

Foreign Direct Investment And Economic Growth: An Empirical Analysis Of Kenyan Data

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The paper investigates the main drivers of real Gross Domestic Product growth in Kenya as well as those that drive the foreign direct investment (FDI) in Kenya. It is widely acknowledged that FDI has potential benefits that accrue to host countries. The view suggests that FDI is important for economic growth as it provides much needed capital, increases competition in host countries and helps local firms to become more productive by adopting more efficient technology. Kenya's record in attracting FDI from the 1980s has been poor though it was a favoured destination in the 1970s. The study findings show that FDI in Kenya are mainly market-seeking and these require growing GDPs, political stability and good infrastructure, market size as well as reduction in corruption levels. The prevalence of crime and insecurity would be impediments to FDI inflow. The policy implications of this study are that Kenya's FDI's tend to be mainly market seeking and for this reason policy makers in Kenya should focus on improving political stability, emphasize the development of good infrastructure and growing the country's GDP. This should be coupled with a serious attempt at reducing corruption levels as well as a serious assault on the prevalence of crime and insecurity which are major impediments to this type of FDI inflows.

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Introduction

Foreign direct investment (FDI) in Kenya is defined as investment in foreign assets, such as foreign currency, credits, rights, benefits or property, undertaken by a foreign national (a non-Kenyan citizen) for the purposes of production of goods and services which are to be sold either domestically or exported overseas (Investment Promotion Centre Act, Chapter 518). FDI generally refers to an investment made to acquire a lasting management interest (normally 10% of voting stock) in a business enterprise in a country other than that of the investor defined according to residency (World Bank, 1996). Ownership of less than 10% is regarded as portfolio investment. Foreign direct investment has grown enormously in the last three decades. For example prior to the recent economic crisis, global FDI has risen to US \$ 1,833 billion in 2007 well above the US \$ 1,748 billion in 2000 (UNCTAD, 2008). The production of goods and services by multinational corporations and their foreign affiliates have continued to rise as evidenced by increase in FDI from US \$ 15 trillion in 2007 US \$ 18 trillion in 2010 (UNCTAD 2010). The increase in FDI has been singled out as the most important factor for poverty reduction (Rose and Mwega, 2006). Most developing countries such as Kenya are interested in FDI a source of capital for industrialisation. This is because FDI involves a long term commitment to the host country and contributes significantly to the gross fixed capital formation.

FDI has been identified to contribute significantly to the economic growth of countries. Governments of many host countries (recipients of FDI) are using

financial incentives such as tax allowances and grants in aid among other policies to attract FDI into their economies due to the perceived benefits associated with FDI inflows. It has been suggested in numerous papers that foreign firms are able to positively affect the levels of productivity and growth rates in the industries they enter and to also promote skill upgrading, increase employment and increased innovation (Blomström, 1986; Blomström and Persson, 1983; Görg and Strobl, 2001; UNCTAD, 2005). However, it has also been argued that FDI may lower or replace domestic savings and investment, transfer low level or inappropriate technologies for the host country's factor proportions target primarily the host country's domestic market and even inhibit the expansion of indigenous firms thereby limiting growth. By focusing solely on local cheap labour and raw materials, foreign firms may not be helpful in developing the host country's dynamic comparative advantages (UNCTAD, 2005). Nevertheless, the negative consequences of FDI can be managed with proper business and labour regulation (Rose and Mwega, 2006; Kinuthia 2010).

There are at least three major types of FDIs. The market-seeking FDI usually serves local and regional market and involves the replication of production facilities in the host countries. A variant of this type of FDI is also known as Tariff-jumping or export-substitution FDI and it is driven mainly by market size and market growth of the host economy. Due to market and income considerations FDIs in small and poor countries are unlikely to be of the market seeking type (see Lim 2001;

Campos and Kinoshita, 2003 and UNCTAD, 1998).

The resource or asset-seeking FDI is another type of FDI and involves the relocation of parts of the production chain to the host country. This is usually driven by the availability of low-cost labour and is often export-oriented. This type of FDI is also attracted to countries with abundant natural resources such as oil and gas.

The third type of FDI is the efficiency-seeking type where the firms gain from common governance of geographically dispersed activities in the presence of economies of scale and scope. The idea here is to take advantage of special features such as labour costs, skills of the labour force and quality of infrastructure. We next examine the evolution of FDI flows in Kenya and how it has affected economic growth in Kenya.

The hope of vision 2030 has apparently not been fulfilled and Kenya's share in the regional market, both in EAC and the wider COMESA is still less than 15%. However, it still appears that the economic growth of a developing country may well depend on among other things on an opportunity to make profitable investments and accumulate capital. It is similarly true that one of the ways of achieving this objective is through the attraction of foreign capital and investments which allows a country to exploit opportunities that would otherwise not be available (OECD, 2002).

Evolution of FDI and Kenya's Economic Growth

Kenya has had a long history with foreign firms. From independence of 1963 through the 1970s and part of the 1980s it was one of the most favoured destinations of FDI in the Eastern Africa. FDI grew steadily

through the 1970s as Kenya was the prime choice for foreign investors seeking to establish a presence in Eastern and Southern Africa. In the 1970's Kenya was the most favoured destination for FDI in East Africa. However, over the years she has lost her appeal to foreign investors a situation that has continued to the present. In 2008, Kenya launched vision 2030 with the objective of among other things to achieve global competitiveness for FDI and gain economic prosperity. This initiative has seen a renewed commitment to attract FDI to assist in achieving higher economic growth rates. Kenya has had inconsistent trends of FDI inflows starting with the 1970-1980 period. The then relatively high level of development, good infrastructure, market size, growth and openness to FDI at a time when other countries in the region had relatively closed regimes all contributed to the multinational companies (MNCs) choosing Kenya as their regional hub. There was also relative political stability and security during the period. FDI started at a low of around US\$ 10 million a year in the early 1970s before peaking at US\$ 60 million by 1979-80. The country received relatively large capital inflows partly driven by rapid expansion in the agricultural sector, expansionary fiscal and monetary policies, sustainable budget deficit and the import substitution industrialisation (ISI) strategy. This involved overvalued exchange rates, import tariffs, quantitative restrictions and import licensing (Ikiara *et al*, 2003). Other factors included large and favourable regional markets from the original East African community (EAC) which attracted FDI into the country (World Bank, 2010). However, after the 1980s, Kenya's economy was characterized by

deterioration in economic performance, corruption and bad governance. Inconsistency in the implementation of economic policies and structural reform measures as well as the deterioration of public service and infrastructure ensured decades of low level of FDI inflows. FDI inflows in the period 1981-1999 averaged only US\$ 22 million per annum. It is noted that although Kenya was the leading destination of FDI in the East African region in the 1970s and 1980s the relative level of flows was never high even by developing countries' standards. This can be seen by looking at the stock of FDI which was only 7.5% of the GDP in 2003, compared to 25.3% for Africa as a whole and 31.5% for developing countries (UNCTAD, 2005). Kenya's regional leadership in attracting FDI also disappeared as soon as Tanzania and Uganda started reforming their economies and opening up to foreign investors in the early 1990s. FDI flows in the 1996-2003 period averaged some US\$ 29 million annually while flows to Tanzania and Uganda surged to US\$ 280 million and US\$ 220 million respectively from negligible levels in the 1980s (see UNCTAD, 2005). In relative terms, Kenya's case was even worse since its economy was about 30% larger than Tanzania's and twice as big as Uganda's in 2002. It is notable that developing countries as a whole attracted an annual average of US\$ 41 of FDI per capita in 1996-2003 when Kenya only managed inflows of US\$ 1.3 per capita. Kenya's share of FDI inward stock was 55% among the East African countries in the mid 1990s but this declined to 18% by the end of 2003. The biggest beneficiary of this loss was Tanzania who's share rose by

34% share, rising to 46% by the year 2003. The same scenario was repeated in the period 2003-2009 where the average FDI flows into Kenya was US\$ 106 million per annum compared to US\$ 456 and US\$ 521 million for Tanzania and Uganda respectively (World Bank, 2010). Kenya now attracts about one third of what each of her neighbours attracts in terms of FDI inflows. This situation has persisted despite the Kenya government's attempts to implement a series of measures aimed at attracting foreign investors into Kenya since 1988, especially with respect to export platforms such as Export Processing Zones (EPZs). Nevertheless, these export platforms have themselves been disappointing in performance; with exports from EPZs accounting for about 3.5% of total manufacturing exports while employment in these firms accounted for barely 1% of total manufacturing employment by 1997 (see Glenday and Ndi, 1997). This rose somewhat due to the effects of the African Growth and Opportunity Act (AGOA) after 2001.

Kenya also missed out in the global surge in FDI that was experienced in most parts of the world in the 1990s and beyond. While the average FDI inflows to Kenya doubled in the 1981-85 and 1996-2003 periods, the average inflow into African countries increased sixfold and the average inflows into developing countries as a whole increased almost tenfold. It seems clear that Kenya's poor performance in attracting FDI at a time of global surge of inflows and with similar economic structures must be found mainly within the country.

Studies on Kenya's inability to attract FDI despite it having been the prime destination of FDI in the 1970s and 1980s

have identified such factors as macroeconomic instability, corruption and bad governance, inconsistencies in economic policies, deteriorating public service and poor infrastructure as some of the factors responsible for the low FDI inflows. These studies also highlight market size, low economic growth, lack of policy transparency and rising cost of electricity and labour. The studies include Kinaro, 2006; Opolot *et al*, 2008 and UNCTAD, 2005 among others.

The deterioration of Kenya's infrastructure, particularly at a time of major improvement in infrastructure in other parts of the developing world have induced many foreign investors already established in the manufacturing sector to divest or consolidate their operations out of Kenya in recent years.

The trend of FDI in Kenya has shown that foreign investors are moving out of Kenya with few new investors coming in or even existing investors planning significant expansion. Kenya's Vision 2030 asserts that the country intends to attract at least 10 large strategic investors in key agro-processing industries and raise its market share in the regional market from 7% to 15% by the year 2012. Exports can affect the economy as a whole through productivity enhancing externalities such as technology spillovers and therefore if FDI is found to promote exports, FDI can enhance economic growth. Numerous studies have concluded that exporting is crucial to growth and foreign direct investments can play a role in enhancing the export capability of a country (see Bernard *et al*, 2000; Bernard and Jensen, 2001; Bigsten *et al*, 1999, 2002; Girma *et al*, 2005, and Kneller *et al*, 2004).

The Investment Promotion Act enacted in 2004 is a key policy initiative aimed at promoting foreign direct investment in the country. It provides incentives and promotes foreign direct investments that earn foreign exchange, provide employment and promote backward and forward linkages and transfer technology. The Act, however, took away some of the benefits through imposing compulsory investment certificates and high minimum capital requirements, thus creating a legal barrier to and administrative burden for FDI thereby discouraging both domestic and foreign investment (UNCTAD, 2005). These general restrictions of the Act are contrary to practice in many other countries in Africa and elsewhere in the world that adopt more liberal entry regimes and / or more precisely targeted policies to regulate FDI entry. Tanzania for example does not impose minimum capital requirements for FDI entry in general, but makes special incentives conditional upon holding an investment license and investing a minimum of US\$ 300,000 (compared to Kenya's US\$ 500,000). Uganda does not require foreign investors to invest minimum amounts but offers the facilitation support of its Investment Authority when investments exceed US\$ 100,000. Additionally, the minimum capital requirement does not effectively grant protection to national investors in sensitive areas and maximize the benefits of FDI. The size of investment is by no means an indicator of "seriousness" and benefits to the economy since at times large foreign investments may crowd out small national investors' as much as more modest foreign investments (UNCTAD, 2005). The UNCTAD(2011) data shows that Tanzania and Uganda have

made tremendous improvements in their attractiveness for FDI since 1994. Tanzania's FDI increase has been attributed to the mining sector especially uranium and tanzanite, gas and oil discoveries as well as favourable policies that liberalized both local and foreign investments (Kajara 2010). Uganda's FDI increase has been attributed to a wide range of tax incentives to businesses as well as its own discovery of oil and gas reserves (Ngowi, 2005). This suggests that

FDI increases with increases in discovery of natural resources. Furthermore, the UNCTAD (2011) figures suggest that economic growth rate of Tanzania and Uganda has exceeded that of Kenya since 1994 when their FDI begun to increase. This may lend credence to the hypothesis that increases in FDI leads to increases in economic growth, but these are not proportional suggesting that other factors also affect growth.

Table 1: Flows into Kenya and Tanzania (in selected years, in US\$ million)

Item	2005-2007 (annual average)	2009	2010	2011	2012
Kenya	267	115	178	335	259
Kenya's FDI as % of Gross Fixed Capital Formation (GFCF)	6.1	-	2.7	4.9	2.9
Tanzania	640	953	1813	1229	1706
Tanzania's FDI as % of GFCF	15.3	-	24.6	15.6	17

Source: UNCTAD (2013).

Table 2: FDI stock in Kenya and Tanzania (selected years, in US\$ million)

Item	1995	2009	2010	2011	2012
Kenya	732	2104	2282	2617	2876
Kenya's FDI stock as % of GDP	6.3	-	7.1	7.7	7.0
Tanzania	620	8066	8762	9278	10984
Tanzania's FDI stock as % of GDP	10.2	-	37.1	38.1	38.2

Source: UNCTAD (2013).

UNCTAD (2005) had argued that Kenya's inability to attract FDI is a result of corruption, poor governance, inconsistencies in economic policies and structural reforms, deteriorating public service and poor infrastructure all of which are being addressed. Despite massive efforts by the government to implement

reforms such as trade reforms, the country continues to loose its competitiveness for FDI to Uganda and Tanzania. However, Sims (2013) indicates that inflows of FDI to Kenya could match those of Tanzania and Uganda beginning 2014 aided by opportunities created by the discovery of oil deposits in Turkana. The FDI inflows

are projected to average US \$ 1.3 billion annually for the period 2013-2018 , placing it at par with Tanzania and Uganda who had over the years attracted more investors due to their vast natural resources such as gas , oil and other minerals.

The UNCTAD (2011) figures show that Uganda and Tanzania have overtaken Kenya in terms of growth rates due to their rising FDI inflows , but Kenya is still the regional business leader ,is it that FDI is a key factor in driving economic growth or are other factors equally important ?.

Some of these shortcomings have been recognized by the government and it has sought to amend the Investment Promotion Act by making investment certificates optional for all investors .The special incentives remain conditional upon holding a certificate, though the minimum capital requirement to qualify for one would be lowered to US\$ 100,000 for foreign investors and US \$ 13,000 for national investors.

From the year 2000, the Kenya government has implemented a number of initiatives to improve both economic performance and stimulate foreign direct investments. The government joined the Free Trade Area of the Common Market for Eastern and Southern Africa (COMESA) in 2000; negotiated for the resumption of donor aid by the International Monetary Fund (IMF); adopted the United Nations Millennium Development Goals (MDGs) in 2002 and resolved to reduce poverty levels by half by the year 2015; implemented the Economic Recovery Strategy for wealth and employment creation (ERS) in 2003 to stimulate private investment to generate wealth and reduce poverty; implemented

Kenya's Vision 2030 in 2008 and promulgated a new constitutional dispensation in 2010. The Vision, implemented in successive five-year medium term plans, with the first plan covering the period 2008-2012, is expected to encourage FDI, achieve high average Gross Domestic Product growth rate (of 10% per annum beginning 2012) and boost investments. It is also expected to enhance macroeconomic stability, raise national savings (from 17% in 2006 to 30% by 2012). These measures did see Kenya's growth rise from 0.6% in 2000 to 7% in 2007. The growth rate however fell to 1.6% in 2008 but has been rising since to 4.7% in 2012. The fall in GDP growth was due to global financial crisis; fall in commodity prices and post-election chaos that followed the December 2007 general elections in Kenya.

Despite the recent impressive economic growth, FDI flows to Kenya average below US\$ 39 per capita between 2003 and 2006 compared to US\$ 418 and US\$ 310 for Tanzania and Uganda respectively. By 2009, Kenya's net FDI flows stood at US\$ 116 million while Tanzania's and Uganda's US\$ 415 and US\$ 789 respectively (World Bank, 2012). This is despite the Kenyan governments implementing a series of measures to attract foreign investors that included among others Manufacturing Under Bond (MUB) in 1987, Export Processing Zones (1990) and accession to the African Growth and Opportunity Act (AGOA) in 2001 (World Bank, 2012). The last measure however led to significant FDI inflows from Asia whose investors used Kenya as a platform for quota-hopping to access the otherwise restricted US market,

particularly for clothing manufactures (UNCTAD, 2005).

The Study Objectives

It has been argued in numerous studies that FDIs contribute positively to economic growth in the host economies. This is particularly true where FDIs bring in investible financial resources and fill the gap between desired investment and domestically mobilized savings, facilitate entry into export markets, and strengthen the export capabilities of the host country resulting in productivity gains, technology transfer, introduction of new processes, managerial skills and knowhow in the domestic markets, employee training, international production networks and access to markets (Caves 1998; Ayanwale, 2007; Borensztein *et al*, 1998. Findlay (1978) also makes a case for the increase in the rate of technical progress in the host country through a “contagion effect” from the more advanced technology as a result of FDIs. FDIs have also been credited with increase in tax revenues and improvement in management and labour skills in host countries (Todaro and Smith, 2003; Hayami, 2001). Employment creations, human capital development, contribution to international investments are some of the positive effects of FDIs (Jenkins and Thomas, 2002; World Bank, 2002).

To the contrary, despite the important role played by FDI in economic growth in host countries, the level of FDI in Kenya has been low and stagnant over the past couple of decades as alluded to above. It is equally clear that FDI flows and GDP growth rates fell in the 1980s and 1990s. After 2000, rising economic growth rates contrasted with low and stagnant FDI flows. Kenya’s experience also contrasts with both Uganda and Tanzania where

both FDI flows and economic growth have been on a steady rise since the early 1990s. There are few studies that analyze the empirical relationship between FDI and economic growth in Kenya; these include Kinaro, 2006; Opolot *et al*, 2008, and Mwega and Ngugi, 2007. Though it can be important in informing government investment policy in the host country, the empirical linkage between FDI and economic growth in Kenya is not clear.

On the basis of the foregoing arguments the study will raise two main questions; namely what is the empirical relationship between Foreign Direct Investment and economic growth in Kenya? And what factors determine the FDI flows to Kenya? The objective of the study is to empirically investigate the relationship between foreign direct investment and economic growth in Kenya and to examine and quantify the factors that drive foreign direct investment flows into Kenya. Specifically the study will seek to use Kenyan FDI flows and gross domestic product data to establish the empirical relationship between foreign direct investment and economic growth in Kenya with a view to quantify the relationship. The study also seeks to determine and empirically quantify the factors that drive FDI flows into Kenya and to suggest policy options that can be implemented to increase both FDI inflows into Kenya and hence increase economic growth in the economy based on the results of the study. The rest of the paper is organized as follows. Following this introduction, the next section briefly reviews the literature on the FDI and economic growth and their relationship as well as providing the theoretical foundation of the study; this is followed by a brief presentation of the

methodology and a theoretical framework to be used in the study and includes a model to be estimated. The section also briefly discusses the types and sources of the data used in the study. The last section discusses the results and policy implications based on the results of the study.

Literature Review

In this section we briefly review some of the theoretical and empirical literature on foreign direct investments and economic growth. The section is divided into three parts comprising theoretical literature review, empirical review and an overview of the literature.

Theoretical Foundation

It has been argued that foreign direct investment can either positively or negatively affect economic growth in the host economies. There are many channels through which FDI can impact on growth. Blomstrom et al (1994) argue that FDI exerts a positive effect on growth but there is a threshold level of income above which FDI has a positive effect on economic growth and below which it does not or is insignificant. Borensztein et al (1998) is of the opinion that the interaction of FDI and the quality of human capital has important effect on economic growth and suggests that the differences in the technological absorptive ability may explain the variation in growth effects of FDI across countries. They point out that countries may need a minimum threshold of human capital to experience positive effects of FDI on economic growth. It is similarly suggested by Oloffsdotter (1998) that the beneficial effects of FDI are stronger in the countries which have a higher level of institutional capability.

In another study Alfaro et al (2003) find little support that FDI has an exogenous positive effect on economic growth, however, their findings suggest that local conditions such as the level of education and the development of local financial markets play an important role in allowing the positive effects of FDI to materialize in the economy.

Many studies exist concerning FDI and its determinants, where the main factors include the rate of investment return, market size, macroeconomic variables (especially their stability), quality of labour, infrastructure, property rights and the effects of globalisation which has led to FDI in LDCs to shift from market seeking and resource seeking to the more efficiency seeking FDI.

The literature indicates that there is no conclusive argument on factors determining FDI and its subsequent effect on economic growth. Causality between FDI and growth is still unclear. The direction of FDI might be associated with domestic policy variables. The direction of the relevant causalities between FDI and growth may well depend on the determinants of FDI. If the determinants have strong links with growth in the host country, growth may be found to cause FDI, and output may grow faster when FDI takes place in other circumstances like the case of oil discovery.

The understanding of the impact of specific categories of foreign capital inflows has important policy implications. Most studies on the growth of specific types of foreign capital flows focus on FDI. However, the empirical evidence on FDI and its impact on host countries growth are ambiguous at both the micro and macro level.

The positive effects on the growth of the host economy can come from investible financial resources filling the gap between investment and domestically mobilized savings, facilitation of entry into export markets and strengthening export capabilities of the recipient country. Caves (1998) has postulated that other positive effects of FDI include productivity gains, technology transfer, new processes, managerial skills, employee training, international production networks and access to new markets. Borensztein *et al* (1998) see FDI as an important channel for transfer of technology and contributing to growth in larger measure than domestic investment. Findlay (1978) postulates that FDI increases the rate of technical progress in the host country through what he calls a “contagion effect” from the more advanced technology, superior management practices used by the foreign firms. Todaro and Smith (2003) and Hayami (2001) noted that FDI may also increase tax revenue, improve management, technology as well as labour skills in host countries. Many other studies have noted the benefits of FDI to include new technology, employment creation, human capital development, international trade integration, enhancing domestic investment, and increased revenue (Jenkins and Thomas, 2002; World Bank, 2000). FDI is seen as being a positive contributor to the economic growth of the host country.

However, it has also been argued that foreign direct investments can also have adverse effects on the economy of the host country. Reis (2001) has advanced the argument that opening up a country to FDI in the research and development sector may replace the domestic firms and

decrease welfare due to the transfer of capital returns to foreign firms.

Firebaugh (1992) points out that the foreign firms may fail to encourage local entrepreneurship, reinvest profits, develop linkages with domestic firms or fail to use appropriate technology. FDI can be detrimental if it “crowds out” domestic businesses and engenders inappropriate consumption patterns or reduce domestic savings and investment rates by stifling competition through exclusive production agreements with the host country. FDI may also lead to less than optimal corporate taxes where they are provided with liberal tax concessions and excess investment allowances and other incentives. In a distorted market, FDI can lead to negative value-added at world prices coupled with repatriation of profits and dividends (Mwega and Ngugi, 2007). The study is based on the theory of profit maximisation, such that the country’s GDP can be increased by the input of the FDI inflows which enhances its productivity as it helps local firms to be more productive through the infusion of capital and more modern and efficient technologies that it brings as well as fostering competition both locally and in the country’s foreign markets.

It is generally believed however, that FDI provides net benefits to the host country. This explains why the importance of FDI in economic performance has been extensively discussed in the economic literature.

Empirical Studies

Several studies have been conducted on the empirical relationship between FDI’s and economic growth. Some of these studies have shown that FDI’s positively

influence economic growth in the host countries. Dees (1998) in a study on the determinants and effects of foreign direct investments in China found that FDI has been important in explaining China's economic growth. Similarly, de Mello (1997) also presents a positive correlation between FDIs and economic growth of selected Latin American countries. Barrel and Pain (1999) explored the benefits of FDI of U.S multinational in four European Union countries and find that FDI may affect the host country's performance positively in the case where there are transfers of technology and knowledge through the FDI to the host economy.

Firm-level studies of specific countries provide contradictory evidence on the role played by FDI in economic growth. For example Wilmore (1986) examining a sample of 282 pairs of firms from 80 industries in Brazil found that FDI had a beneficial impact on growth since foreign firms are more efficient than domestic ones. Moreover, Blomstrom (1986) found that FDI enhances productivity growth of Mexican firms. FDI spillovers that occur when the entry or presence of a foreign investment firm(s) contribute to the productivity or efficiency benefits of indigenous firms are critical in defining the impact of FDI on the growth of host nations.

The literature identifies competition, linkages, labour mobility, skills and imitation as the main channels of technological spillovers from FDI to indigenous firms (Blomstrom and Kokko, 1998). We however, note that FDI spillover may either be positive or negative on their impact on economic growth in the host countries. Some

empirical studies show positive effects of FDI spillovers on economic growth in the host countries.

Some empirical studies show positive effects of FDI spillovers on economic growth (Caves, 1974) on Australia and Kokko (1994) for Mexico. However, Haddad and Harrison (1993) find no evidence of positive spillovers from FDI in Morocco. The study by Aitken and Harrison (1999) for Venezuelan firms in the period 1979-1989 and Djankov and Hoekman (2000) for the Czech Republic firms report negative spillovers. Hanson (2001) concludes that the evidence that FDI generates positive spillovers for host countries is weak. Microeconomic studies report positive effects of FDI and productivity spillovers, these include studies by Lipsey and Sjöholm, 2004; Black and Gertler, 2008. Most macroeconomic studies generally suggest that FDI exerts a positive impact on economic growth in particular contexts. Balasubramanyam *et al* (1996) and Zhang (2001) find that effects on growth of FDI are more significant in the presence of trade openness and where host country adopted liberalisation. Borensztein *et al* (1998) argue that FDI is an important channel for the transfer of technology and contributes to economic growth when the country has a highly educated workforce. Blomstrom *et al* (1994) found that among developing countries, the positive impact of FDI on growth is larger in those countries that exhibit higher levels of per capita income. FDI is also beneficial for economic growth when the country has sufficiently developed and sophisticated financial markets (Alfaro *et al*, 2004). The other factors that enable FDI to positively impact on growth include political and

economic stability as well as the quality of institutions and infrastructure which complements FDI (see Oloffsdotter, 1998; Hall and Jones, 1999; Rodrik *et al*, 2002; Aschauer, 1989 and Tondl and Prüfer, 2007). The literature therefore suggests that openness to trade, human capital, financial market development, public infrastructure and quality of institutions affects a host country's ability to absorb FDI spillover.

The literature on FDI shows that its impact on economic growth can either be direct or indirect. The indirect impact or spillovers are dependent on the host country's conditions. Specifically this depends as per capita income, human capital stock, financial sectors level of sophistication, the level of development and quality of public infrastructure, the quality of institutions, trade openness and macroeconomic stability. The empirical evidence however shows that the relationship between FDI and growth is uncertain and varies across host countries. This paper proposes to use Kenyan data to find out whether FDI enhances economic growth in Kenya.

Using panel data for 25 central and Eastern European and former Soviet transition economies, Campos and Kinoshita (2003) examined the effects of FDI on growth for the period 1990-1998. Their main results indicated that FDI has a significant positive effect on economic growth of each country. Focusing on the factors that explain growth in developing countries, Blomström *et al* (1994) found that foreign direct investments exerts a positive effect on economic growth but that there seems to be a threshold level of income above which FDI has positive effect on economic growth and below which it does not. The

explanation is that only those countries that have reached a certain income level can absorb new technologies and benefit from technology diffusion, and thus reap the extra advantages that FDI offer. They concur with other studies that suggest human capital as one of the reasons for the differential response to FDI at different levels of income (Borensztein *et al*, 1998; Bengos and Sanchez-Robles, 2003).

However, some studies have found that FDI may not influence long-run economic growth. In a study on the interaction between foreign direct investment, economic freedom and growth, Bengos and Sanchez-Robles (2003) estimated the relationship between FDI and economic growth using panel data for eighteen Latin American countries over the period 1970-1999. They show that FDI had positive and significant impact on economic growth. However, they also found that the host country requires adequate human capital, political and economic stability and liberalized market environment so as to gain from long-term FDI inflows. It has also been shown by Ang (2008) that better developed financial systems allow an economy to exploit the benefits of foreign direct investment more efficiently. The author used Thailand as a case study to examine the role of FDI and financial development in the process of economic development. The estimation uses an unrestricted error-correction model to avoid omitted lagged variable bias, and an instrumental variable to correct for endogeneity bias. Using annual firm series data from 1970-2004 the results show that financial development stimulates economic development whereas foreign direct investment impacts negatively on output expansion in the long-run.

However, an increased level of financial development enables Thailand to gain more from FDI, suggesting that the impact of FDI on output growth can be enhanced through financial development.

Some studies indicate that the relationship between the FDI and economic growth is weak and insignificant. Ayanwale (2007) investigating the empirical relationship between non-extractive FDI and economic growth in Nigeria using annual time series and ordinary least squares technique found the relationship between FDI and economic growth to be positive but not significant.

Overview of The Literature

It is clear from this brief review that the effects of FDI on growth are dependent on the characteristics of the host country and the sectors where the FDI is directed. Large market size and high incomes may attract market seeking FDI as opposed to small and low income economies. Market-seeking FDI is therefore induced by market access to host countries for be attributable to differing economic institutional and technological conditions in the recipient countries. The few country specific studies also indicate that there may be endogenous relationship between FDI and growth which may have to be taken into account if the results are to be robust.

The next section presents the methodology used in the study.

Theory And Empirical Model

In this section we present the methodology used in the study. The methods are outlined before the model is specified. Section 3.2 briefly presents the types, sources and measurement of the data used.

efficient utilization of resources and exploitation of economies of scale. FDI complements growth when directed towards highly productive sectors of the host economy. Investment in development of good quality infrastructure, low cost and highly skilled human capital and innovations and technological progress increase productivity and promote growth in the long-run. The empirical evidence shows that the relationship between FDI and growth and the expected significance of the determinants of FDI varies across host countries.

The empirical evidence shows that the relationship between FDI and growth and the expected significance of the determinants of FDI varies across host countries. Some studies show positive effect of FDI on economic growth while others show negative impact; whereas some studies exhibit insignificant relationship between the two variables. The differences in empirical results may

The relationship between FDI and economic growth is situated in growth theory that pronounces the role of improved technology, efficiency and productivity in promoting growth (Lim, 2001). However, the potential contribution of FDI to growth is dependent strictly on the on the circumstances in the recipient or host countries. Certain host country conditions are necessary to facilitate the spill-over effects.

In this study, we assume in line with standard economic theory that foreign capital inflows into a recipient country will increase its stock of capital and level of technology and lead to better economic performance. Foreign direct investment

will affect economic growth positively through improved technology, efficiency and increased productivity (Lim, 2001). However, as noted in the review of literature, the potential contribution of FDI to growth is strictly dependent on the circumstances in the recipient or host country. Theoretically a country's GDP is influenced by a variety of factors. RGDP is measured as nominal GDP deflated by the GDP deflator, (base 2000 s=100).

We hypothesise FDI to positively influence growth. FDI promotes economic growth in host countries by providing external capital (O'hearn, 1990). Apart from increasing tax revenues, improving managerial and labour skills it also creates employment in the host country. The gross fixed domestic investment (GFDI) is proxied in this study by the share of the gross domestic capital formation to GDP less net FDI flows. Increased investments The size of Government (GOVSIZE) is measured in this study by the share of total government consumption to GDP. Anyanwale (2007) points out that higher level of general final government consumption provide social capital that encourages production and growth. Trade openness (OPEN) on the other hand promotes economic growth through increasing competitiveness and providing access to markets for finished products, (Balassa, 1978). It also enables the importation of raw materials and capital goods and facilitates access to new technologies and skills. Large export markets encourage inward market-seeking FDI and foreign capital inflows (Kinaro, 2006; Ajayi 2007).

There are evidently other influences on GDP with varying degrees of importance

rates promote productivity in a country as argued by Grossman and Helpman (1991). We expect a positive relationship between this variable and GDP. The level of human capital measured here by the secondary school enrolment rate should have a positive impact on GDP. It can be argued that widespread availability of cheap and highly skilled labour force tends to attract private investment and enhances productivity in a country (Akinlo 2004, Barro and Lee, 1994). The rate of inflation measured here by the annual percentage change in consumer price index is a reflection of macroeconomic stability. A low and stable inflation rate implies a more reliable economic environment enabling investors to benefit from existing opportunities (see Larrain and Vergara, 1993; Serven and Solimano, 1993). A negative relationship exists between inflation and GDP.

are captured by the error term (e) in our specification.

The Model

As explained in the section above, equation 1 below shows the hypothesized relationship between economic growth and its determinants.

We hypothesize economic growth to be influenced by several factors as shown in the model below

$$RGDP = f(FDI, GFDI, UMCAP, INFL, GOVSIZE, OPEN, ROI, INFRAC, TDS, CPI) \dots \dots \dots (1)$$

Where

RGDP = Real Gross Domestic Product

FDI = Foreign Direct Investment

GFDI = Gross Fixed Domestic Investment

HUMCAP = Level of Human Capital

INFL = Rate of Inflation

GOVSIZE = Government consumption

The equation which relates the real gross domestic product to various factors that influence it can be elaborated as

$$RGDP = g_0 + g_1 FDI + g_2 HUMCAP + g_3 INFL + g_4 GOVSIZE + g_5 OPEN + g_6 + \varepsilon \dots \dots \dots (2)$$

Where g_1, \dots, g_6 are the coefficients to be estimated and g_0 is the constant. ε is the error term.

Equation (2) above shows the growth model to be estimated.

When estimating the growth equation it is possible that some of the variables could be correlated to the error term resulting in a problem of endogeneity and could give rise to biased estimated coefficients. If this were to happen appropriate instruments will be searched and used in a 2 stage least squares (2SLS) estimation.

Since we also wish to quantify the factors that drive direct foreign investment (DFI) inflow into the country we shall estimate an FDI equation. We hypothesize that direct foreign investment is influenced by a variety of factors as shown below:

$$FDI = \mathfrak{R}_0 + \mathfrak{R}_1 RGDP + \mathfrak{R}_2 INFRAC + \mathfrak{R}_3 OPEN + \mathfrak{R}_4 GR + \mathfrak{R}_5 RLIR + \mathfrak{R}_6 TDS + \mathfrak{R}_7 ROI + \mu \dots (3)$$

Where

FDI = Foreign Direct Investment measured share of FDI to GDP

RGDP = Real Gross Domestic Product (nominal GDP deflated by the GDP deflator)

HUMCAP = Level of Human Capital (proxied by the secondary school enrolment rate)

GR = Market size (measured by annual % change in real GDP)

RLIR = Real Interest rate (measured by the difference between the nominal

lending interest rate and the rate of inflation)

GFDI = Gross Fixed Domestic Investment (proxied by the share of the gross domestic capital formation to GDP less net FDI inflows)

OPEN = Openness of the economy (measured by the ratio of trade exports + imports to GDP)

INFRAC = Infrastructure (proxied by the electric power transmission and distribution losses as a % of the total output)

INFL = Inflation rate measured by the annual % change in consumer price index

TDS = Total debt service to GDP ratio measured by the share of total external debt service to GDP

CPI = Corruption Perception Index

ROI = Return on Investment proxied by long-term US interest rates

GOVSIZE = Government consumption measured by the share of the total government consumption to GDP

μ = The Stochastic error term

The coefficients $\mathfrak{R}_0, \dots, \mathfrak{R}_7$ are to be estimated.

In the FDI model equation (3) above, FDI is measured as the ratio of FDI to GDP and is the dependent variable. It is hypothesised that a high real GDP reflects large market size that attracts further FDI especially the market seeking ones, resulting in more demand for products or services to be provided by FDI (Chunlai, 1997; Mwega and Ngugi, 2007). The Gross Fixed Domestic investment increases the rate and efficiency of domestic capital investment, raising productivity in a country and thereby encourages FDIs. We expect a positive impact on FDI. The measure of openness is as defined above. This may encourage

exports and hence lead to market seeking FDI

Infrastructure is critical for both economic growth and competitiveness. In this study it is proxied by Electric power transmission and distribution losses as a percentage of total output. We expect this to have a negative impact on FDI inflows as it relates to high cost of production (see Anyanwale, 2007).

The real exchange rate has an important impact on FDI inflows. A depreciation of the exchange rate

Encourages higher inflows as it makes local assets and production costs cheaper. An appreciation of the exchange rate has the opposite effect.

The choice of variables included in the model specifications has been guided by the theories of economic growth and the determinants of FDI inflows discussed in the literature review above.

The following section elaborates the sources and types of data used in the study.

Data Sources, Types and Measurement

The study covers the period 1970-2010; and therefore includes the period which Kenya was the preferred FDI destination in East Africa as well as the period in which she was overtaken by both Tanzania and Uganda as the main FDI destinations in the region.

The data is annual time series data obtained from secondary sources. The sources include the Central Bank's annual economic reviews, Republic of Kenya Statistical Abstracts and economic surveys produced by the Kenya National Bureau of Statistics (KNBS). Other sources of data included the World Bank's World Development Indicators and Global

Development Finance reports. The UNCTADs World Investment reports and the IMF's International Financial Statistics have also been used. Due to difficulties in obtaining certain qualitative data on such variables like corruption it was left out of the analysis even though we are acutely aware that corruption levels in a country can have a major negative impact on the inward flow of FDI.

Time Series Properties and Estimation Tests

Given the time series nature of our data, it was imperative to carry out estimation tests to be sure that our data is not non-stationary so that we avoid the problem of spurious regression results. We therefore conducted stationarity tests for the series using the Augmented Dickens Fuller (ADF) test. The ADF assumes that the error terms are independently and identically distributed. A time series data is said to be stationary if its mean, variances and autocovariance remain the same no matter at what point we measure them.

Unit root test for stationarity results

We used the Augmented Dickens Fuller test to test for stationarity in our data. The test indicates whether or not the variables are stationary. The null hypothesis is that of non-stationarity while the alternative hypothesis is that of stationarity. The test statistic is then compared with the t-critical. If the t-statistic is less than t-critical we reject the null hypothesis of non-stationarity and therefore the series is stationary. On the other hand, if the t-statistic is more than the critical we accept the null hypothesis and non-stationarity and the series is therefore non-stationary and prone to spurious regression. The table

below shows that our data was stationary and we do not face the possibility of

spurious regression results.

Table 3: Unit Root Test using ADF

VARIABLE	ADF STATISTIC	1% CRITICAL VALUE	5% CRITICAL VALUE	10% CRITICAL VALUE	NATURE
RGDP	-6.900	-3.648	-2.958	-2.612	STATIONARY
GR	-5.015	-3.648	-2.958	-2.612	STATIONARY
FDI	-6.941	-3.648	-2.958	-2.612	STATIONARY
HUMCAP	-6.426	-3.648	-2.958	-2.612	STATIONARY
OPEN	-6.303	-3.648	-2.958	-2.612	STATIONARY
INFRAC	-5.139	-3.648	-2.958	-2.612	STATIONARY
GOVSIZE	-5.190	-3.648	-2.958	-2.612	STATIONARY
TDS	-6.008	-3.648	-2.958	-2.612	STATIONARY
INFL	-6.352	-3.648	-2.958	-2.612	STATIONARY
RLIR	-5.772	-3.648	-2.958	-2.612	STATIONARY
ROI	-6.761	-3.648	-2.958	-2.612	STATIONARY

Results in table 5 above show that the ADF test statistics are less than the t-critical at the 1%, 5% and 10% and we therefore reject the null hypothesis of non-stationarity and accept that the series are stationary and our OLS regression could be conducted since the results would not be spurious (The OLS results are shown in tables 4 and 5).

The study hopes to determine the important variables that may be important in encouraging the inflow of direct foreign investment to Kenya and recommend policies that can enhance the inflow of FDI into Kenya. The study also hopes to determine the empirical relationship between economic growth and foreign direct investment in Kenya with the view to both boost inflow of direct foreign investment and economic growth.

Having elaborated the hypothesised relationships between our dependent

variables and the independent variables in the two models we estimated the relationships using time series data and the results are discussed in the following section.

Results and Discussion

We set out to empirically investigate the relationship between foreign direct investment and economic growth in Kenya by examining the factors that drive foreign investment flows into Kenya. The objective was to establish the empirical relationship between FDI and economic growth in Kenya.

Regression Results

The growth equation

From our results in table 1 we see that the growth in GDP is positively influenced by human capital and the variable is significant at the 1% level (t-value=4.96) and a P- value=0.000. The results also

show that the government expenditure (GOVSIZE) is a significant determinant of the real GDP. The variable is significant at

the 1% level with a t-value of 3.17 and a p-value of 0.003.

Table 4: Determinants of RGDP

Variables	Coefficient	Standard Error	t-values	P-values
fdi	1949.496	2514.297	0.78	0.443
humcap	822.911	166.0322	4.96	0.000
infla	9.835928	32.06965	0.31	0.761
govsize	3523.373	1111.173	3.17	0.003
open	585.8971	215.6161	2.72	0.001
_cons	-45026.6	23981.22	-1.88	0.069

No. of obs = 41; F(6, 34)= 21.28; Prob>F = 0.0000; R-Squared = 0.7897; Adj R-Squared = 0.7526; Root MSE = 8237.2

It was argued that the government size which is measured by the share of total government consumption in GDP should influence economic growth in a positive manner. The higher the level of the general final government consumption the more the social capital and this encourages production and the growth of GDP. The results indicate a highly significant coefficient (t-value=3.17) at the one percent level of significance. The results therefore suggest that government consumption is a major contributor to GDP growth and should be encouraged. It appears that government expenditure on social services and other amenities is an important boost to growth.

The openness of the economy to the rest of the world is similarly shown to be a major driver of the GDP growth rate. The variable was measured as the ratio of trade defined as imports plus exports to the GDP. The idea here is that trade openness promotes economic growth through increasing competitiveness and providing

access to markets both for finished products and exports as pointed out by Balassa (1978). By enabling importation of raw materials and capital goods and facilitating access to new technologies and managerial skills it positively impacts on the growth of GDP. The coefficient is large and positive and is reported to be significant at the 1% level (t-value=2.72) with a p-value of 0.010.

The variables in the growth equation explain about 80% of the variations in the GDP growth rate and the overall model seems to be well specified with an F-statistic of 21.2. The p-value for the model as a whole indicates it is fairly well specified.

The FDI equation

The results in our table 2, shows the determinants of FDI inflows to Kenya. The real gross domestic product measured as defined above is shown to be a major influence on the FDI inward flow.

Table 5: The determinants of FDI

Variables	Coefficient	Standard Error	t-values	P-values
rgdp	2.69E-05	1.09E-05	2.47	0.019
infrac	0.066262	0.03405	1.95	0.06
open	0.017142	0.013785	1.24	0.223
gr	-0.00854	0.022764	-0.37	0.71
rlir	-0.00668	0.010635	-0.63	0.534
tds	0.072952	0.043933	1.66	0.107
roi	-0.07517	0.05979	-1.26	0.218
_cons	-0.73934	1.102412	-0.67	0.507

No. of obs = 41; F(8, 32)= 1.86; Prob>F = 0.1011; R-Squared = 0.3179; Adj R-Squared = 0.1474; Root MSE = .52994

The theoretical basis for this is that a high real GDP reflects a large market size that attracts FDI, especially the market seeking type. The high GDP leads to higher demand for the products and services provided by the foreign firms. A high real GDP therefore has a positive influence on the FDI. The results in table 2 show that the variable is highly significant at the 1% level and has a *t*-value of 2.47. The coefficient is positive as was hypothesized. The results further show that the infrastructure is also an important influence on the FDI inflow. The variable has a positive coefficient and is significant at the 10% level with a *t*-value of 1.95. We had proxied infrastructure by electric power transmission and distribution losses as a percentage of total output. The expectation was that it would have a negative impact on FDI inflows due to the measurement method employed as it relates to high cost of production. However, the results do not support this hypothesized relationship. It is possible and even likely that good infrastructure which improves a country's

competitiveness may in fact attract FDI flows due to improved cost conditions in a country.

The variable on total external debt service as a ratio of GDP (tds) captures the liquidity and solvency constraints imposed by the debt burden and the higher the debt services ratio the more it deters FDI inflows. The results indicate that the coefficient is positive though not statistically significant. The a priori expectation was that it would be negative due to the negative impact of the debt burden which discourages FDI flows.

These results imply that Kenya can attract more FDI which are acknowledged to have potential benefits that can accrue to the country. FDI is important for economic growth as it provides the much needed capital for investment, increases competition within the country and aids local firms to become more productive by adopting more efficient technology or by investing in human or physical capital. FDI also contributes to growth in a substantive manner because it is more stable than other forms of capital flows.

Conclusion And Policy Implications

The driving objective of this study was to investigate the empirical relationship between Foreign Direct Investment and economic growth in Kenya. The study also set out to empirically investigate the factors that drive FDI flows into Kenya, having established that Kenya's FDI inflow record over the recent years has not been impressive despite her being among the most favoured FDI destinations in the 1970s in Eastern Africa. The realisation that Kenya is now among the countries with very low levels of FDI motivated the study. By establishing empirically which factors drive both growth and FDI inflows to Kenya, it is possible to design policies that can attract the flows into Kenya.

The study has shown that human capital, government expenditure and openness of the economy are vital for the growth of the economy and therefore policies that can enhance these factors would be needed. Furthermore, the drivers of Foreign Direct investment have been shown to be the real GDP growth, low levels of indebtedness and improved infrastructural facilities. It is clear that the role of government would be crucial in encouraging FDI inflow to Kenya. It can also be argued that most FDI to Kenya is the market-seeking type and this requires a rapidly growing real GDP. The formation of regional blocks, and political stability would also be crucial. It can be concluded that the main FDI determinants in Kenya are market size (rgdp), political stability (d2007) and openness of the economy as well as infrastructure. The major impediments to FDI inflow would be political instability, institutional factors as well as crime and insecurity. There is little doubt that the

cost of doing business, bureaucratic red-tape, high cost of electricity and other utilities and poor investment code as well as endemic corruption are some of the factors that help explain the low FDI inflows into Kenya in the recent decades.

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