Policy Brief

The KENYA INSTITUTE for PUBLIC POLICY RESEARCH and ANALYSIS

No. 15/2006

Improving public policy making for economic growth and poverty reduction

Attracting Foreign Direct Investment into Kenya

Kenya has witnessed a decline in net flows of foreign direct investment (FDI) in the last two decades. A significant decline occured in the 1990s when the economy was going through various policy and institutional changes, coupled with un-sustained improvement in macroeconomic environment. While the early 2000s indicate a rise in inflows, this is coupled with huge outflows, meaning that the economy is losing in its ability to sustain FDI. The country shared 87% of FDI in East Africa in the 1980s. This declined to 21% in 2001 and 5.3% in 2002. Kenyan firms are increasingly re-locating to Uganda and Tanzania, implying that Kenya is losing its competitiveness to the neighbouring countries.

Kenya generally attracts FDI firms aimed at supplying the domestic market at a close range (market-seeking FDI). The few cost-saving FDI are generally located in export processing zones. Market-seeking FDI is determined by the size and growth of the host market while the cost-saving FDI is determined by relative costs of production. Therefore, when the costs of exporting to the domestic market are low, the market-seeking FDIs do not necessary have to locate in the domestic market. When the cost of labour and raw materials goes up, an economy will not sustain the cost-saving FDI.

Factors influencing the flow of FDI

Various factors influence the flow of FDI. These factors reduce the investors' confidence by creating uncertainty on investment returns.

Political risk factors

The international rating for political risk for Kenya indicates that for the last two decades, Kenya has generally been rated as either high risk or moderate risk economy. While the rating moved from high-risk to moderate-risk in early 2000s, the rating is getting back to high-risk levels. This is attributed to, among other things, the un-sustained improvements in corruption, law and order and government stability.

A politically risky environment reduces investment growth by penalizing the investment return. Investors take a precautionary behavior in avoidance of risk by either postponing the investment decisions or by changing their location. When law and order is observed, corruption reduced and government stability maintained, FDI net flows increase. Further, unfavourable macroeconomic environment characterized by low economic growth and instability denies firms' ability to exploit their growth potential and makes them face high costs. This may explain why Kenya is was losing to neighbouring countries as they were experiencing high GDP growth rates when the Kenya economy was slackening.

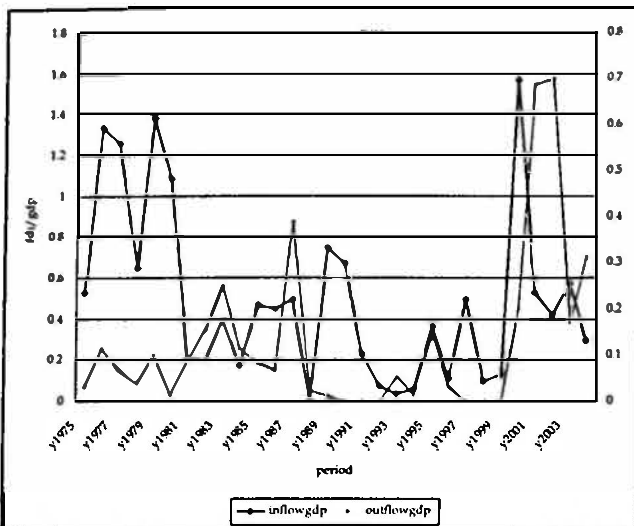
The most common form of corruption met directly by business is financial corruption, where investors make special payments and bribes in order to be provided with licenses, tax assessments, installation of utilities, and security through police protection and justice system. This makes it difficult to conduct business effectively, and in some cases forces investors to withdrawal or withhold business investment decisions. One of the reasons why Kenya faced a freeze on aid flow in 1997 was because of government failure to show commitment in fighting such corruption. This had implications on the confidence of foreign investors and the ability of the government to continue providing economic services, given that most of the development funding is donor dependent.

The Economic Recovery Strategy emphasizes the role of good governance in attracting investment and in determining the effectiveness of government institutions and revenue generation capacity. In response, the government established a Ministry of Justice and Constitutional Affairs and a new department, under the President's Office, in charge of Governance and Ethics. The Kenya Anti-Corruption Commission was also created, through the Anti-Corruption and Economic Crimes Act, in May 2003 to investigate corruption and economic crimes. Also, the passing of the Public Officers Ethics Act provided for a code of conduct for all public officers. The judicial Code of Conduct and Ethics was also approved and published by the Judicial Service Commission in May 2003, which set up the door for an inquiry into corruption in the judiciary. Despite these efforts, Kenya's international rating has deteriorated, losing 2.5 points since 2003. Further, in a recent survey of manufacturing firms, corruption was indicated as a major factor constraining business.

Insecurity and a weak legal system hinder firms from exploiting their full potential. Insecurity affects the production and distribution of goods and services and therefore the performance of the firm. In 2005, the government initiated police reforms aimed at reducing the level of crime in Kenya. However, the international rating of

This policy brief is based on KIPPRA Discussion Paper No. 48 of 2005 on Institutional Factors and Foreign Direct Investment Flows: Implications for Kenya. The study analyses various factors that influence foreign direct investment, using and empirical analysis that brings together traditional and non-traditional factors.

Flows in FDI as aratio to GDP



law and order indicates that the economy is yet to reap the benefits of the reforms as the condition is worsening.

Cost of doing business

Business investment can be constrained by legal and administrative constraints such as entry procedures, registration issues, commercial legislation, insolvency regime, commercial disputes resolution, and licensing procedures. In the Economic Recovery Strategy, the government commits itself to address legal and regulatory factors that make its costly to do business. A law reform commission was set up to review the legal and regulatory framework within which businesses operate. In the 2005/06 and 2006/07 fiscal budgets, a number of licenses were harmonized through the guillotine method. This saw the licensing procedures drop to 11 in from XX in XX (Table 1). However, little has been achieved in the time it takes to start a business and in the enforcement of contracts and duration to close a business. Entry and exit procedures are still cumbersome and this reduces the level of business investment because of the uncertainty. It also means that investors are denied access to credit, for example, when contract enforcement is delayed. Delays in deciding cases also mean that business operations are halted and in some cases businesses tend to look for alternative ways of resolving disputes.

Macroeconomic issues

The international rating of economic risk indicates that Kenya's economic situation is generally moderately risky. With the increased economic growth in the 2004 and 2005, the market has improved its rating. GDP growth is a pull factor for FDI given that FDI is attracted not only by the conditions for their entry but also prospects for growth for such economies, as this defines the scope of the market. GDP growth measures the potential market size and investment opportunities. Growth-oriented firms are driven by their ability to capture a wider market share and grow their operations. At the moment, the economy is growing at an average rate of 5%. Sustaining this growth is crucial in attracting more investment.

In an effort to promote investment and exports, various initiatives were introduced, including the establishment of Export Processing Zones in 1990. The Zones carry out various activities including manufacturing, commercial and export-oriented services. They enjoy considerable incentives such as ten-year tax holiday followed by a 25% tax rate for ten years, exemption from import duties, value added tax and stamp duty and no restriction on management or technical agreements. Special incentives are given to foreign companies that invest in lesser-developed areas. There are no restrictions on foreign investment, or on foreign ownership, and repatriation of profits is unrestricted. The Zones have attracted foreign investment into the garment industry to take advantage of the AGOA initiative. This has seen diversification in origin of FDI with a significant entry of FDI from other developing countries.

In addition, import controls have been removed and capital controls relaxed. Low tariffs enable importation of inputs essential for production, which should attract the low-cost FDI. An open economy with no sustained economic growth will not see location of FDI in the domestic economy. Instead, FDI will locate outside and serve the domestic economy, especially if openness means reducing the transaction costs. For the market seeking FDI, openness may mean low costs of exporting, and therefore the ability to supply the domestic market from any other location.

At the moment, the level of openness of Kenya economy measured by the ratio of export plus imports to GDP is 48%, meaning that the economy has achieved a substantial level of openness with the trade liberalization process. Note that some of the FDI firms were set up during the import substitution strategy and in the policy control regime. It was very costly to produce outside and supply the local market due to the high transaction costs. With trade liberalization, most of the transaction costs have been reduced such that firms have a choice of producing outside and supplying the domestic market.

Infrastructure development

Infrastructure facilitates access to markets and the production process. Efforts towards improvement of infrastructure have included liberalization of telecommunications and energy sector, expansion of road network, improvement in public transport and establishment of water boards to ensure efficient supply. However, a survey of manufacturing firms still rates infrastructure as a major barrier to growing investment. For example, power is a problem in terms of outages, high losses in transmission and distribution. About 64% of firms reported damage to equipment due to power outages or fluctuations. To cope with the outages, 70% of the firms acquired generators, which further add to their cost of doing business. Road and rail services are of very poor quality and some firms even spend their resources in improving the quality of the roads in the surrounding.

The government has initiated reforms in the energy sector to increase power generation and service quality through

Table 1: Costs of entry and exit

	2003	2004	2005
Starting a business			
Number of procedures	11	12	13
Numberof days	61	47	5.4
Cost as % of income per capita	54.0	53.4	48.2
Dealing with licenses			
Number of procedures	-	-	11
Number of days	-	-	170
Cost as % of income per capita	-	-	40
Enforcing contracts			
Number of procedures	25	25	25
Number of days	255	360	360
Cost as % of debt	49.5	41.3	41.3
Closing a business			
Number of years	4.6	4.5	5
Cost as % of estate	18.0	18.0	22
Recovery rate, cents on the dollar	-	14.7	15

Source: Doing Business, various issues

separation of generation, transmission and distribution of power. Recently, the government sold some of its stake in KenGen in an effort to improve the management and fund the necessary investment. Other on-going reforms include the streamlining of the regulatory framework in the energy sector.

Investment regulatory system

In an effort to promote foreign investment, the government enacted an Investment Code, which is defined in the Investment Promotion Act 2004, setting out the investment framework for foreign investment. The Code was reviewed to address some aspects thought to create a barrier for the entry of foreign investors, such as setting of minimum capital requirement. While the investment code generally addresses issues of FDI, an economy is unlikely to sustaine FDI inflows if it not able to steer domestic investment.

In order to facilitate foreign investment, the government established the National Investment Council (NIC) as an advisory and monitoring body, and the Kenya Investment Authority (KIA) to provide professional assistance, facilitation, information and advice to investors. The Authority acts as an investment agent for the government with the aim of providing a one stop shop for foreign investors. However, it operates under a ministry and this constraints its ability to discharge its services effectively as an independent body. Furthermore, it has no mechanism to follow up with the investors to ensure that what it promised when providing the licenses is actually provided. As a result, it is very difficult for it to capture the issue on the ground affecting investors.

Origin of FDI firms

Most of the FDI firms in Kenya have their origin in the developed countries, and it is not until recently that the economy started experiencing an inflow of FDI from other developing countries. For example, the AGOA initiative has seen the entry of FDI from Sri Lanka and India. Further, the market is experiencing Chinese FDI in the hotel industry. This situation implies that the relationship between Kenya and development partners matters a lot in attracting foreign investors. Any indication of strained relationship, for example, failure to meet the aid conditionality would mean losing even the potential foreign investors.

Policy Recommendations

Strengthen the institutional structures to reduce the political risk factor

The government must sustain its war against corruption to reduce the transaction costs and enhance investor confidence. The fight against corruption calls for an understanding of its implications on economic development, and political will. It also requires restructuring and frequent auditing of the institutions that continue to rank high in the corruption index. Further, given that bribes are in most cases paid because of information asymmetry on the procedural requirements, it should be made mandatory that the list of services, processes, documentations required and payments for the same are made public in the public offices. With corruption becoming conditionality for external funding, and the heavy government reliance on such funds for development expenditure, failure to tackle it will have huge repercussions on provision of infrastructure services.

In ensuring 'popular' observance of law and order, the government must sustain the on-going reforms in the police force with adequate budgetary support. There must also be political will to fight crime. A major internal factor that the police force must deal with is the corruption in their system. The police force has continued to rank among the institutions with the highest level of corruption in Kenya. This curtails the ability of the institution to perform its major role of enforcing the rule of law.

In strengthening and ensuring impartiality of the legal system, the government must sustain the on-going legal and judicial reforms. While commercial courts were founded in 1998 to bring about specialization and efficiency in handling commercial cases, the courts are overwhelmed with growing backlogs. Court reforms should include simplifying and streamlining court procedures for commercial cases. It also requires adequate personnel, including appointing additional judges and magistrates specializing in commercial disputes settlement. Further, commercial courts would benefit from a strong credit bureau, as it would facilitate access to credit information and enhance debt recovery.

Investor confidence is also ruined by perceived inability of the government to pursue its policies. The government can enhance its stability by maintaining government unity and responding its people's needs.

Reduce the cost of doing business by relaxing entry and exit requirements

The on-going licensing reforms aim to reduce the number of licenses required to do business. While government support

in this is crucial, this should not be done at the cost of reducing standards. It means, therefore, that the exercise must be accompanied by tight enforcement of standards.

To reduce the time taken in insolvency requires an overhaul of the insolvency regime. The government has made attempts to deal with this issue through the Companies (winding up) Amendment Bill. However, it is important that measures for asset recovery are enhanced and bankruptcy procedures streamlined for individual insolvents.

Maintaining a favourable macroeconomic condition

Macroeconomic stability is significant in defining investment returns. At the moment, the economy is experiencing a two-digit inflation, which is far above the target level of 5%. While this target keeps the economy in a competitive basket, considering its trading partners, failure to sustain it means that the economy will not be competitive in the external market. Therefore, for the market-seeking FDI, the alternative would be to operate from outside and supply the market. High and unpredictable inflation cripples business planning. Therefore, the monetary authority must sustain its checks on liquidity growth in the economy.

Sustaining the growth momentum requires growth in investment. It is therefore important to promote domestic investment to enhance the capacity of the domestic economy. Investment opportunities must be made known to potential investors through effective promotion, which includes marketing a country and coordinating the supply of a country's immobile assets with the specific needs of targeted investors.

While debt in itself does not constrain FDI flows, debt burden is not conducive to FDI inflows. At the moment the ratio of total debt to GDP is 30% while the interest payment ratio is 6.9%, which is far above the current GDP growth rate of 5%. This gives a signal that the current debt burden is high and not sustainable, creating uncertainty on fiscal position. Therefore, while the country requires external resources to boost public investment, it is important that the flows are efficiently utilized to promote investment and economic growth. It is also important that the government is able to maintain a sustainable debt.

Tax incentives have been used to attract foreign investors. The idea is to reduce the cost element faced by the investors. Some of the costs emanate from failure to provide the necessary infrastructure services. The government should therefore provide adequate infrastructure services to reduce the effective tax.

While openness of the economy enables the economy to tap a wider market, it also faces location competition. For it to be an attractive location for FDI, it must sustain its competitiveness against the neighbouring countries. An economy that does not accompany openness with reduced trade transaction costs will see market-seeking FDIs relocate. The government must support the efforts towards regional integration, especially in harmonization of regulatory and policy framework across member countries. At the same time, it must sustain a favourable macroeconomic environment including competitive real exchange rate and high economic growth and ensure adequate supply of infrastructure.

Infrastructure development

Private-public partnership in provision of adequate infrastructure is recommended as a method of relaxing the government constraint in supplying such services. For this to be accomplished, it is important to develop a public-private partnership policy framework to guide the process.

A major issue raised in provision of infrastructure is the time it takes in the procurement process. It is hoped that reforms in the procurement system will lead to faster procurement.

Maintenance as an issue of concern in road infrastructure can be dealt with by ensuring there is adequate funding for the maintenance costs. There is also need to tighten the system of monitoring the roads conditions so that repairs are done in good time.

There are various reforms in the energy sector aimed at achieving efficient supply of electricity. Efforts should be made to sustain such reforms.

Strengthen the investment authority

For the Kenya Investment Authority to discharge its activities effectively and efficiently, it requires a level of independence in decision-making.

Reaching out to diversify the origin of FDI

The government must be strategic in attracting FDI. While diversifying to developing countries is crucial, it is also important that it provides incentives in specific areas that will have more benefits to the economy. Setting minimum capital requirement is important in avoiding flooding of small foreign enterprises.

About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

KIPPRA acknowledges support from the Government of Kenya, the European Union (EU), the African Capacity Building Foundation (ACBF), and all the other development partners who have supported the Institute's activities.

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