraging developing counties from giving tax holidays to attract FDI. However, the results are inconsistent with some previous studies, which found that provision tax holidays and period of period of losses carried forward are key in attracting FDI. Klemm and Parys (2012) found that longer tax holidays and lower corporate income tax rates are effective in attracting foreign direct investment. Drebler and Overesch (2013) found that investors take into consideration the loss carry forward period offered by a host country with a short carry forward time limit lowering investments. Other studies which have shown tax holidays to be important in attracting FDI includes Thuita (2017); Gebremedhin and Saporna (2016) and Sari, Dewi and Sun (2015).

The study established that the relationship between investment allowances and FDI inflow is positive and statistically significant. These findings support the neoclassical investment theory by Jorgenson (1963) which states that the relationship that exists between tax incentives and foreign investment is positive in nature. It also support the assertion of eclectic theory conceptualized by Dunning (1977) which argues that investors will prefer countries with locational advantages as Tavares-Lehmann (2012) argues that locational advantages include provision of tax incentives. Empirically, the results support Olaleye (2016) who established that provision of investment allowances attracts FDI in Nigeria manufacturing sector. But the study contradict the findings by Van Parys and James (2010) who found no evidence that provision investment allowances attract FDI in Sub Sahara Africa. The findings under objective one demonstrates that various forms of tax incentives have different influences on location of FDI. While tax holidays and period of losses carried forward have no statistically significant influence on FDI location, investment allowances on the other hand, were found to be statistically significant in influencing location of FDI in EAC partner states. This implies that caution

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need to be exercised when providing tax incentives so that only those tax incentives, which will lead to attraction of investments are granted.

Table 4: Summary of Hypothesis 1 Results

Hypothesis	Sub hypothesis	Study findings	Hypothesis test results
The relationship between tax incentives and FDI in EAC partner states is not significant	The relationship between tax holiday and FDI in EAC partner states is not statistically significant	The relationship between tax holidays and FDI inflow is negative and insignificant	Fail to Reject Null
	The relationship between investment allowances and FDI in EAC partner states is not statistically significant	The relationship between investment allowances is positive and statistically significant	Reject null
	The relationship between the period of period of losses carried forward and FDI in EAC partner states is not statistically significant	The period of period of losses carried forward has a negative and insignificant relationship with FDI inflows	Fail to Reject Null

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Conclusions

The aim of the study was to determine the relationship between tax incentives and foreign direct investments in East Africa Community partner states. The study revealed that FDI inflow had an insignificant relationship with tax holiday and period of losses carried forward. The study therefore concluded that tax holidays and period of losses carried forward do not have statistically significant influence on FDI inflows among the East African Community partner states. This leads to conclusion that countries in EAC need not offer tax holidays and periods to carry loss forward to attract FDI. The findings of the study also found a significant and positive relationship between investment allowances and FDI inflows. The study therefore concludes that investment allowances has a significant influence on FDI inflows among the East African Community partner states. This means that investment allowances can help to attract FDI in EAC the partner states. The findings under objective one concludes that various forms of tax incentives have different influences on location of FDI. While tax holidays and period of period of losses carried forward showed no statistically significant influence on FDI location, investment allowances on the other hand, revealed a statistically significant influence in location decisions of FDI in EAC partner states. This implies that caution need to be exercised when providing tax incentives so that only those tax incentives, which will lead to attraction of investments are granted. The study recommends that governments in East Africa Community Partner states should offer only investment allowances as the tax incentives and discontinue offering of tax holidays and period of losses carried forward as tax incentives.

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