

## The determinants and impact of foreign direct investment (FDI) in Kenya and Tanzania: an OECD and non-OECD perspective 1996-2016

Item Type	Thesis or dissertation
Authors	Odunga, Peter Shoko
Publisher	University of Wolverhampton
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# **THE DETERMINANTS AND IMPACT OF FOREIGN DIRECT INVESTMENT (FDI) IN KENYA AND TANZANIA: AN OECD AND NON-OECD PERSPECTIVE 1996 - 2016.**

**Peter Shoko Odunga**

A thesis submitted in partial fulfilment of the requirements  
of the University of Wolverhampton UK  
for the degree of Doctor of Philosophy

March 2020

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## **Abstract**

This thesis investigates the determinants of FDI and FDI's subsequent effect on the growth and export between and within Kenya and Tanzania, using panel data analysis (pooled and fixed effect models) comprising of 22 home countries for Kenya and 23 for Tanzania for the period 1996-2016. The investigation of both the determinants and impacts of FDI is considered on the basis of the heterogeneity of investing MNEs in terms of economic development levels by grouping the home countries into OECD and non-OECD countries between and within Kenya and Tanzania. The study employed quantitative methods and the findings of this thesis reveal for the determinants that imports, infrastructure development and institutional factors are important for both countries. However, mineral resources and cultural distance, financial crisis of 2008 are important for Kenyan full sample while human capital, labour force, agglomeration and exchange rates are important for Tanzanian full sample of FDI home countries. Exchange rates and infrastructure development determine FDI flows from OECD into both countries, whilst cultural distance and quality of institutions, agglomeration and financial crisis of 2008 are determinants of FDI from OECD countries into Kenya, imports and human capital and natural resources, agglomeration and financial crisis of 2008 determine FDI from OECD countries into Tanzania. Meanwhile, infrastructure attracts FDI from non-OECD countries into the two countries. However, non-OECD FDI in Kenya is determined by market size, exchange rates and quality of institutions as human capital, exchange rates, imports and inflation rates determine FDI flows from non-OECD countries into Tanzania. The findings obtained also show that the impact of FDI is positive and significantly correlates with economic growth in Kenya within all the three contexts of full sample, OECD and non-OECD home countries. However, it is only FDI from non-OECD countries that is positive and significantly correlates with economic growth in Tanzania. The results on economic impact further show that the magnitude of the effect of FDI is higher when the investments originate from non-OECD countries compared to OECD countries into both Kenya and Tanzania. The empirical findings further confirmed that while FDI from the full sample, OECD and non-OECD countries contribute positively and significantly to export performance in Kenya, only FDI from OECD countries make a positive and significant contribution to the export performance in Tanzania. There is a difference in the intensity of the impact of FDI on export performance in Kenya and Tanzania, with non-OECD countries having greater effect on export performance in both Kenya and Tanzania compared with OECD countries. The research contributes to the body of knowledge of FDI/IB literature by providing empirical evidence on the specific determinants

of inward FDI and its impact on Kenya's and Tanzania's economic growth and export performance by considering the heterogeneity between investing MNEs. Another contribution is also, the comparison between two countries and examination of heterogeneity of inbound FDI as well as policies that can be used by governments of Kenya and Tanzania in managing FDI inflows.

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## **Acknowledgements**

The PhD study is a long journey and its accomplishment is a major achievement. Certainly, a task of this magnitude and gravity can never be performed solely by an individual without contribution from other interested parties. Firstly, praises and thanks to the God, the Almighty, for His blessings and favours throughout my research work to complete PhD study successfully.

I am extremely grateful to my dear parents, Emmah and Gaetano Odunga for their love, prayers, caring and sacrifices in educating and preparing me for my future.

I would like to express my deep and sincere gratitude to the Commonwealth Scholarship Commission (UK) for awarding me a full-funded PhD scholarship at the University of Wolverhampton (UK).

Any PhD cannot be done without a supervisory team. In that regard, I would like to extend my gratitude to my Supervisory Team i.e. Dr. Mark Cook and Prof. Lucy Zheng for invaluable guidance throughout this research. Without their support, dedication, direction and mentoring, this thesis would have not been completed properly and punctually.

My sincere thanks also go to all the staff of the University of Wolverhampton Business School, the Doctoral College and the STAR office. Most specifically, I am grateful to Prof. Yong Wang, Dr. Ben Haligan, Sheila Gill, David Law, Sabrina Mall, Steven Greenfield and Andy Groves for their kind support in one form or the other. My further special thanks go to Dr. Victor Atasie for the support and sharing interest in my PhD study. I also thank former and present colleagues Keziah, Michael, Remi, Osagie, Thomas, Adike and Ari.

I am thankful to my employer, Moi University Kenya for granting me a study leave and support during the research journey.

I am also thankful to my lovely wife Doreen Raeleen Shoko and my sons Meroni, Matiya and Mannie for their love, understanding, prayers and continuing support to complete this research work. I also express thanks to my eldest brother Prof. Pius Odunga for leading by example in terms of academic excellence and the encouragement and support he offered me. I thank my other brothers and sisters Paul, Patrick, Pauline, Robert (Dr.), Fr. Godfrey, Fr. Norbert, Margaret and Sebastian for their prayers and support during the PhD journey.

Finally, special thanks go to Thomas Masese and the Kenya Investment Authority for enabling me access data on Tanzania and Kenya respectively.

## List of Conference Papers

The following conference papers have been presented during the course of this research.

Odunga, P.S., Zheng, L. Cook, M. (2020). The Impact of Foreign Direct Investment (FDI) on Economic Growth in Kenya and Tanzania – An OECD & Non-OECD Perspective. *A paper presented at the AIB conference on Prospects and Perils of Doing Business in Africa*. United States International University Africa – Nairobi, Kenya 6 - 9 January. Michigan: Academy of International Business.

Odunga, P.S., Zheng, L., Cook, M. (2019). The Determinants of Foreign Direct Investment in Kenya and Tanzania – An OECD & Non-OECD Perspective. *A paper presented at the AIB conference on Sustainable Development of Africa: Trade, Not Aid*. Kwameh Nkrumah University – Accra, Ghana 4 -7 August. Michigan: Academy of International Business.

Odunga, P.S., Zheng, L., Cook, M. (2018). The Nexus between Foreign Direct Investments and Economic Growth in Kenya and Tanzania. *A poster exhibition and presentation at The Commonwealth Scholarship Commission's Maximising Your Impact – Training for Development Workshop*. Cumberland Lodge, 16 -18 March. Windsor: The Commonwealth Scholarship Commission.

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## **List of Acronyms and Abbreviations**

AfDB – African Development Bank

AGOA – The African Growth and Opportunities Act

ASEAN – Association of South East Asian Nations

BRICS – Brazil, Russia, India, China and South Africa

COMESA – Common Market for Eastern and Southern Africa

DI - Domestic Investments

EAC – East African Community

FDI – Foreign Direct Investment

FSA – Firm’s Specific Advantages

GDP – Gross Domestic Product

IB – International Business

IDP – Investment Development Path

KenInvest – Kenya Investment Authority

LDCs – Less Developed Countries

LLL – Linkage, Leverage and Learning

MNEs – Multinational Enterprises

MRA – Multiple Regression Analysis

NEPAD – The New Partnership for Africa’s Development

NIC – Newly Industrialised Countries

OECD – The Organisation for Economic Co-operation and Development

OLI – Ownership, Location and Internalisation

PLC – Product Life Cycle

SSA – Sub-Saharan Africa

TI – Transparency International

TIC – Tanzania Investment Council

UK – United Kingdom

UN – United Nations

UNCTAD – The United Nations Conference on Trade and Development

US – United States

WDI – World Development Indicators

WGI – World Governors Indicators

## **CHAPTER 1: INTRODUCTION**

### **1.1.0. Background of The Study**

#### **1.1.1. What The Thesis is About**

Investments in Sub-Saharan African countries such as Kenya and Tanzania are relatively lower than in the most countries in other parts of the world. As a result, organisations such as NEPAD (2012), OECD (2012) and World Bank (2014) have identified FDI flows as a form of investment needed to boost growth in non-OECD countries such as Kenya and Tanzania. This is because, according to UNCTAD (2018), FDI remains the largest external source of finance for non-OECD economies. Indeed, FDI made up to 39% of total incoming finance in non-OECD countries as a group in 2017.

The FDI trend patterns indicate that the global FDI flows were \$1.3 Trillion in 2018, a fall by 13% from 2017 which had \$ 1.43 Trillion and a decline by 23% from \$1.87 Trillion in 2016 (UNCTAD, 2019). Although 88% of the foreign assets and 87% of the top MNEs were located in the triad (European Union, Japan and the USA) (UNCTAD, 2007), FDI flows continued to fall in OECD countries, while those to non-OECD economies remained stable in both 2017 and 2018. As such, non-OECD economies accounted for a growing share of global FDI inflows in the three years, absorbing 54% of the total, compared to 47% in 2017 and 36% in 2016. In terms of regions, flows to developing Asia, were up by 4% from its stable growth at \$ 476 Billion in 2017. The region maintained its position as the largest recipient of FDI in the world. FDI flows to Africa rose by 11% to \$46 Billion despite declines in many major recipient countries. This was a recovery after sliding in 2017 to \$42 Billion, down by 21% from 2016 (UNCTAD, 2019).

Tanzania is one of the most preferred destinations of FDI in Africa (it counts amongst the 10 biggest recipients of FDI in Africa). FDI flows into Tanzania reached \$1.1.0 Billion in 2018 and showed a significant increase compared to previous year (\$ 938 Million). The FDI stock in 2018 was estimated at \$ 20.7 Billion and represented 35% of the GDP (TIA, 2019 and UNCTAD, 2019). Comparatively, Kenya remains relatively weak in terms of FDI stock, considering the size of its economy and its level of development. Nevertheless, Kenya too is one of the largest recipients of FDI in Africa, with FDI increasing by 27% to \$ 1.6 Billion in 2018 from \$1.2 Billion in 2017. The total stock of FDI stood at \$14.4 Billion in 2018 (KenInvest, 2019 and UNCTAD, 2019).

Most of the FDI into Tanzania was attracted by the mining sector, the oil and gas industry as well as the primary agricultural products sector (Coffee, Cashew nuts and Tobacco). The Country's primary investors are China, India, the UK and the USA (AfDB, 2019 and TIA, 2019). Meanwhile, in recent years, ICT sector has attracted the most FDI in Kenya. Other sectors targeted by FDI are banking, tourism, infrastructure and extractive industries. The main investors in Kenya are the UK, the Netherlands, China and Belgium (AfDB, 2019 and KenInvest, 2019).

Investments in Tanzania are drawn to the country's commitment to implement sound economic policies, its efficient privatisation program, access to the sea and abundant natural resources. However, low level of infrastructure, environmental concerns, lack of transparency and poor compliance with legislation are barriers to investments. Meanwhile, investments in Kenya were attracted by the development of public-private partnerships as part of the Vision 2030 strategy which should also have a positive influence on FDI inflows. The country acts as East African regional economic hub. It benefits from strategic geographic location with sea access, growing entrepreneurial middle class, a diversified agricultural sector and recently discovered hydrocarbons resource. Nevertheless, the country's barriers to investment persist, notably the country's poor-quality infrastructure, skills shortage, instability related to terrorism, political and social divisions, ineffective rule of law and corruption (AfDB, 2020 and World Bank, 2020).

Although Kenya had a relatively better growth rates of FDI inflows than Tanzania in both 2017 and 2018, statistics for preceding years of 1996 to 2016 show that Tanzania has been more effective in attracting FDI than Kenya. This is because Kenya's total cumulative FDI inflows stood at \$2.31 Billion against Tanzania's \$19 Billion between 1996 and 2016 (UNCTAD, 2018).

These trend patterns display differences that need to be investigated in terms of MNEs' preference for undertaking business in one country rather than another. This challenge and the growth in the magnitude and significance of FDI flows has not been matched with an increase in understanding the actual motivation behind these flows (Dunning, 1998; Jensen, 2008, Zheng, 2009 and Fallon & Cook, 2014). Consequently, identifying the determinants of FDI is vital in explaining why foreign investors preferred one country over the other (Dunning, 1998; Dupas & Robinson, 2010 and Okafor, Piesse & Webster, 2017). Therefore, the study aims to investigate determinants of FDI from disaggregated groups of OECD and non-OECD home countries to determine whether FDI flows into Kenya and Tanzania are determined by the same

or different factors. However, not only is it important for these countries to get FDI, it is also important to know the impact of FDI in the host countries. This research considered the impact of FDI on economic growth and the impact of FDI on export performance. The impact of FDI might also be different in the two countries and this thesis further explores the impact of FDI from disaggregated groups of OECD and non-OECD home countries to see whether investing firms from OECD and non-OECD countries have different impacts on economic growth and export performance both between and within the two countries. Therefore, this study intends to complement the existing literature by investigating the determinants of inward FDI, its impact on economic growth and export performance in Kenya and Tanzania from the OECD and non-OECD perspectives.

### **1.1.2. The Significance of The Thesis**

FDI has become a prime concern for policy makers (Adams, 2009 and Zheng, 2009 & 2013) as it has developed into an important element of globalisation overtaking the growth in trade in recent years (Almsafir, Nor & Al-Shibami, 2011 and Okafor, 2015). FDI also provides an important role in provision of capital for investment, greater managerial skills and technology transfer while creating employment, increasing competition, export performance and ultimately economic growth for both OECD and Non-OECD countries (Ajayi, 2006 and Assuncao et. al., 2011). It plays critical roles in bridging the shortfall caused by lack of development, dearth of foreign exchange, low level of investment, poor tax revenue and foreign aid gaps in non-OECD economies (Adams, 2009; Anyanwu, 2012 and Economou, Hassapis, Philippas & Tsionas, 2017) such as Kenya and Tanzania. Further, it can play a key role particularly in Africa's development such as supplementing domestic savings, generating employment and growth, helping integration into the global economy and the transfer of modern technologies, enhancing efficiency and raising skills of manpower and creation of backward and forward linkages with the rest of the economy (Dupasquier & Osakwe, 2003 and Hailu, 2010). Concomitantly, MNEs see emerging and developing markets as high growth markets.

However, some studies (Kentor & Boswell, 2003; Mweha & Ngugi, 2006 and El-Wassal, 2012) have found no significant importance of FDI on host countries, pointing out the potential harm the FDI can be if it led to exploitation of these vulnerable states with several undesired effects. They have argued that FDI encouraged a reduction in domestic savings and investment rates by stifling competition through exclusive production agreements with the host government.

FDI dominance may also adversely influence the development of local entrepreneurship. The incentives granted to foreign firms such as liberal tax, excessive investment allowances, disguised public subsidies and tariff protection, may make FDI's contribution to public revenue through corporate tax to be less than ideal.

Nonetheless, the general belief is that FDI provides positive net benefits to the host country. FDI has been the least volatile source of foreign investment for developing countries (Lipsey, 1999) and the realisation that FDI is a more reliable source of capital than portfolio investment has motivated governments to provide incentives and adopt FDI-stimulating policies (Moosa, 2002). The increasing amount of research in FDI has been encouraged by the growing interest in the field of economic development, particularly in developing countries.

Therefore, understanding the main determinants of FDI flows and its impact on economic growth and export performance in the host countries enable policy makers to understand the scale and direction of FDI movements and why some countries attract more FDI and benefit from FDI more than others. As a result, there have been many theories developed such as neoclassical models and trade theory (MacDougall, 1960 and Kemp, 1964) as well as FDI theories (Kindleberger, 1969; Hymer, 1976; Knickerbocker, 1973; Vernon, 1966; Buckley & Casson, 1976 and Dunning, 1977, 1979, 1988) in response to the increased interest in FDI (Freckleton, Wright & Craigwell, 2012). These theories attempted to explain why MNEs undertook FDI, their preference of one country over the other and the mode of entry (Moosa, 2002 and Okafor, 2015). To compliment the theories, there are established scholarly debates in international business research that have noted that MNEs are attracted by different determinants (Dunning, 2004; Aizenman & Noy, 2006; Teece, 2006; Cleeve, 2008 and Hailu, 2010) and by the same token, not all FDI has positive impact on the host economy (Blomstrom & Kokko, 1994 & 2003; Ruane & Sunderland, 2005; Herzer & Klasen, 2008; Sun, 2009 and Zhang, 2015).

Drawing on findings in several studies that link determinants of FDI and its impact on the host economy (Driffield and Love, 2005; Zhang, 2005 and Prasanna, 2010), it is argued that traditional FDI prompted by the desire to exploit home-based assets (usually from OECD countries), tends to generate technology and knowledge spillovers from the foreign affiliates to domestic enterprises (Adams, 2009; Gui-Diby, 2014 and Iamsiraroj & Uluhasoglu, 2015), whereas MNEs attracted to augment home-based assets (usually from non-OECD countries), are unlikely to generate significant productivity growth or technological spillovers (Meyer,

2015 and Zhang, 2015). MNEs from OECD was favoured due to their access to capital, managerial and technological knowledge that could be embedded in foreign products produced by their foreign affiliates abroad as opposed to MNEs from non-OECD countries (with lesser managerial and technological capabilities transferred to host location) which might spur little or no spillover effect on the host economy (Lall & Narual, 2004; Hezer & Klasen, 2008 and Kotey & Abor, 2019). The consensus is that positive externalities from foreign affiliates that are knowledge-creating would facilitate positive spillovers that could affect competition, productivity, efficiency and export performance (Ascani et. al., 2018 and Chanegriha et. al., 2020).

The conventional determinants of FDI can be categorised into economic factors such as market size, market growth, human capital, labour costs, degree of openness to trade, exchange rates, inflation, availability of natural resources, quality of infrastructure and agglomeration (Anyanwu, 2012, Falk, 2014, Anyanwu & Yameogo, 2015 and Shan et. al., 2018); social-cultural factors such as geographical distance, cultural distance, colonial ties and linguistic ties (Bevan & Estrin, 2004, Zheng, 2009, Makino & Tsang, 2011 and Demir & Im, 2019); and political and institutional factors such as political stability, quality of institutions and control of corruption (Bénassy-Quéré, 2007, Faeth, 2009, Zheng, 2009, Dupas & Robinson, 2010). The significance of each of these factors varied across regions, countries, time and methodology employed (Irandaoust, 2010 and Suleiman et. al., 2015). There is also absence of generally accepted theories for FDI growth nexus (Borensztein et. al., 1998, Lall & Narula, 2004, Zheng et. al., 2006 and Kotey & Abor, 2019) as well as FDI export nexus (Zheng et. al., 2004, Jenkins & Edwrds, 2015 and Fetai & Morina, 2019). Despite the massive volumes of scholarly studies in both OECD and non-OECD economies on the determinants and impacts of FDI, bulk of existing empirical research has taken a more aggregate approach (i.e. using data of multiple countries aggregated together). As such and in general, there is a dearth of knowledge on country-specific assessment of determinants and impact of FDI flows to countries in Africa and in particular to Kenya and Tanzania. Authors have also concentrated their investigations on sub-regions of Africa such as Sub-Saharan Africa (for example, Morrisset, 2000; Asiedu, 2006; Cleeve, 2008; Adams, 2009; Anyanwu, 2012 and Okafor, 2015). Inter-country comparisons in Africa such as Kenya and Tanzania are far less common. This could be because they are relatively small economies and therefore considered relatively unimportant. Indeed, findings from the few studies conducted within the Africa diaspora have

not proved conclusive or have generally been based on data of multiple countries aggregated together without an effort to compare one country with another.

A deeper interest in the two economies was generated by the fact that Kenya and Tanzania are two neighbouring countries in Africa, that attained independence at the same time and yet they seem to receive different amounts of FDI inflows with Kenya lagging behind Tanzania by a huge margin in both absolute FDI amounts and FDI as a proportion of GDP as shown in the previous section. Accordingly, and given the level of significance accorded to inbound FDI on the two countries' economic growth and export performance, this study aims to establish why there are such substantial variations in the volume of FDI flows into the two countries bearing similar social, economic, political and geographical conditions which may help policy makers better understand and contrast the determinants and impact of FDI in the two seemingly similar countries. Although few of studies such as Mwega & Ngugi's (2006), Dupas & Robinson's (2010), Kinuthia's (2012), Omanwa's (2013), Kinuthia & Murshed's (2015) and Paudel's (2016) have analysed FDI determinants and impact in Kenya and Tanzania, they did not distinguish the FDI determinants and impact between the home economies. Therefore, as much as the two countries are neighbours and attained independence at the same time, they possess similarities and differences to each other and yet no study has empirically investigated the two economies together and in a comparative setting based on heterogeneity of home countries of investing foreign firms, this study intends to. These differences and considerations raise important questions for both academic and policymakers.

### **1.2.0. Research Objectives**

This thesis thus seeks to contribute to our understanding of determinants of FDI, impact of FDI on economic growth and export performance in Kenya and Tanzania.

Most specifically the objectives of this research are in three main strands;

1. To identify determinants of FDI in Kenya and Tanzania both between and within the two countries from an OECD and non-OECD perspective.
2. To investigate the impact of FDI and factors responsible for the economic growth in Kenya and Tanzania both between and within the two countries from an OECD and non-OECD perspective.

3. To examine the impact of FDI and factors responsible for export performance in Kenya and Tanzania both between and within the two countries from an OECD and non-OECD perspective.

### **1.3.0. How the Works Were Done**

In light of this, this research considers the determinants followed by impact of FDI in Kenya and Tanzania. The FDI determinants and impacts on economic growth and export performance will be considered both between and within Kenya and Tanzania at the full sample, OECD and non-OECD levels. This is necessitated by the fact that little or none of research work has been done on determinants and impact of OECD and non-OECD FDI approach in these countries.

Consequently, the assessment of FDI determinants in this study will focus mainly on Dunning's (1979, 1988 and 1998) OLI Paradigm complemented by other models such as investment motivations and the push and pull and demand and supply factors (Faeth, 2009 and Zheng, 2009). This is because these frameworks identified location factors determining FDI flows, based on investors' motives. This study also employs new growth theories (Zheng et. al., 2006; Adams, 2009; Gui-Diby, 2014 and Okafor, 2015) to explain the impact of FDI on economic growth in Kenya and Tanzania. Also, trade theories (Zhang ,2005; Prasanna (2010) and Iamsiraroj & Ulubasoglu (2015) are used in this study to explain FDI export nexus in the two host countries.

Therefore, the main focus of the next five chapters identifies and investigates FDI determinants while the impact of FDI on economic growth and export performance is considered in chapters six and seven by focusing on similarities and differences of OECD and non-OECD FDI both between and within, Kenya and Tanzania. Models are developed from a review of the existing literature and tested to investigate determinants and impact of FDI in Kenya and Tanzania based on the OECD and non-OECD source country groups. Thus, this study's main aims are: One; to find out why have the two countries, that are neighbours, and attained independence at the same time and seemingly with similar economic, social and political conditions, had different amounts of FDI inflows. Two; to find out whether FDI from the OECD and non-OECD home countries are motivated by the same or different factors in Kenya and Tanzania. Three; to find out whether the impact of FDI from OECD and non-OECD home countries is similar on economic growth in Kenya and Tanzania. Four; to discern any differences in the impact of FDI from OECD and non-OECD economies on export performance of Kenya and Tanzania.

### **1.3.1. Data, Sample and Technique**

In order to validate existing theories of which the study hypotheses are developed to address the study research questions, the research draws its research theoretical and philosophical assumptions from the positivist, quantitative and deductive research approach (Burrell and Morgan, 2016). Deductive research employs quantitative data to test causal relationships to either accept or reject hypotheses (Soiferman, 2020; Jones, 2014 and Creswell & Creswell, 2017). Data was collected from secondary sources including the United Nations Conference for Trade and Development (UNCTAD), the World Bank Development, the World Bank Governance Indicators, National Central Bank Databases, Kenya Investment Authority (KeInvest) and Tanzania Investment Centre (TIC). The dataset used for empirical analysis is at country level covering 22 home countries that have invested in Kenya and 23 home countries investing in Tanzania. The data covers a time period of 21 years, from 1996-2016. Data before 1996 was not used because there were many gaps in the data. As such, the data period was much dependent on data availability. The study datasets were further organised into two groups. The first group is the OECD countries comprising of 12 countries for Kenya and 13 for Tanzania and the second group is non-OECD countries comprising of 10 countries for both Kenya and Tanzania. The split considers heterogeneity of investing MNEs in terms of economic development level by grouping the home countries into OECD and non-OECD countries. The analyses in the three empirical chapters on determinants of FDI, economic growth and export performance were conducted quantitatively using panel data techniques (random and fixed effects) on eviews software.

Panel data or longitudinal data is a dataset which allows for exploration of time series and cross-sectional data. The choice of panel data analysis is that it is associated with the accuracy in estimating parameters. It also allows for a more robust analysis with less potential for endogeneity problems. It is also associated with the accuracy in estimating parameters (Baltagi, 2008).

A statistical test was used to test the assumption of no structural and behavioural difference between sample sizes prior to either pooling or not pooling the data. The dependable variable employed to model the determinants of FDI was the ratio of FDI flows from home to the host country. The independent variables were modelled on the basis of economic, social-cultural and political and institutional factors. The ratio of host to home country's GDP per capita was used as a dependent variable to determine the impact of FDI on economic growth. The

dependent variable used to model export performance was the ratio of host to home country's exports of goods and services.

#### **1.4.0. A Summary of Research Contributions**

The contribution of this research to the literature span not just Kenya and Tanzania but other developing countries as well. The two countries' experience can provide a guideline for other developing countries, hence any knowledge contributed to the literature through this study can be extended to other developing countries. Three major studies are evident in the contribution: first, the determinants of FDI, second the impact of FDI on economic growth and third, the impact of FDI on export performance.

A summary of contributions made include; Firstly, previous studies on FDI in Kenya and Tanzania have not extensively investigated how the different hypotheses under the theories of FDI explain FDI activities in Kenya and Tanzania and other developing countries. Through this study, a greater understanding of the determinants and impact of FDI in the context of the two countries is developed. Secondly, inter-country comparisons in Africa such as Kenya and Tanzania are far less common. Indeed, findings from the few studies conducted within the Africa diaspora have generally been based on data of multiple countries aggregated together without an effort to compare one country with another and within itself. This study has compared determinants and impacts of FDI between and within Kenya and Tanzania. Thirdly, although few of studies have analysed FDI determinants and impacts in Kenya and Tanzania, they did not distinguish the FDI determinants and impacts between the home economies. Through this study, a greater understanding of the determinants and impacts of FDI in the context of the two countries has been developed by considering both home and host countries' characteristics based on OECD and non-OECD economic groups. The analysis is more systematic and holistic compared to the existing studies - for both determinants and impact, that include the impact of inward FDI on both the export and growth of the two economies. Fourthly, very few studies exist on the impact of FDI on economic growth and export performance in Kenya and Tanzania, unlike most studies in this context, this study distinguishes flows originating from OECD countries and other non-OECD countries with the aim of testing the assumption that they might impact differently on the ability of the two recipient countries to absorb the positive spillovers embedded in inward FDI. Understanding the impact of FDI from either OECD or non-OECD economic groups to host economies can lead to efficient targeting of FDI from specific home economies for enhanced economic growth

and export performance in Kenya and Tanzania. In terms of strength of impact of FDI on economic growth and export performance, it does appear that FDI from non-OECD countries has a greater impact than OECD countries and very little work has been done in this area. As a result, this is another contribution to the literature.

### 1.5.0. The Research Outline

The rest of this thesis is organised as follows: Chapter two provides an empirical research context: overview of Kenya and Tanzania. Chapter three reviews theories, models, previous studies and gaps in the existing literature and develops the hypotheses. Chapter four develops the research methodology while the fifth Chapter presents the issues and findings on determinants of FDI in the two countries. Chapter six empirically analyses and presents findings on the impact of FDI on economic growth. Chapter seven considers the impact of FDI on export performance and Chapter eight summarises the key conclusions, the works' contribution to literature and a range of policy implications. This final chapter also outlines weaknesses of the study and also the direction of the future studies. This outline is shown in Table 1.0 below.

**Table 1.0. Summary of The Thesis Outline**

<b>Chapter</b>	<b>Chapter Content</b>	<b>Key Elements</b>
<b>1</b>	<b>Introduction</b>	The object of study, justification of the study, the research objectives and an overview of the thesis.
<b>2</b>	<b>Empirical Research Context</b>	Overview of Kenya and Tanzania
<b>3</b>	<b>Critical Literature Review</b>	A review of theories, models, previous studies and gaps in the existing literature. Hypothesis development.
<b>4</b>	<b>Sources and Methods</b>	Research methodology, methods, overview of the empirical research domain and contexts, and data analysis
<b>5</b>	<b>Issues and Findings (1)</b>	<i>Research Objective 1:</i> To identify determinants of FDI in Kenya and Tanzania both between and within the two countries from an OECD and non-OECD perspective.
<b>6</b>	<b>Issues and Findings (2)</b>	<i>Research Objective 2:</i> To investigate the impact of FDI and factors responsible for the economic growth in Kenya and Tanzania both between and within the two countries from an OECD and non-OECD perspective.

7	<b>Issues and Findings (3)</b>	<i>Research Objective 3:</i> To examine the impact of FDI and factors responsible for export performance in Kenya and Tanzania both between and within the two countries from an OECD and non-OECD perspective.
8	<b>Conclusion</b>	Restatement– Review of main findings– Contribution to management knowledge and practice– Limitations and directions for future research.

## **CHAPTER 2: EMPIRICAL RESEARCH CONTEXT: OVERVIEW OF KENYA AND TANZANIA.**

### **2.1.0. Introduction**

This chapter discusses the patterns of FDI inflows in Kenya and Tanzania as well as the sectoral differences in this FDI between the two countries. It then proceeds to discuss economic growth of Kenya and Tanzania both within and between the two countries. Finally, possible export-led growth in Kenya and Tanzania is discussed.

### **2.2.0. Kenya and Tanzania in Detail**

Kenya and Tanzania are located in the eastern plateau of the African continent and on the South of the Sahara Desert. The two Sub-Saharan African (SSA) countries are both diverse and similar in their historical, political, cultural and environmental contexts. Kenya and Tanzania cover 580,367 and 945,087 square kilometres respectively which are characterised by dry and cool highland climate. The approximate population in 2018 for Kenya was 53 million and 58 million for Tanzania in the same period. Both the two countries had an estimated average growth rate of 2.5% between 1996 and 2016. The two countries have some of the fastest population growth rate in the world.

Historically, Africa was divided amongst the various European powers, after the Berlin conference of 1884-1885. It was then that the British colonised Kenya while Tanzania became a colony of Germany. However, the German rule of Tanzania ended after the 1<sup>st</sup> world war in 1918, when Tanzania (then known as Tanganyika) was taken over by the British. Both Kenya and Tanzania attained their independence from the British in 1963 and 1962 respectively (Tyler and Gopal, 2010). Like most African countries that attained independence in the 1960s, the predictions of their economic advancement were positive and encouraging. However, decades later, the two countries are faced with high poverty rates amid their location in one of the poorest regions in the world (Go et. al., 2007). SSA countries have become synonymous with underdevelopment and low or non-existent economic growth (Garner, 2006 and Okafor, 2015).

Since the two countries are considered some of the poorest compared with other developing countries, the issue of economic growth will remain an essential challenge to their governments and international organisations. Although there have been reforms, most of these economic reforms and social programs in the two countries seem to be ineffective (Okafor, 2015). It has

often been argued in studies such as those by Easterly and Levine (1997) and Ndulu (2006) that for countries like Kenya and Tanzania to sustain growth, they need to embark on reforms but need to improve their investment climate, develop infrastructure and protect property rights.

Investment is an important requirement for growth. However, savings and investments in the two countries are relatively lower than in the most countries in other parts of the world. Studies such as Asiedu's (2002 and 2006) and Okafor's (2015) suggested that, that was a constraint to development in the SSA region. As such, FDI flows as a form of investment needed in Kenya and Tanzania is discussed in the section below.

### **2.3.0. FDI in Kenya and Tanzania**

FDI is an important source of foreign investment and as such has become increasingly important in global economy (Ajayi, 2006) and therefore one of the most reliable sources of capital for economic growth in host countries. However, according to UNCTAD (2018), Kenya only accounted for 0.001% and Tanzania 0.1% of global FDI between 1996 and 2016. In the same period of time, the two countries accounted for 0.4% for Kenya and 4% for Tanzania of total FDI flows into Africa. The tiny share in global FDI by the two countries could be attributed to the factors discussed below.

Until very recently, countries in Africa, particularly Sub-Saharan Africa (SSA) (see Figure 2.1), viewed foreign capital with suspicion. The likelihood of losing political sovereignty was largely the basis of their fear (Okafor, 2015). Other reasons for policy makers' dislike of FDI were an adverse impact on domestic firms due to increased competition and rapid economic degradation that occurred when foreign entrants focused on natural resource sector (Dupasquier and Osakwe, 2003). Many policies were introduced therefore to deter foreign capital. For example, many post-independence countries adopted socialist development strategies by nationalising foreign companies and creating state-owned industrial sectors. Consequently, SSA gained a reputation as an unattractive location for firms that intended to compete in the market place, due to high levels of political and economic risk, the poor quality of labour, the lack of infrastructure, highly inefficient and costly financial systems and the distance from export markets (Pigato, 2000 and Ezeoha & Cattareo, 2011).

In an attempt to change this view, Tanzania introduced a privatization program of its national firms in mid-1990s with the objective of attracting the much-needed foreign capital into the

country. Similarly, though much later, Kenya launched in 2008, vision 2030 through which it hoped to achieve global competitiveness and prosperity at the national level to levels that of Singapore and Malaysia. Both countries which were in fear of inward FDI in the 1960s. This initiative resulted into a renewed commitment to attract FDI to assist in industrialisation process of the country (Kinuthia 2012 and Kinuthia & Murshed,2015).

**1Figure 2.1: The Location of Kenya and Tanzania on the Map of Africa.**



Source: Adopted from Google World Geographical Maps.

### **2.3.1. The Pattern of Kenya’s and Tanzania’s Inward FDI**

Statistics show that Tanzania has been more effective in attracting FDI than Kenya. From 1996 to 2016, Tanzania received cumulative and absolute FDI amounts, eight times higher than that of Kenya during the same period. Furthermore, Table 2.1 shows that in every year Tanzania has consistently exceeded Kenya’s FDI net flows as a percentage of GDP. For instance, FDI flows in 2016 as a percentage of gross domestic product (GDP) were 2.88% in Tanzania compared with 0.55% in Kenya.

**2Table 2.1: FDI Flows into Kenya and Tanzania 1996-2016.**

<u>YEAR</u>	<u>FDI (US\$) 100 MILLION</u>		<u>FDI NET FLOWS (% of GDP)</u>	
	<b>Kenya</b>	<b>Tanzania</b>	<b>Kenya</b>	<b>Tanzania</b>
<b>1996</b>	1.086729	1.50066382	0.90	2.31
<b>1997</b>	0.620968	1.578850639	0.47	2.05
<b>1998</b>	0.265482	1.723062449	0.18	1.84
<b>1999</b>	0.519535	5.167006417	0.40	5.32
<b>2000</b>	1.109046	4.634008588	0.87	4.54
<b>2001</b>	0.053026	5.492703515	0.04	5.29
<b>2002</b>	0.276184	3.95567134	0.21	3.66
<b>2003</b>	0.817382	3.184012987	0.54	2.73
<b>2004</b>	0.460639	4.425395484	0.28	3.45

<b>2005</b>	0.212117	9.355205917	0.11	5.52
<b>2006</b>	0.506747	4.030389914	0.19	2.16
<b>2007</b>	7.290441	5.81511807	2.28	2.70
<b>2008</b>	0.955857	13.8326	0.26	5.05
<b>2009</b>	1.162576	9.5263	0.31	3.33
<b>2010</b>	1.780646	18.132	0.44	5.77
<b>2011</b>	1.398621	12.29361018	3.45	3.62
<b>2012</b>	1.634102	17.99646137	2.73	4.60
<b>2013</b>	1.118824	20.8726131	2.03	4.70
<b>2014</b>	0.820937	16.722204	1.33	3.46
<b>2015</b>	0.619721	16.04658	0.96	3.51
<b>2016</b>	0.394006	13.65400	0.55	2.88

Source: Column (2) and (3) are from World Bank Database (2018), data in columns (4) and (5) has been computed by the author.

The top 22 and 23 home countries listed alphabetically investing in Kenya and Tanzania respectively, are shown in Appendix 1. The main source countries of FDI into Kenya are the UK, Netherlands and more recently China whereas main home economies for FDI inflows into Tanzania are China, India and The UK as presented in Tables 2.2 and 2.3 respectively.

### **Top Home Country Lists**

#### **3Tables 2.2. and 2.3. Top Home Country Lists for Kenya and Tanzania.**

Table 2.2. For Kenya

<b><u>Country</u></b>	<b><u>Rank</u></b>	<b><u>U.S. \$ million Amount</u></b>	<b><u>%</u></b>
United Kingdom	1	712.8	7.8
Netherlands	2	648.41	7.1
China	3	631.59	6.9
Belgium	4	593.34	6.5
South Africa	5	546.77	6.0
United States	6	521.08	5.7
India	7	506.27	5.5
Germany	8	472.72	5.2
Australia	9	459.78	5.0
Japan	10	439.08	4.8
Switzerland	11	436.74	4.8
Canada	12	423.87	4.6
France	13	408.53	4.5
Norway	14	371.35	4.1
Saudi Arabia	15	283.60	3.1
Korea, Rep.	16	279.48	3.1
Egypt, Arab Rep.	17	263.22	2.9
Tanzania	18	259.80	2.8

Table 2.3. For Tanzania

<b><u>Country</u></b>	<b><u>Rank</u></b>	<b><u>U.S. \$ million Amount</u></b>	<b><u>%</u></b>
China	1	1138.86	7.8
India	2	1082.86	7.4
United Kingdom	3	1038.70	7.1
USA	4	968.82	6.6
Canada	5	950.67	6.5
Kenya	6	861.12	5.9
France	7	785.26	5.4
Belgium	8	742.78	5.1
Switzerland	9	710.61	4.9
Denmark	10	630.02	4.3
South Africa	11	611.52	4.2
Australia	12	592.50	4.1
Botswana	13	533.68	3.6
Norway	14	530.41	3.6
Pakistan	15	524.29	3.6
Sweden	16	522.20	3.6
Uganda	17	445.10	3.0
Malaysia	18	399.38	2.7

Uganda	19	238.39	2.6	Italy	19	399.37	2.7
Nigeria	20	226.38	2.5	Egypt	20	358.21	2.4
Pakistan	21	215.36	2.4	Ireland	21	306.12	2.1
Hong Kong SAR, China	22	190.76	2.1	Spain	22	264.21	1.8
<b>Total of above 22</b>		<b>9129.35</b>	<b>87.0</b>	Iran	23	229.66	1.6
<b>Total of the world</b>		<b>10,500.99</b>	<b>100.00</b>	<b>Total of above 23</b>		<b>14626.37</b>	<b>85.00</b>
<i>Table Created by author</i>				<b>Total of the world</b>			
				<i>Table Created by author</i>			
				<b>18578.00</b>			
				<b>100</b>			

### OECD and Non-OECD Home Countries – Sources of FDI to Kenya and Tanzania

The OECD-member home countries led by the UK and the Netherlands accounted for 54.9% (USD. 5,767.2 million) whereas non-OECD member home countries led by China and South Africa accounted for 32% (U.S.\$ 3,362 million) of Kenyan inward FDI, during the period of study as shown in Tables 2.4 and 2.5 respectively.

#### **4Tables 2.4. and 2.5. OECD and Non-OECD Home Countries for Kenya.**

**Table 2.4.**  
**OECD Home**  
**Countries for**  
**Kenya**

	<b><u>Rank</u></b>	<b><u>U.S. \$ million Amount</u></b>	<b><u>%</u></b>
United Kingdom	1	712.8	12.4
Netherlands	2	648.41	11.2
Belgium	3	593.34	10.3
United States	4	521.08	9.0
Germany	5	472.72	8.2
Australia	6	459.78	8.0
Japan	7	439.08	7.6
Switzerland	8	436.74	7.6
Canada	9	423.87	7.3
France	10	408.53	7.1
Norway	11	371.35	6.4
Korea, Rep.	12	279.48	4.8
Total of the above 12		5767.20	100
% Total of the world			54.9

*Table created by author*

**Table 2.5. Non-**  
**OECD for**  
**Kenya**

	<b><u>Rank</u></b>	<b><u>U.S. \$ million Amount</u></b>	<b><u>%</u></b>
China	1	631.59	18.8
South Africa	2	546.77	16.3
India	3	506.27	15.1
Saudi Arabia	4	283.60	8.4
Egypt, Arab Rep.	5	263.22	7.8
Tanzania	6	259.80	7.7
Uganda	7	238.39	7.1
Nigeria	8	226.38	6.7
Pakistan	9	215.36	6.4
Hong Kong SAR, China	10	190.76	5.7
Total of the above	10	3362.15	100
% Total of the world			32.02

*Table created by author*

As shown in Tables 2.6 and 2.7 below, 45.4% (USD 8,441.69 million) of Tanzanian inward FDI was accounted for by OECD home countries led by the UK and the USA. The non-

OECD-member source countries led by China and India accounted for 33% (USD. 6,184.68 million) of total FDI flows to Tanzania.

**5Tables 2.6. and 2.7. OECD and Non-OECD Home Countries for Tanzania.**

<b><u>Table 2.6. OECD Countries for Tanzania</u></b>				<b><u>Table 2.7. Non-OECD Countries for Tanzania</u></b>			
	<b><u>Rank</u></b>	<b><u>U.S. \$ million Amount</u></b>	<b><u>%</u></b>		<b><u>Rank</u></b>	<b><u>U.S. \$ million Amount</u></b>	<b><u>%</u></b>
United Kingdom	1	1038.70	12.3	China	1	1138.86	18.4
USA	2	968.82	11.5	India	2	1082.86	17.5
Canada	3	950.67	11.3	Kenya	3	861.12	13.9
France	4	785.26	9.3	South Africa	4	611.52	9.9
Belgium	5	742.78	8.8	Botswana	5	533.68	8.6
Switzerland	6	710.61	8.4	Pakistan	6	524.29	8.5
Denmark	7	630.02	7.5	Uganda	7	445.10	7.2
Australia	8	592.50	7.0	Malaysia	8	399.38	6.5
Norway	9	530.41	6.3	Egypt	9	358.21	5.8
Sweden	10	522.20	6.2	Iran	10	229.66	3.7
Italy	11	399.37	4.7	Total		6184.68	100
Ireland	12	306.12	3.6	% Total of the world			33.3
Spain	13	264.21	3.1				
Total		8441.69	100				
% Total of the world			45.4				

*Table Created by author*

**2.3.2. The Share of FDI Inflows Between Kenya and Tanzania**

The two countries' pursuit of economic reforms and discovery of oil and gas deposits in both countries has attracted a huge increase in foreign direct investment with Tanzania leading with \$1.4 billion worth of inflow of FDI in 2016 against Kenya's \$ 394 million in the same period (UNCTAD, 2018). For instance, in 2014, Tanzania received the 3<sup>rd</sup> highest FDI in Africa due to investors being attracted to the country's commitment to complementary sound macro-economic policies, its effective privatisation program and rich natural resources. However, there were still some obstacles to increased investment such as low level of industrial development, environmental concerns, lack of transparency in governance and poor compliance with legislation. Inward FDI is expected to increase in Tanzania thanks to a number of hydrocarbon reserves that were discovered and the increased coal reserves (AfDB Report, 2018).

On the other hand, Kenya remained relatively weaker in attracting FDI, its economy and level of development notwithstanding. This weakness could be adduced to hindrances such as poor quality of infrastructure, insecurity from threats of terrorism and unfavourable business climate. Nevertheless, FDI inflows to Kenya have significantly been increasing since 2010. For example, in 2015, although Kenya was still behind Tanzania, it was fourth to South Africa as an FDI recipient country in Africa. Much of this upsurge in foreign investment was undertaken by China mainly in mining and hydrocarbon sectors (AfDB, 2018).

Despite Kenya's dramatic FDI gains in 2015, it still lags far behind Tanzania (Table 2.8). For instance, data from UNCTAD (2017 and 2018) showed that Kenya was one of the few countries that attracted less FDI inflows in 2016 compared to the previous year. FDI inflows to Kenya dropped by 36% even as inflows to East Africa rose by 13%. This was the most dramatic decline in investment inflows in a year and was more than double the 15% drop in Tanzania. The fall in investment inflows into Kenya has persisted over the past 3 years, signalling the overall lack of competitiveness of the region. The significant decline in Kenya's FDI has come despite the reforms creating a supportive domestic policy environment in Kenya.

### **2.3.3. Sectoral FDI in Kenya and Tanzania**

There is limited information on composition of sectoral FDI in Kenya and Tanzania. However, the scant information available indicates that FDI flows and stocks are mainly in primary sector. The two countries have attracted very little in the manufacturing sector (Ajayi, 2006; Kinuthia & Murshed, 2015 and Paudel, 2016). Sectors with the greatest potential to attract FDI in countries based in SSA were natural resources and industries for which the domestic market needed telecommunication, transportation and electricity. The percentage of FDI flows in the SSA in the primary sector was estimated to be between 55% to 80% (Ajayi, 2006). This implied that most of the region's FDI flows were in the natural resources sector and very little was attracted into the manufacturing sector.

Key investments in Kenya are in oil, gas exploration, natural resources particularly those in agro-industry and cement industry, industrial products and transport whereas key investments in Tanzania are gas reserves, natural minerals, and now Tanzania is competing with Mali for the slot of the third largest producer of gold in Africa (UNCTAD, 2018). In addition, the export processing zones in both countries (EPZs) are run by foreign firms from China, India, the US and the UK (Ajayi, 2006 and Kinuthia, 2012).

#### **2.4.0. Economic Growth in Kenya and Tanzania.**

Kenya and Tanzania are among the SSA countries that have achieved lower economic growth rates compared to other developing economies, in spite of initial optimism at independence (Taylor and Gopal, 2010). Ironically, in 1960s, these countries had a higher average GDP/Capita than their developing counterparts in East and South Asia. However, in the early 1990s, their average GDP/Capita had dropped five times behind the countries in the two Asian regions.

As a result, the economic performance of Kenya and Tanzania can be classified into three periods. Firstly, post-independence positive growth rates through the 1960s and the early 1970s. Secondly, twenty years of decline and stagnation of economic growth, 1975-1995. Thirdly, the period of recovery of 1996 onwards (Go et. al., 2007 and Okafor, 2015). These countries still have a long way to make up for the last 40 years plus and a real impression in reduction of poverty and economic development (Aka et. al, 2004 and Kinuthia & Murshed, 2015). Economic growth in SSA countries is characterised by little investment, low schooling, insufficient infrastructure, high government deficits and ethnic fragmentation (Easterly and Levine, 1997, Kinuthia, 2012, Kariuki, 2015 & Okafor, 2015).

#### **2.5.0. Possible Export-led Growth in Kenya and Tanzania.**

In the last few years, Kenya and Tanzania, like some SSA countries, have exploited new markets giving rise to what appeared to be a historic re-orientation of their trade and investment towards new partners as well as those within the region. Besides, its association with international trade, the gains from this orientation and trade expansion are associated with economies of scale, comparative advantage, dynamic effects through exports and long-term growth. Importantly, the reorientation has occurred through trade creation rather than trade diversion as engagement with traditional trade partners such as the UK, the US and Germany has grown in recent years though at a slower pace compared to new trade partners such as China, India and South Africa. For example, non-traditional partners now account for approximately 50% of these countries' exports (Selassie, 2011 and Okafor, 2015).

Most exports from Kenya and Tanzania are concentrated in primary products – mainly Agricultural produce and minerals. Ghura (1995) and Okafor (2015) found a strong linkage

between export-led growth and economic growth. Nonetheless, Selassie (2011) noted that exports had benefited Kenya and Tanzania through transfer of technology and related 'learning-by-doing' impact on growth and access to less expensive and less sophisticated technologies that were more appropriate for their level of development.

China and India have significantly increased their investments in the two countries. Chinese FDI to Kenya as a percentage of the total FDI, increased from less than 1% in 2003 to approximately 9% in 2018 (UNCTAD, 2019). The percentage rate in Tanzania is even higher at 12% (T.I.C, 2019), during the same period of time. Indian investments have also increased to 7% for Kenya and 9% for Tanzania during the same period of time (KenInvest, 2019 and T.I.C, 2019). Kenya's and Tanzania's governments have launched Special Economic Zones (SEZs) and China has taken advantage of them to develop incrementally their FDI in manufacturing and textile in the two countries. The zones produce manufactured goods for both advanced economies and domestic markets with the opportunity of additional investment, employment and technology transfer (Selassie, 2011).

These factors have highlighted the significance of openness to international trade, reduction in the cost of international trade (Export Processing Zones), a favourable business environment to further increase investments and exports to a level comparable to emerging economies in order to maximise growth potential (Bruckner and Lederman, 2012). However, Kenya and Tanzania have both been less effective in attracting FDI, in the secondary sector. For instance, considerable amounts of FDI in the secondary sector can help to diversify the export base in the East African economies and thereby achieve higher sustained growth (Dupasquier and Osakwe, 2003).

Therefore, Kenya and Tanzania present an important comparative analysis match for comparison between both type, source country and impact of FDI. Whilst the two countries neighbour each other, attained independence at the same time, they exhibit striking differences and similarities useful in understanding FDI determinants and impact in the two East African countries.

## **CHAPTER 3: LITERATURE REVIEW: FOREIGN DIRECT INVESTMENT: SOURCES, TRENDS AND LOCATION DETERMINANTS.**

### **3.1.0. Introduction**

This chapter is a critical review of the existing literature on FDI. The chapter is divided into five main sections. First is a critical review of what constitutes FDI. Second is a discussion of types of FDI. Third is a review of FDI sources and trends. Fourth is a critical review of the broad subject of FDI and its determinants where Neoclassical Trade theories and FDI theories are considered. Fifth, is the hypotheses development.

### **3.1.1. What Constitutes FDI**

Foreign direct investment has been defined as private capital flows from a parent company to an enterprise outside the parent company's home country (Pajunen, 2008) or simply the establishment of a new business abroad (Bradley, 2002). The organisation for economic cooperation and development (OECD) defines FDI as cross-border investments made with the intention to establish lasting interest in the firm of the receiving country by residents and businesses from another country (OECD, 2017).

Firms are positioned at a threshold level of 10% or more of equity ownership or voting power to qualify as a foreign direct investor. This is meant to establish an effective control in equity-based firms. Some studies (Duce, 2003 and Goldstein & Razin, 2005) have however suggested that, in some cases, an investor might own less than 10% of ownership or voting power, yet still maintains an effective voice in management. Accordingly, by gaining an effective voice may not imply that the foreign investors have absolute control of the enterprise, but rather that direct investors are able to influence the management of the enterprise. Meanwhile, internalising foreign activities could facilitate the implementation of strategies aimed at gaining certain benefits (Casson, 2015). High equity facilitated intra-MNEs knowledge flows which acted as a mechanism for MNEs to enhance their competitiveness by exploitation of existing capabilities as well as development of new capabilities (Tseng, 2015).

Consequently, internalisation of markets across national boundaries effectively generated MNEs. However, firms may not always internalise foreign operations as internalisation was considered only when the benefits perceived by the firm exceeded the costs (Casson, 2015).

### **3.1.2. Types of FDI**

FDI can be classified in terms of modes of entry. This may include greenfield subsidiary that is described as an establishment of a subsidiary in another country from a scratch and is sometimes referred to as brick and mortar investment (Bronzini, 2007). Another form of entry is acquisition, which is acquiring an existing firm in a foreign country as a subsidiary. Brownfield is another FDI entry mode that is to some extent a hybrid of greenfield investment and mergers and acquisitions (Meyer & Estrin, 2001 and Cheng, 2006). With this entry method, the foreign firm acquires another in a host country to have access to locational advantages (Dunning, 1981 and 1993). However, sometimes it becomes essential that the acquired firm undergoes tremendous changes that it loses its original identity (Cheng, 2006 and Osei, 2010). Wholly owned subsidiary is also a form of FDI where the foreign investor owns 100% of the assets and liabilities. Joint venture is another FDI type defined as an agreement by two or more firms to produce a product or a service together (Gooderham and Nordhaug, 2004). Joint venture can be 50/50, majority or minority owned (Cavusgil et. al, 2008).

FDI can also be identified by its nature of ownership, whether it is wholly owned or a joint venture. It can also be categorised as either vertical integration or horizontal integration. Vertical integration occurs when a firm establishes a subsidiary in a foreign country to internalise one or more stages of the value chain, such as provision of raw materials for manufacturing purposes in the home country or for provision of sales and after sales services for products manufactured in the home country. Horizontal integration is an establishment of a subsidiary in a host country to perform similar functions as those in the home country. For example, both the subsidiary and the parent company maybe involved in manufacturing of similar goods or provision of similar services (Cavusgil et. al, 2008 and Osei, 2010).

### **3.1.3. FDI Sources and Trends**

The increased flows of FDI indicates the growing internationalisation and integration of economic activities around the globe. With the gradual change in the motives for FDI as well as the shift of some location specific advantages from developed to developing countries, the

patterns and trends of FDI has been experiencing a significant change in recent years (UNCTAD, 2017 and World Bank, 2018). The motives of MNEs have been shifting from more conventional resources or market-seeking to efficiency or strategic-seeking (Faeth, 2009 and Pradham, 2015).

Sales and assets of MNEs are growing faster than world GDP, exports and gross fixed capital formation. However, global FDI flows fell by 23% to \$1.43 Trillion in 2017 from \$1.87 Trillion in 2016. This was stark contrast to the accelerated growth in other macroeconomic variables of GDP and Trade. The fall was attributed partly to the decrease in value of cross-border mergers (UNCTAD, 2018). A similar trend was witnessed when FDI flows fell in OECD economies by more than a third to \$712 Billion in the same period. The fall was explained in large by a decline from high inflows in the preceding year caused by cross-border mergers and acquisitions and corporate reconfiguration. A significant reduction in the value of such transitions resulted in decline of 40% in flows in the USA to \$ 275 Billion and 92% in the UK to \$15 Billion. However, FDI influx to non-OECD countries remained stable at \$671 Billion in 2017, seeing no recovery following 10% drop in 2016 (UNCTAD, 2018 and World Bank, 2018).

While OECD group of countries are the dominant source of FDI, non-OECD countries have emerged as a new investor accounting for a group share of 47% of global FDI inflows in 2017 compared to 36% in 2016 (UNCTAD, 2018). Regionally, FDI to developing Asia remained stable, at \$ 476 Billion. The region regained its position as the largest FDI recipient in the world. FDI flows to Africa rose by 11% to \$46 Billion in 2017 despite declines in many major recipient countries. The increase was supported by continued resource-seeking inflows, some diversified investments and a recovery in South Africa after several years of low-level inflows. This was after Africa had continued to experience decline in FDI flows to \$42 Billion in 2017, a slide of 21% from 2016. The decline was concentrated in the larger commodity exporters. Equally, FDI in structurally weak and vulnerable economies remained fragile as flows to LDCs fell by 17% to \$70 and \$26 Billion respectively (UNCTAD, 2018).

However, Sub-Saharan region of whom Kenya and Tanzania are part of, only accounted for 5% of the total global FDI during the same period (2017). For several years, FDI has unevenly distributed and concentrated in the hands of few countries in the SSA (UNCTAD, 2018). For instance, between 2009 and 2017, there was a 33% increase in FDI in SSA and 41% of average inflows to the region respectively went to four oil producing countries namely Nigeria, Angola,

Congo Republic and Equatorial Guinea. Angola accounted for 25%, Nigeria 16% and South Africa 14.4% while Tanzania, Sudan, Zambia, Mauritius and Uganda received a total of 19%. (UNCTAD, 2018).

Countries in Africa and particularly in Sub-Saharan Africa are yet to attract a pattern of resources flow that would give rise to competitive upgrading of the productive or export structure. Even countries that have embarked on economic reforms still attract the largest proportion of FDI to their primary sectors (Ezeoha and Cattaneo, 2011). For instance, Table 3.1 below shows that soon after the financial crisis of 2008, the global inward FDI was \$1186.5 Billion in 2009. Out of this, Africa received \$54.3 Billion, Kenya U.S.\$0.11 Billion and Tanzania \$0.95 Billion (UNCTAD, 2017). Kenya and Tanzania have increased their FDI flows since 2009, but their share of FDI compared to other regions is very poor. Infact, FDI lags behind official development assistance (Okafor et. al., 2017). For example, in 2016, Kenya had inward FDI amount of U.S.\$0.394 Billion but Tanzania's had gradually increased to U.S.\$1.4 Billion of Africa's total amount of U.S.\$59.2 Billion and global flows of U.S.\$1525 Billion as shown in Table 3.1 below (UNCTAD, 2017).

**Table 3.1. FDI Inflows in a Comparative Setting between 1991 and 2016.**

Country	1991-1996 (\$b.)	1997-2002 (\$b.)	2003-2008 (\$b.)	2009 (\$b.)	2010 (\$b.)	2011 (\$b.)	2012 (\$b.)	2013 (\$b.)	2014 (\$b.)	2015 (\$b.)	2016 (\$b.)
World	253	813.6	1152.3	1186.5	1328.1	1563.7	1402.9	1467.2	1228.3	1760.1	1525
Africa	5.1	13.1	34.6	54.3	44.072	47.705	56.434	53.969	53.912	54.1	59.2
East Africa	1.38	1.46	2.58	4.47	4.520	4.779	5.473	6.127	6.794	6.177	7.1
Kenya	0.1	0.28	0.61	0.11	0.178	0.335	0.259	0.505	0.989	0.619	0.394
Tanzania	0.63	0.24	0.64	0.95	1.813	1.229	1.800	2.131	2.142	1.60	1.40

*Source: Created by author using materials from UNCTAD Reports (2018).*

It is clear that the countries such as Kenya and Tanzania have received by far the lowest amount of inward investment in comparison to other countries in the world. Nevertheless, there are many theories that have been developed in response to the rising interest in selection of FDI locations by foreign investors and why they prefer one country over the other (Konig, 2009; Zheng, 2009; Freckleton et. al., 2012 and Blanc-Brude et. al., 2014).

### **3.2.0. Neoclassical Trade Theories and FDI**

#### **3.2.1. Neoclassical Trade Models.**

Neoclassical trade models were some of the first attempts to explain FDI (MacDougall, 1960 and Kemp, 1964). In truth, these models traditionally assumed there was no capital mobility, but it was the first attempt to explain FDI. However, by relaxing the immobility of capital assumption, Mundel (1957) had already attempted to integrate capital flows into neoclassical trade economics. His argument was that, in cases where there were large barriers to trade, FDI would take place to complement international trade and would therefore be essentially a substitute for trade. However, Kojima (1973) suggested that FDI occurred to complement trade, for instance in situations where imperfections in trade weakened the exploitation of competitive advantage. Even earlier, Iversen (1936) had theorised that FDI resulted from capital arbitrage. This perspective held that, capital would move to where the marginal product of the factor in one country exceeded the marginal product in another more than the costs and risks of the movement. Therefore, differentials in the interest earned on capital in different locations was the motivator of FDI.

These early neoclassical theories advocated that in industrialised economies, the rate of profit tended to shrink, because of domestic competition and this prompted firms to engage in FDI in undeveloped countries. This was due to scarcity of labour that had resulted from industrialisation in the developed economies (Kinuthia, 2012). Hobson and Lenin as quoted in O Neal and O Neal (1988) for example, argued that the more developed an economy was, the lower was the rate of profit, the greater the overproduction of capital and hence the lower the demand of capital. The owners of capital were then forced to explore means of operating in other less developed countries where capital was considered scarce but with higher returns.

Trade theories using the Heckscher-Ohlin's (1919) model, advanced this notion by suggesting that FDI was a function of international differences in the rate of return on capital and that FDI flowed out of countries with low returns on capital, to those with potential of yielding high returns on capital employed (Faeth, 2009). When considering the rate of return on capital, investors also considered the risk of selecting their portfolios and by portfolio diversification reduced their risks. This line of thinking was further expanded by Aliber (1970) positing that the differences in the returns seen in undeveloped economies were due to differences in currency risks and endowments of capital, since interest rates entailed a premium that was charged according to the anticipated currency depreciation. Therefore, firms from stronger currencies were able to borrow at lower costs and capitalise the earnings on their FDI at a higher rate in weaker currency countries than the indigenous firms.

A flexible accelerator model by Chenery (1952) and Koyck (1954) which was generalised by Jorgenson (1963) developed the same line of thought that holds in the output/market size hypothesis, which assumed a positive relationship between a company's FDI and its output in the host country. More precisely, the explanation offered in the context of these models lies in the differences in return to capital in favour of FDI. These theories however were criticised mainly by Kindleberger (1969) in that they assumed perfect factor mobility among countries and emphasized the monetary form of FDI. As a result, the neoclassical approach was perceived to be unable to clarify the nature of FDI flows. Kindleberger (1969) argued that FDI could not exist in a world of perfect competition. Thus, if no trade and competition barriers were in existence, then international trade was the only way to partake in the international market. He developed the concept of oligopoly which inspired the formation of market imperfection and international organisational theories discussed in the next section.

### **3.2.2. Theories of FDI**

The objective of these theories is to explain why MNEs undertake FDI, their preference for undertaking business in one country rather than another, and the mode of entry (Moosa, 2002 and Okafor, 2015). However, the ability of each theory to serve as a general theory which could explain the inward FDI at firm, industry and country level has been inconclusive as shown in several studies such as Agarwal's (1980), Parry's (1985), Teece's (2006), Faeth's (2009) and Denisia's (2010). It has been argued in these studies that each theory adds some new elements whilst criticising existing theories. What makes an over-arching theory difficult is the multifaceted nature of the theoretical underpinning and literature of FDI is now fragmented across different areas of economics and IB (Braunerhjelm and Svensson, 1996).

#### **3.2.2.1. Theory of Market Imperfection and International Organisation Theories.**

Drawing on Kindleberger's (1969) oligopoly view, Hymer (1976) developed his Industrial Organisation theory in which he theorised that FDI was motivated by the desire of a firm, one; to control foreign enterprises in order to remove competition between them, and two; that the firm's possession of special advantages. In this theory, Hymer (1976) implied that for FDI to succeed, and because of disadvantages foreign firms faced when they competed in the host country, they needed to possess a set of countervailing advantages over local firms. Therefore, perfect competition needed to be avoided and imperfect competition created.

Whilst contradicting views of portfolio theorists such as Iversen (1936), Hymer (1976) insisted that FDI did not just involve finance capital but also the transfer of a package of resources such

as technology, management skills and entrepreneurship. Motivation of firms to invest abroad was the anticipation of earning economic rent on totality of their resources. There was no change in ownership of resources and transfer of rights, and since indirect investment was transacted through the market, such a change was not necessary. Consequently, the organisation of both the transaction of the resource and the value-added activities linked to this transaction were different. In doing so, Hymer (1976) perhaps was interested in FDI only, since this was the means by which firms were able to control the use of property rights transferred to the foreign subsidiary. This possession of special advantage was adequate to outweigh liability of foreigners.

Drawing upon Bain's (1956) classic exposition on the barriers to competition in domestic markets, Hymer (1976) extended this analysis to explain the cross-border activities of firms, arguing that such firms had to possess some form of propriety or monopolistic advantage. However, as much as some ownership advantages may arise, from the firm's ability to improve the allocation of resources or organise transactions more efficient than markets; Dunning and Lundan (2008) found the use of the term 'monopolistic' inappropriate, since the advantages, may but not necessarily allow the firm to enjoy temporary economic rent.

Nevertheless, the power of prediction by Hymer's thesis made it appealing. He showed that FDI tended not to occur in industries best approximated by perfect competition; rather FDI was clustered into natural resource industries and industries where there was some important level of industrial concentration. His major contribution was to relocate the theory of FDI out of international trade and finance, into industrial organisation theory and theory of the firm. However, it was fair to note that at the time Hymer was writing, the field of industrial organisation was not prominent as it is now since it was dominated by monopoly rather than efficiency of business behaviour and complex organisational forms (Teece,2006).

Further criticism of Hymer's work pointed out that efficiency implications and relevancy of Coase's (1937) theories were not fully appreciated by Hymer. He was unable to properly connect and explore the fact that if MNEs possessed special advantages, rather than deploying their advantages via contractual mechanisms they would rather do that through internal transfer. Hymer also embraced the notion that if an MNE had a special advantage then it must restrict competition, stating that direct investment in a foreign processing industry protected a firm against competition which was also challenged by Yamin (1991) and Teece (2006).

The emphasis of Hymer on the role of market power in explaining the international scope of enterprise was a matter of choice and not ignorance but in terms of intellectual development in the theory of the firm and in terms of field of strategic management (Pitelis, 2004). Similarly, Teece (1998 and 2006) found Hymer's view inadequate.

It was however important to keep in mind that in absence of realistic welfare criteria for evaluating the MNE, Hymer was handicapped, forcing him to seize upon perfect competition as his benchmark. However, Teece (2006) argued that perfect competition was unrealistic and impractical policy benchmark, which inevitably made Hymer draw and arrive at awkward conclusions and recommendations. On the other hand, Teece (2006) further observed that there was little activity at that time to enable Hymer to understand organisational capabilities which influenced his crude state of approach to the MNE that reflected poor understanding of competition policy at the time. He found Hymer's first tenet of desire to control foreign enterprises in order to remove competition between them as a distraction, particularly in today's open and competitive world. In spite of Hymer's (1976) emphasis on market power rather than efficiency (Teece, 1985), the theory encouraged the development the PLC cycle theory in another attempt at explaining FDI discussed below.

### **3.2.2.2. The Product Life Cycle (PLC) Theory.**

Drawing from firm rivalry view, Vernon (1966) suggested that the pattern of products traded between countries were influenced by the stage of production reached in the international life cycle of a variety of products, notably knowledge intensive products. The balance between production and consumption could shift geographically in response to varied stages of the product life cycle reached.

The new product stage typically occurred in the most advanced industrialised innovating country, in response to demand conditions.

The mature product stage was characterised by the standardisation of the product, the rise of both production and consumption in the innovating country, increased economies of scale and low prices. Here, export to other countries became a higher proportion of total sales. At this stage, other advanced and industrialised countries also began production of the product through FDI.

At the standardised product stage, the product was entirely sold on the basis of price. Relocation to low-cost locations became a more feasible decision hence the relocation of production to the

LDCs where labour was relatively cheap. The new locations of production (LDCs) sometimes even became net exporters to the innovating country and other advanced economies.

As much as this theory explained well the industrialised economies' outsourcing of production function to the countries with low labour, its validity has rather waned. According to Piggott and Cook (1999 and 2006), the United States of America, which Vernon (1966) used to disseminate his model, no longer held a dominant position in terms of FDI, since European, Japanese, Newly Industrialised Countries (NIC)'s and lately, emerging economies' MNEs too, necessitated an explanation.

By modifying his model to posit that MNEs adapted in order to prevent entry of new firms into the market, Vernon (1979) overcame the first criticism. He then explicitly identified the reduction of organisational risk as a motive for, and determinant of, FDI (Vernon, 1994). Vernon, like Hymer developed a model that addressed a partial view of MNEs activities and in this case, International PLC theory did not explain, or attempt to account for, resource-based, efficiency-seeking or strategic-asset seeking FDI. Nonetheless, this model pioneered dynamic interpretation of the determinants of foreign investment and the relationship between international trade and foreign production. Its introduction of some new hypotheses on spurs of demand, technology leads and lags and information and communication costs later proved to be useful instruments of research in foreign production and exchange (Dunning and Lundan, 2008).

Further criticisms of Vernon's (1966) theory were posited by Kojima (1973) who described the PLC as a model that was obsessed with FDI as import–substitution vehicle. In the context of rapidly expanding economies, firms relocated mature lines of production in countries that were a step behind the home country's development stage and concentrated on higher valued activities in the more developed home environment (Kojima and Ozawa, 1984). Also, companies do not really follow the PLC model for instance, suppose there is no domestic market in the country of initial production.

In spite of the criticisms, the PLC model has been extensively quoted by authors of IB literature for numerous reasons such as; it's being dynamic because there is a strong interplay between the role of consumers, the role of producers and the structure of the market. It also related production with market elements; technology and know-how were linked to the economic environment of countries and to market conditions. However, the excessive focus on the

product and its life cycle was the main weakness of Vernon's (1966) theory (Moreira, 2009). It is apparent that this theory would not be applicable to this study. For instance, due to information technology, new products launched in one country may be available to consumers in another country pretty much at the same time. For example, Hill (2007) observed that laptop computers, compact discs and digital cameras are sometimes introduced in the United States, Japan and some advanced countries at the same time.

Due to the above, the PLC theory could not explain why some OECD and non-OECD countries have relocated their operations in Kenya and Tanzania. Furthermore, it had been stated that this theory is rather more effective in explaining licencing and franchising and not so much why firms invest abroad (Chee and Harris, 1998 and Osei, 2014). As a result of these facts, the PLC theory has not been adopted for this research. The next section discusses oligopolistic rivalry model in another attempt to explain FDI activities.

### **3.2.2.3. Oligopolistic Rivalry (Follow The Leader) Model.**

Another motive in location choice was presented by Knickerbocker (1973) who suggested that firms might invest in a foreign country to match a rival's move. He argued that firms particularly in oligopolistic industries tended to follow decisions of each other (Head et. al.,2002).

In the same line of thinking, Hoenen and Hansen (2009) and Hansen and Hoenen (2016) described FDI as a defensive move in oligopolistic markets. This was based on Knickerbocker's (1973) argument that the risk-averse firms followed their main rivals to evade any distortions in oligopolistic equilibrium. Firms followed the actions of the market leader in oligopolistic market industries and if FDI was the decision of the market leader then other firms followed suit by investing abroad and oligopolistic equilibrium sustained (Schenk, 1996 and Das, 2007).

The "follow the leader" pattern was a rational response to oligopolistic rivalry. Similar patterns detecting activities of MNEs in foreign countries have been put forward by other studies such as Flowers' (1976), with further detailed studies like Chwo-Ming and Ito's (1988) and others confirming Knickerbocker's findings. Graham (1978 and 1990) also suggested FDI might occur as an "exchange of threat" in which firms invade each others' home market as a strategy of oligopolistic rivalry. There are similarities between this model in construction and the

“reciprocal dumping models” that have characterised subsequent strategic trade theory (Krugman, 1990).

The important elements in Knickerbocker’s framework are oligopoly, uncertainty and risk-aversion. A strong risk-aversion made FDI decisions strategic complements, thus making Knickerbocker’s proposition hold. This finding was presented by Head et.al. (2002) who demonstrated that when uncertainty existed about costs in a foreign market, there was a greater likelihood of sufficiently risk-averse oligopolist establishing a manufacturing facility once his competitors have invested there. It was further proposed by these authors that uncertainty and risk-aversion were essential ingredients of obtaining oligopolistic reaction. The incentive to move abroad fell with rival investment there, in the case of uncertainty. Furthermore, the desire to follow a rival into a foreign market was reinforced by the uncertainty coupled with risk neutrality.

A number of authors such as Kogut and Chang (1996) have cited Knickerbocker’s work as a motivation for adding covariates in regressions explaining FDI. Oligopolistic reaction hypothesis’ relevancy extends beyond IB literature to the economic literature identifying sources of strategic complementarity in investment decisions. When there exists positive spillovers (agglomeration economies) between firms locating in geographic proximity, firms obtain greater profits from clustering rather than from dispersing (Head et. al., 2002). Caves (1971) introduced the notion of mergers as a strategic complement, an idea that was later extended by Faulí-Oller and Sandonis (2018) who argued that a firm’s incentive to merge decreased in the number of outside firms in a cournot oligopoly. Thus, mergers of two firms were likely to increase subsequent mergers of other firms. If the leader’s investment lowered the fixed costs of subsequent investment of rivals then, Flaherty and Raubitschek (1990) predicted that the follow-the-leader behaviour would occur.

The role of uncertainty in generating imitative behaviour in investments decisions were also explained by studies such as Banerjee’s (1992) model that showed a herd behaviour developing if the leader conveyed positive information about uncertain investment. The situation in which agents used observable actions of others to infer unobservable signals about a choice was referred to as information cascade by Bikhchandani et. al. (1998). In a large number of contexts, such cascades aided the FDI scholars in understanding imitation. Payoff model developed by Aaron and Lazear (1990) suggested that rank-order position determined payoffs. Trailing firms

were compelled by “first to the post” competition, to undertake risky investment decisions that were matched by the leading firm.

This part of literature shared a common ground in predicting strategic complementarity that firms imitated because they expected imitation to raise profits. However, Head et al.’s (2002) interpretation of Knickerbocker’s hypothesis was that despite the result and if their actions still lowered their expected gains, the firms still chose the same location. This happened when high-risk averse firms attempted to evade scenarios in which their competitors had a cost advantage. Therefore, practical relevance of oligopolistic reaction was determined by the level of risk aversion that characterised firm’s decision-making. This may have led to development of internalisation theory discussed below.

#### **3.2.2.4. Internalisation Theory of FDI.**

Internalisation as a concept was first broached by Coase (1937) but it was Buckley and Casson (1976) who first incorporated internalisation specific advantage (ISA) into the main analysis of FDI by arguing that firms chose to internalise operations through FDI when transaction costs were higher than internalisation costs.

The basic hypothesis of internalisation theory is that alternative mechanisms for coordinating related value-added activities across national boundaries to that of market, is represented by multinational hierarchies. Therefore, there is a likelihood of firms engaging in FDI whenever they suspect that there is a possibility of the net benefits of their common ownership of domestic and foreign activities and transaction arising from them, exceeding those offered from external trading relationships (Piggott & Cook, 2006; Das, 2007; Dunning & Lundan, 2008 and Assunção et. al., 2011).

At the time of inception of this concept, FDI was growing in high-technology-intensive manufacturing industries where it was vital to integrate R&D and marketing imperfection in the intermediate product markets, mainly by those patented by technical knowledge and human capital, as emphasized by Buckley and Casson (1976) and Piggott and Cook (1999 and 2006).

Contrary to the wide belief by scholars such as Penrose (1959), MacDougall (1960) and Kemp (1961) that MNEs transferred capital to a foreign country, Casson (1979) argued that it was mainly knowledge that was transferred by MNEs. If capital was transferred, it was mainly to protect the knowledge and appropriate profit from its exploitation abroad. Rugman (1990)

waded into the argument by asserting that the focus of internationalisation theory was the imperfections in intermediate markets.

The theory distinguished knowledge flows linking R&D to production and raw materials from an upstream production facility to a downstream one. The knowledge flow was the main focus of application of the theory. When intellectual property rights such as patents and trademarks were weak, proprietary knowledge were easy to copy. Therefore, firms protected their knowledge, effectively internalising the market knowledge within the firm (Dunning and Lundan, 2008).

Internalisation resulted into multinationalism because knowledge was a public good (Buckley and Casson, 1976). The knowledge was transferred to subsidiaries abroad as a result of development of a new technology's concentration in a single R&D facility. The firm then became the owner of production plants in various countries hence by definition, a multinational (Casson, 2015). Internalisation occurred only when gains expected by the firm exceeded costs and therefore firms do not always internalise markets. When foreign investment resulted from internalisation, the firm, as a result of its unfamiliarity with the foreign environment could incur costs of doing business abroad such as political risks and also commercial risks (Hymer, 1976) which arose from the 'liability of foreignness' (Zaheer, 1995).

Casson (2015) suggested that a firm may opt to licence or subcontract production to an independent foreign firm or may produce at home and export to the country instead, when the costs of doing business abroad are high. They do this to internalise supplies of components or raw materials in order to guarantee quality and reliable flow of supplies or if there are tax advantages from transfer pricing, firms without special knowledge may become international.

The theory of appropriation was a further reason for internalisation. It held that the key firm-specific advantages, which resulted into FDI, occurred in a key input market, for instance its managerial competency, a patent or an invention. This kind of advantage enabled the firm to acquire economic rent but did not create any monopoly powers in the market. The best way of appropriating the potential gains from the firm's advantage was to keep control and ownership of the advantage itself, hence, the firm's decision to engage in FDI. The strong presence of technology industries among MNEs could be explained by this theory. Therefore, the theory's policy is that the host countries should either forego FDI altogether or positively encourage it (Piggott and Cook, 1999).

Although internalisation theory was able to predict the circumstances under which firms internalised foreign markets, it could be considered a general concept. Buckley (1990), one of the protagonists, suggested it would be best to describe it as a paradigm rather than a theory. This is, because as much as market failure determined one form of added-value activity, the added value may be quite different from that of another. For instance, forward integration may be the reason for replacing of market due to failure of an intermediate to provide sufficient control of quality of products that bore the company's name.

In contrast, for instance, the perceived need to reduce the risk of unreliable flow of supplies or price hike, may motivate firms to do backward integration for example into natural resources. Meanwhile, the desire to gain economies external to the activities in question but internal to the firm owning them, could prompt governance of multiple activities in dispersed locations. Therefore, Dunning and Lundan (2008) suggested that internalisation theory was mainly concerned with explaining a firm's exchange function and intermediate product markets rather than its transformation of value-added function, which resulted from coordination of different activities within a single firm.

While setting up the Eclectic paradigm, Dunning (1979 and 2003) accepted the logic of internalisation theory but argued that the theory was insufficient in itself in explaining the level and structure of production of a country's own firms outside their national borders or of the production of foreign-owned firms in its midst. While accepting this criticism, separately though, Buckley (1987) and Casson (1987) acknowledged the need to integrate location-specific variables and the internalisation variables to fully explain the amount and direction of MNE activity. However, the legitimacy of viewing the growth of the firm as a time-related activity was also found questionable by Dunning and Lundan (2008).

Besides, Buckley and Casson (2009) described the OLI as more encompassing than the internalisation theory. This fact combined with Dunning's (2001) assertion that the OLI still held, regardless of the motive of investment which made the OLI paradigm appropriate to this research in comparison with the internalisation theory.

Similarly, Hymer (1976), as discussed earlier, developed ownership and location factors in his theory. Although he emphasized the necessity of the two factors, it did not appear that they were specific to FDI. It is Dunning (1977 and 1979) who brought the three advantages of ownership, location and internalisation together and formed OLI paradigm as discussed in the next section.

### **3.2.2.5. The Eclectic (OLI) Paradigm.**

Within FDI theories, Dunning (1977 and 1979) eclectic paradigm remains one of the most comprehensive frameworks for analysing FDI determinants. The paradigm otherwise known as the OLI paradigm brought together internalisation theory and traditional trade theory, by synthesising the objectives of the firms to operate internally and the FDI modes of entry. The paradigm suggested that MNEs possessed Ownership advantage (O), Internalisation advantage (I) and Location advantage (L) which enabled them to compete with domestic firms in the host country otherwise the foreign firm would export its products to the foreign market (Demirhan & Masca, 2008 and Kinuthia & Murshed, 2015). The concise configuration of OLI parameters facing a particular firm, and the response of the firm to that configuration is strongly contextual, reflecting the features of both the home and host country, industry and the characteristics of the investing firm which varied according to whether economies were developing or developed, large or small and industrialised or not (Dunning, 2001).

Dunning, (1993 and 2008) further advanced the thinking of attractiveness of FDI location by describing four types of FDI based on the motive behind the investment from the perspective of the investing firm. The first type was called market-seeking FDI, whose aim was to serve local and regional markets. It was also called horizontal FDI as it involved replication of production facilities in the host country (a strategy to access materials and labour costs, market size, government policy with respect to regulations and import controls and investment incentives). The variant of this type of FDI included tariff-jumping or export substituting. The essence for horizontal FDI was to better serve a local market by local production, hence market size and market growth of the host country were significant in this case. This type of FDI was also encouraged by obstacles of accessing local market such as tariffs and transport costs (Demirhan and Masca, 2008).

The second type of FDI was called resource-seeking (when firms invested abroad to access resources not available at home such as natural resources and related transport and low labour costs, tax and other incentives). This was particularly common in manufacturing sector when foreign firms directly invested in order to export. Contrary to horizontal FDI, vertical or export oriented FDI entailed relocating some stages of the production chain to the host country. The key driver of export oriented FDI was the availability of low-cost labour. FDI in the resource sector such as oil and natural gas was naturally attracted to countries with abundance of natural resource endowment (Dunning and Lundan, 2008).

The third type of FDI was efficiency-seeking which occurred when the firm could gain from the common governance of geographically dispersed activities in the presence of economies of scale and scope (a vertical strategy to take advantage of lower labour costs, incentives to local production by host government and a favourable business environment).

The fourth type of FDI was strategic-asset seeking (to access research and development (R&D), innovation and advanced technology) for activities that favoured MNEs such as knowledge intensive industries that recorded a high ratio of fixed to overhead costs and which offered substantial economies of scale (Dunning and Lundan, 2008).

Meanwhile, factors within the location (L) categories of the OLI paradigm were altered overtime, for instance, some variables could be grouped into more than one category and some which Dunning presented as location factors, such as cheap labour, have been latterly designated as market-seeking variable.

By combining several complementary theories and identifying a set of factors that influenced the activities of MNEs, the eclectic paradigm was a major contributor to the existing literature on FDI and it therefore received a wide acceptance among scholars.

However, the framework too had limitations, such as its inability to explain dynamic processes. The internationalization process models based on the work of Uppsala school (1977 and 1990) were the most familiar dynamic approach to FDI. Other approaches that appeared later included Porter's (1990) and Krugman's (1990) works of the rediscovery of economic geography, Helpman and Krugman's (1985) and Markusen's (1991) integration of MNE into models of international trade and the Leuven School works of game-theoretic analysis (Meyer, 1998).

Further criticism of the paradigm entailed its involvement of so many variables that it lost operational practicality. Dunning (2008) accepted the criticism by stating that the shortcoming was an inevitable consequence of trying to incorporate different motivations of FDI into a single paradigm.

The criticism of eclectic theory dynamics resulted into Investment Development Cycle Path (IDP) that Dunning (1981) used to explain the changing international direct investment position of countries as they passed through various stages of economic development measured in GDP per capita and its foreign investment position (Dunning, 1988 and Dunning and Narula, 1996).

The theory conjectured that when a country's economy expanded, the conditions encountered by foreign and indigenous firms changed, which inturn affected the inward and outward flow

of FDI. This affected the economic structure of the country. There was a dynamic interaction between the two and unlike the eclectic paradigm; the new theory accepted the role of the government in influencing the country's position through policies, thereby affecting FDI flows and domestic firm's ownership advantage. Therefore, IDP introduced a new idea of dynamic approach to the eclectic paradigm (Nayak and Choundry, 2014).

Although the eclectic paradigm can be considered as one of the most influential approaches in studying the international activities of MNEs, one of the main criticism of this paradigm was its lack of ability to explain the recent rise of developing country MNEs since such firms might not possess similar competitive advantages to MNEs from developed economies and thus; they might not invest abroad on the basis of their unique O-advantages. Consequently, internationalisation may be viewed in many cases as a strategy that aimed to enhance the firms themselves to accumulate resources previously not available (Sanfilippo, 2010 and Amighini et. al.,2014). In response to some of the criticism of the OLI paradigm, RBV theory was developed by Barney (1991 and 1996) built on seminal contributions of Penrose (1959) and others

#### **3.2.2.6. The Behaviour Theory of Uppsala School.**

Drawing from the works of Penrose (1959); Johansen and Vahlne (1977) developed a model known as the behaviour theory of Uppsala School also known as internationalisation process model. The theory identified four different steps of entering an international market. Step 1; firms normally began their expansion in a psychic nearby market because they had high knowledge of the market and more control of resources. They then gradually expanded to more distant markets after acquisition of better resources and gaining more experience. Step 2, firms entered new market by exporting via an independent representative; Step 3, establishment of a foreign sales subsidiary and Step 4, foreign production (Zohari, 2008).

The Uppsala model may explain some FDI in Kenya and Tanzania, particularly in circumstances where foreign firms invested in former colonies. This enabled firms to exploit advantages associated with areas such as common language and cultural similarities, as well as the state of political relationships between the home and the host countries (Meyer, 1998).

Owing to the empirical support received by the stage model of internationalisation from studies outside the Scandinavian, Johanson and Vahlne's (1990) dismissed the idea that this was a particularly a Nordic model applicable to only tiny, open and wealthy countries.

The various Uppsala models' key limitations were their confinement to focusing on explaining market and some subsequent horizontal-seeking FDI. The current surge in growth and expansion of Chinese FDI in oil exploration in Angola or relocation of office-based services from the UK and the US to India, for instance, is difficult to be explained by this model. It is not easy either for the model to account for much of the asset-augmenting occurring today (Dunning and Lundan, 2008).

The model did not reflect on the management structure of the company. Firms could employ a manager who already had international experience in managing companies and therefore may not need to go through Uppsala stages (Zohari, 2008). In their sequential four steps of market entry, they ignored other forms of market entry which are difficult to place on the model's scale such as franchising which is, as noted by Doole and Lowe (2008) perceived to be less risky market entry mode.

In recent times technological advancement and tremendous changes in international trade environment have been witnessed with emerging economies becoming major players on global stage. Similarly, reduction in barriers to trade by World Trade Organisation (WTO) and other trading agreements as increase in culture de-territorialisation have had major influences on consumer behaviour and market situation which do not require to pass through the stage process of Uppsala model. There are also missing out stages in the model for instance retreating. Thus, the firm may have knowledge, but it does not work for it in the market and is then forced to retreat. For instance, the British Supermarket Tesco failed in the USA and had to retreat. Other similar cases were reported by Amankwah-Amoah, Zhang and Sarpong (2013) included Best Buy and Bertelsmann AG that entered the Chinese market and retreated a few years after the entry.

Service industry is lately the fastest growing sector in the industrial world. However, the Uppsala model focused on product manufacturing, thus failing to predict or describe the service sector behaviour. For instance, unlike traditional firms that move gradually into international market, Altinay et. al. (2007) and Knight and Cavusgil (2009) found that Born Global firms internationalised first, contradicting Uppsala model which suggested that market knowledge could only be acquired through activities on the market (experimental knowledge). Moreover, it was possible to get experimental knowledge through imports. Furthermore, born globals, as noted by Saarenketo (2004), embraced a combination of experimental learning with other forms of knowledge creation such as knowledge acquisition through imitation, grafting or

searching. For example, there is now a complete reverse of internationalisation process witnessed within the music and fashion industry where American and European artists and designers look for market in Tokyo Japan before they launch their music in home markets as designers look to venture into Paris, London and New York as their first markets before launching their products in their home country market (Tohari and Retnawati, 2010).

A further weakness was, lack of clear understanding of the role of institution in the theory of Uppsala School. This led this study to consider institutional theory in the context of FDI as discussed in the next section.

### **3.2.2.7. Institutional Theory.**

FDI has also been explained by institutional theory which suggested that firms operated in a complete, uncertain and sometimes confrontational environment and therefore their (firms') decision making would be determined by the institutional forces that had an influence on them, particularly in terms of regulations and incentives (Francis et. al., 2009 and Assunção, 2011). Therefore, the strategies adopted by the firms and their performance were determined by institutions such as the role of governments, public organisations, trade unions and non-governmental organisations in what was referred to by Peng et. al.'s (2009) as "rules of the game". Foreign investment could thus be considered a game in which the players were MNCs and the governments of both the host and home countries or a contest to attract FDI (Faeth, 2009). The choice between exporting, FDI and licencing could be influenced by governments' policies such as tax breaks, subsidies, easy repatriation of funds and support for state firms to invest abroad (Faeth, 2009; Assunção, 2011 and Kang and Jiang, 2012).

The theory of internalisation which is based on transaction cost assessment at firm level could be considered institutional since internalisation factor has always been institutionally oriented as it relates to the costs and benefits of alternative methods of governance. Meanwhile, the paving way for introduction of institutional consideration into mainstream of theorising was helped by authors such as Kogut (1993) and Westney and Zaheer (2009) and others who discussed the role of culture and sociological analysis of culturally-related patterns of organising work at the firm level (Dunning and Lundan, 2008). At this point, various studies conducted on culture, building on Hofstede's (1983 and 2001) work such as Kirkman, Lowe and Gibson's (2006) and Jing and Graham's (2008) could be considered for their contribution to Institutional theory.

DiMaggio and Powell's (1983) typology has also been frequently employed by management scholars who identified three institutional diffusion mechanisms of coercive, normative and mimetic behaviour that could be drawn from part of Scott's (2001) framework. Attention of scholars has been attracted particularly to the influence of mimetic pressure in their analysis of what makes firms choose to adopt practices or structures that are similar to those that prevail in the human or physical environment in which they operate (Dunning and Lundan, 2008).

Scott (2005) described legitimate firms as those established by, and operated in accordance with, relevant legal and quasi-legal requirements. A location choice for MNEs, from a legislative institutional perspective, was determined by favourable environment where the regulative institutional constraints, are less oppressive to FDI activity so that there can be easy conformity for a firm to the host's country's regulative constituents.

Foreign firms are more vulnerable to attacks from local interest groups, in comparison to the indigenous firms. They therefore need to establish a social legitimacy (Kostova and Zaheer, 1999) which could be more difficult than the case for regulative legitimacy. This is so because of Scott's (2005) narrative that normative controls, stress a deeper moral base and are more likely to be internalised than regulative controls.

Yiu and Makino (2002) identified cultural differences as the main hindrance to foreign firms gaining normative legitimacy in a host country and Du (2009) found it to be a strong influence on FDI location choice. Therefore, the bigger the culture distance between home and host countries the more difficult it is for a firm to gain normative legitimacy in the host country.

Dunning (2004) attempted to incorporate institutional variables into the OLI paradigm because MNEs activities in developing countries and economies in transition are affected by this variable. Dunning and Lundan (2008) argued that there was need to simultaneously consider institutional influences inside the firm as well as those between the firm and the external environment in which they operate in order to understand the determinants of MNE activity.

However, the institutional theory did not address the issue of emerging markets and since this study is examining FDI determinants in OECD and non-OECD countries it is worthwhile to examine theories that have attempted to explain FDI originating from emerging economies discussed below.

### **3.2.2.8. LLL Theory.**

FDI from non-OECD to non-OECD countries could fit well with Uppsala model discussed earlier. However, emerging MNEs also spread to OECD countries. This could be considered as an upward investment and not the familiar pattern of MNEs from developed economies. This non-OECD to OECD FDI challenged conventional FDI theory.

Mathews (2006) argued that this type of investment was a means to access a resource that was not available at home. These latecomer firms had managed to overcome their lack of O-specific advantage by identifying and combining resources globally and leveraging them within the firm. He developed LLL paradigm (Linkage, Leverage and Learning) to explain this up-stream investment. Linkage was the international strategy with which MNEs used the globalised world for the resources to access their integration. Leverage was the decision strategy on how to access these resources. Thus, the way links could be established with incumbents or partners so that resources could be leveraged. Learning came from the repeated actions of linkage and leverage. Leverage and learning were recursive behaviours that allowed emerging MNEs to acquire comparative advantages so that they could fight back at home or in different host markets.

Although still a small group, the dragon multinationals are firms that are highly internationalised, and have grown to a substantive size, regardless of a peripheral home market and severely restricted resources. Mathews (2017) had suggested that these dragon multinationals had accomplished this by maximising the utility of their cross-border network relationships by accessing complementary assets to their own and by concentrating their global activities on their core capabilities.

However, the criticism of LLL framework related to its focus on firms originating from rapidly expanding economies in the Pacific Asia region (Narula, 2006) and according to Dunning (2006), some latecomer firms might indeed possess certain unique advantages such as country-specific ownership advantages (Dunning and Lundan, 2008). In more difficult institutional environments, for instance, Cuervo-Cazurra and Genc (2008) argued that MNEs from emerging economies enjoyed a competitive advantage in comparison to their counterparts from developed economies. As such, MNEs from emerging economies were able to transform their relative disadvantage of originating from countries with poor institutions to an advantage including movement with ease into more difficult contexts.

LLL paradigm was also criticised for being only able to explain South-North FDI flows without a concrete prescription on South-South FDI (Sanfilippo, 2010). Therefore, this paradigm could

only explain well the differences between south-south and south-north FDI; when combined with other theoretical approaches such as institutional theory (Aykut and Goldstein, 2006) already discussed above. However, an extension of this view might have been captured in the model of Springboard Perspective discussed below.

### **3.2.2.9. Springboard Perspective**

Similar to LLL paradigm, was that of Luo and Tung (2007) Springboard Perspective. This framework opined that emerging MNEs systematically and recursively used international expansion as a springboard to acquire critical resources. This allowed them to compete more effectively against global rivals at home and abroad and reduce vulnerability to institutional and market constraints at home.

Another difference is the non-sequential internalisation pattern of South-North FDI. This path was independent from an IDP perspective and radical behaviour from an Uppsala perspective. Additionally, poor institutions at home and also poorly developed home markets could act as push factors on emerging MNEs. This institutional difference meant that institutional framework was not a “wall-paper”. If emerging MNEs did not possess FSA, their going abroad could be one of the advantages of dealing with imbalances. Therefore, emerging MNEs went abroad to fill resource gaps not because they had some resource superiority as did MNEs from developed economies. However, both LLL and Springboard perspective theories accept the fact that emerging MNEs had to accept the environment which was established by developed countries.

### **3.2.2.10. Other Studies on Determinants of FDI.**

The Literature on factors attracting FDI inflow has also been determined by both policy and non-policy factors. Policy factors entail openness, product-market regulations, labour market arrangements, corporate tax rates, direct FDI restrictions, infrastructure and trade barriers whereas market size of the host nation (often measured by the GDP), distance/transport costs, factor of natural resource endowments, political and economic instability are non-policy factors (Fedderke and Romm, 2006, Mateev, 2009 and Anyanwu,2012).

FDI determinants have also been summed up into two categories with the first one identifying FDI determinants as demand side factors (host market size and income distribution) supply-side factors (skilled labour, R&D, and infrastructure), institutional factors (political and

economic instability, culture, intellectual property rights, transaction costs, bureaucracy and corruption) (Dunning, 2006; Zeng, 2009).

The second category identified push and pull factors. The push factors or domestic factors refer to home country conditions that motivate FDI outflow such as the rising labour costs, appreciation of local currency, rising cost of capital and deflation and the pull factors that attract FDI to host countries such as low labour costs, natural resource endowment, low transacting costs, geographical and cultural proximity, political and institutional factors such as political and economic stability, minimum corruption levels, bureaucracy and openness of the host country (Gottschalk, 2001; Karakaplan et al., 2005; Dunning, 2006; 2008; Zheng, 2009 and Anyanwu, 2012). The major pull factors in developing countries such as Kenya and Tanzania include low costs and huge labour force, natural resource endowment, high foreign exchange rates, large regional markets (both domestic and export) and cultural proximity.

Literature has also grouped the factors determining the inward flow of FDI into three main categories; basic economic factors (that include the difference in the rate of return on capital across countries, portfolio diversification strategy and market size of the host country); trade and the exchange market policies (refer to liberalisation of trade, foreign exchange rates and their volatility) and other aspects of the investment climate (Sekkat and Veganzones-Varoudakis, 2007) factors relate to infrastructure, cost of labour, availability of skilled labour, political risk and economic risk factors (transport, commerce and communication costs) and social factors (political stability, the role of institutions in terms of commitments and enforcements of rules and regulations) (Schneider and Frey, 1985).

Since the introduction of Dunning's OLI framework, many studies have been undertaken to examine the determinants of FDI, particularly in the case of developing countries. In addition to the OLI framework presented by Dunning, earlier studies such as Agarwal's (1980) and Schneider and Frey's (1985) focused on factors like country size, labour cost, exchange rate and political factors. Some studies have also highlighted economic factors such as trade policy, tax policy and foreign investment policy in explaining FDI flows to host countries. For example, determinants of FDI were analysed by cross-sections of countries on FDI from the United States to OECD countries in the Pacific Rim – Australia, New Zealand, Korea and Japan by Filippaios et. al. (2003). The findings suggested that market size, income level and qualified and productive labour had a significant impact on the time and location of US investors in the region. Similarly, Park (2003) investigated the patterns and strategies of FDI by Japanese

manufacturing firms and found that Japanese FDI in Asia and other developing countries tended to be low-cost resource-seeking particularly in labour intensive sectors. Contrary to this, Naude and Krugell (2007) observed that Japanese FDI in the US and Europe tended to be in knowledge intensive sectors with the major motive of market-seeking. Janicki and Wunnava (2004) conducted a cross-country study on emerging economies by investigating the determinants of FDI from the EU to eight Central and Eastern European economies. The study found that the size of the host economy, host country risks, labour costs in the host country and openness to trade to be determinants of inward FDI.

In a cross-country study on determinants of FDI, Love and Lage-Hidalgo (2000) analysed investments from United States to Mexico and established that domestic demand and relative factor costs affected FDI flows to the host country. Timing of the investment decision was however influenced by exchange rate movements. Similarly, Ismael (2009) investigated the determinants of FDI flows into ASEAN countries and found that market size of the host and source countries, short distance, common language, border and extended market relative to distance attracted more foreign investments. FDI was also attracted to ASEAN by other macroeconomic factors such as lower inflation rate, exchange rate and good management of the government budget. Social factors such as good telecommunication and infrastructure, and non-economic factors such as transparency and trade policy also encouraged inward FDI to ASEAN region.

In terms of BRICs countries, market size, labour cost, infrastructure, currency value, and gross capital formation were found by Vijayakumar et. al. (2010) to be the main factors that influenced FDI flows. However, economic stability and trade had insignificant relationship with FDI flows. A similar study on the BRICs by Ranjan and Agarwal (2011) for the period 1975-2009 generated similar results in which market size, trade openness, labour cost, infrastructure, macroeconomic stability and growth prospects had significant effect on FDI flows. Meanwhile, gross capital formation and labour forces had no significant effect on FDI.

Regarding investment in Asian countries, Wadhwa and Reddy's (2011) analysis focused on Dunning's (1988) three motives of market seeking factors (including market size and population growth), resource-seeking factors (including imports and infrastructure) and efficiency-seeking factors (including inflation) and concluded that all these factors affected inward FDI in these countries. Elsewhere, Tsai (1994) found market size and economic growth were key determinants of FDI flows in developing countries.

After categorising determinants into economic, political and institutional factors, Jadhav and Katti (2012) suggested that trade openness, rule of law, market size, voice and accountability had a positive relationship with FDI flows to BRICs countries. Natural resources had a negative relationship with FDI flows to these countries. The study further intimated that the nature of FDI flows to BRICs countries were of market-seeking and efficiency-seeking. Jadhav and Katti (2012) however asserted that “resource-seeking was motivated by natural resources in host countries and that this form of FDI was historically fairly important and remained a relevant source of FDI for various developing countries”.

Previous studies such as Asiedu’s (2002 and 2006) and Dupasquier and Osakwe (2003) had already showed that natural resources played an important role in overall FDI attraction or decision since natural resources in African countries attracted more FDI compared to other factors. For example, Suleiman et. al. ‘s (2015) examination of determinants of FDI to Southern African Customs Union (SACU) for the period 1990-2010 established that besides market size and trade openness, natural resource availability was also positive and significant determinants of FDI for SACU member countries.

The determinants of FDI were also estimated by Morisset (2000) for Sub-Saharan countries for the period 1990-1997. It was found that FDI flows had a positive relationship to trade and economic growth. However, there was a negative relationship between FDI flows and illiteracy rate and infrastructure. The study however stressed that African countries could still successfully attract FDI inflows even in the absence of natural resources and a large market size.

A similar study by Bende-Nabende (2002) of Sub-Saharan African countries suggested that market growth, trade openness, liberal FDI policies, real effective exchange rates and market size had a positive relationship with FDI. The study concluded that FDI could be improved in the long run by strengthening the macroeconomic management, expanding the export base and liberalising FDI regimes. Similarly, Asiedu’s (2002) study explored 71 developing countries from the period of 1980-2000 also found that market size, natural resources, policy environment, institutions and political stability were significant factors in attracting FDI to these countries. Also, Onyeiwu and Shretha’s (2004) study on macroeconomic and institutional determinants of FDI in 29 African countries found that growth, openness of the economy, inflation, natural resources, and international reserves had impact on inward FDI in Africa.

The influence of market size, political instability, inflation, legal system, infrastructure and education levels on FDI flows was analysed by Asiedu (2006), for 22 developing countries over the period 1984-2000. The research confirmed that natural resources, market size, good infrastructure, lower inflation, higher education, population rate, openness to FDI, political stability, lower corruption and a reliable legal system attracted inward FDI. Asiedu (2006) then suggested that countries with shortage of natural resources and lower market size could still attract FDI by improving the institutional quality and policy environment.

It is evident from the empirical review that FDI inflows to the host countries are affected by numerous factors (Dunning, 1988). Despite the massive volumes of scholarly studies conducted in both developed and developing economies, there is no consensus as to the specific factor consistently affecting FDI flows to a host country. The main variables measured include market size and growth, labour, human capital, exchange rate, infrastructure, openness, inflation rates among others. Subsequently, the empirical review established that the significance of each of these factors varied across regions, countries, research methodology and time. Consequently, studies on African region or specific countries in Africa are very few (Irandaoust, 2010 and Suleiman et. al., 2015). Therefore, this study intends to complement the existing literature by investigating the determinants of FDI flows into Kenya and Tanzania.

### **3.3.0. Determinants of FDI Flows to Kenya and Tanzania and Hypotheses Development.**

The potential determinants of FDI flows into Kenya and Tanzania have been categorised under economic, social cultural, political and institutional factor headings as discussed below. The structure of the hypothesis has been developed in accordance with the theoretical framework of FDI, based on Moosa's (2002) classification. The survey of literature has informed the development of this study's three main hypotheses thus;

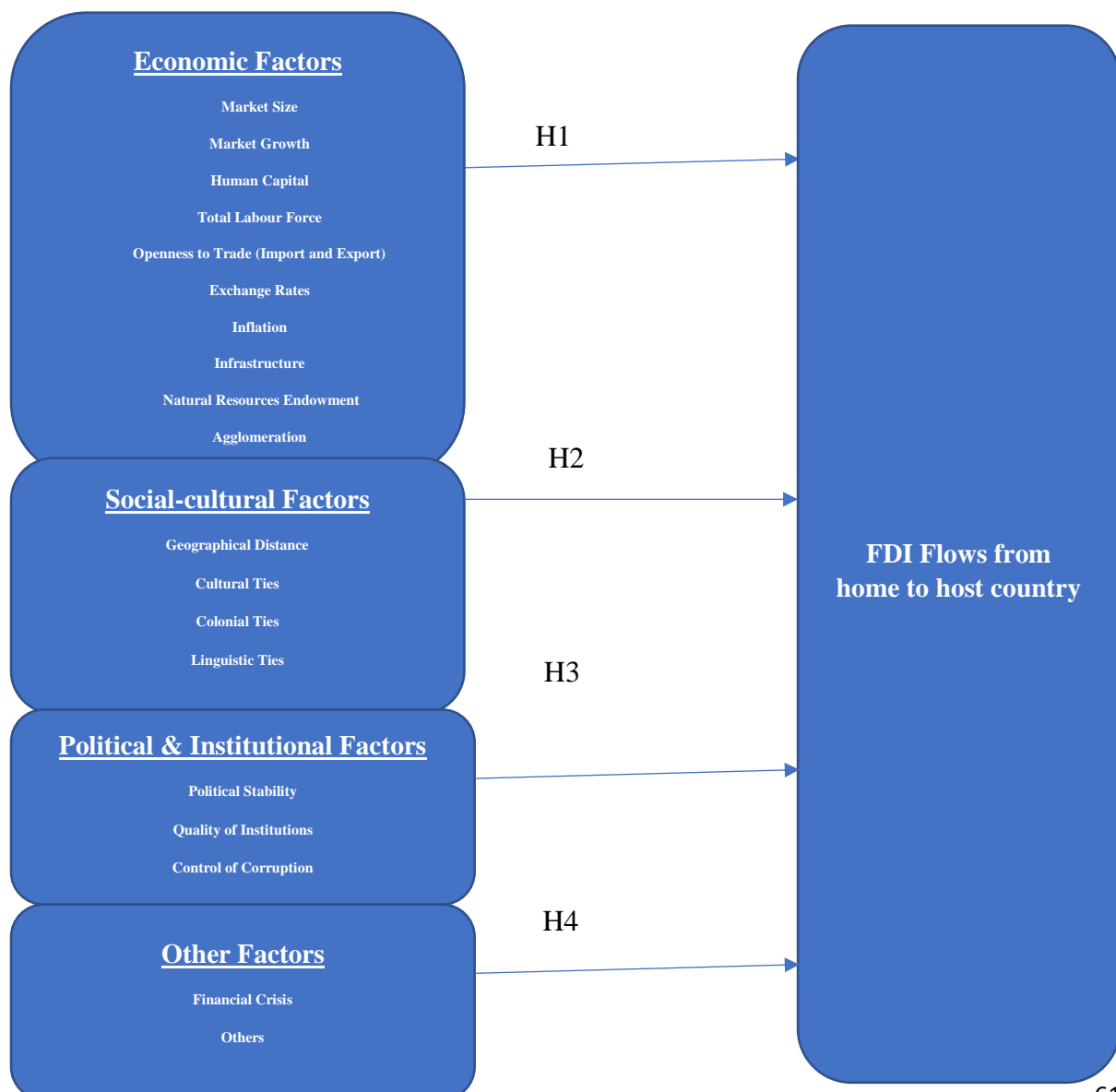
Hypothesis 1: Economic Factors in both host and home countries are associated with FDI flows from home countries to Kenya and Tanzania.

Hypothesis 2: Social-cultural factors in both host and home countries are associated with FDI flows from home countries to Kenya and Tanzania.

Hypothesis 3: Political and institutional factors in both host and home countries are associated with FDI flows from home countries to Kenya and Tanzania.

Hypothesis 4: Other factors in both host and home countries are associated with FDI flows from home countries to Kenya and Tanzania.

**2Figure 3.1. Proposed hypotheses between factors determining FDI and FDI flows.**



*Source: Created by author using materials from Literature on Determinants of FDI.*

These three hypotheses have further been developed into sub hypotheses examined below.

### **3.3.1. Economic Factors' Effect on FDI Inflows**

#### *3.3.1.1. Market Size and Growth*

As one of the most important determinants of FDI location, Streak and Dinkelman's (2000) and Zheng (2009) found that market size played a key role in the design of international expansion strategy for horizontal market-seeking FDI. Investment returns and profits can be directly influenced by market size. Besides, a potential larger market and more promising prospects are indicated by a higher market growth. Market size and market growth variables are presented in terms of GDP and GDP growth rates among other measures, which are normally utilised in determining the standard of living and the purchasing power of the populace (Osei, 2014). For instance, Wei (2000) and Asiedu (2002) alluded that FDI tended to flow to countries with larger market size and greater economic growth rates in which economies of scale could be obtained and efficient utilisation of resources achieved. Indeed, Bende-Nabende's (2002) empirically established that growth rate was the most dominant long-run determinant of FDI flows to Sub-Saharan region.

However, Anyanwu and Yameogo (2015) found an insignificant impact of market size to FDI inflows to the West African region. This could be attributed to availability of abundant natural resources in this part of Africa which seem to attract resource-seeking more than market-seeking FDI. Contrary to this, market-seeking was the motive of over 50% of foreign investors in Kenya and Tanzania (UNIDO, 2012); which meant they were mainly driven by access to local, national and supranational markets (Dunning, 1988). The two countries' population and GDPs are likely to provide a good market for consumer goods, but it is the regional market that is potentially more vital to foreign investors. This can be attributed to the two countries' membership of the East Africa Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA), with nearly 160 million and 450 million people respectively (AfDB, 2017). Foreign firms have set up bases mainly in Kenya in order to access this supranational market (Kinuthia, 2012). As such, GDP size and GDP growth rate ratios between home and host country are used to measure market size and market growth respectively. They

are both expected to be positively correlated with FDI flows for the case of Kenya and Tanzania and the hypotheses that flow in this study are;

*Hypothesis 1a: The higher the ratio of Kenya and Tanzania to home country market size, the greater the flow of FDI from the home country to both Kenya and Tanzania.*

*Hypothesis 1b: The higher the ratio of Kenya and Tanzania to home country market growth, the greater the flow of FDI from the home country to both Kenya and Tanzania.*

### *3.3.1.2. Human Capital*

The amount, and cost, of human capital is usually perceived as a pull factor for foreign MNEs. However, its effect on FDI flows is determined by the type of FDI and productivity of the labour force. MNEs may not only be interested in low cost labour but also need professionals and quality human capital of which the low wages might reflect lack of productivity (Wang and Swain, 1997 and Omanwa, 2013). Empirical studies such as Wheeler and Mody's (1992) and Mijiyawa's (2015) have demonstrated how quality of human capital is an important determinant of certain types of FDI particularly in Africa.

In this study, the adult literacy percentage for both sexes of the population is used to measure the human capital. This measure has been chosen because accumulated stock of human capital, which is a measure of labour quality and indicative of the level of education skills of the workforce within a host country, is presented by higher education enrolment rate (Anyanwu, 2012). Furthermore, the existence of relatively new technological advances and FDI's shift towards more capital, knowledge and skill intensive industries which now require a skilled, but affordable labour force and therefore importance of the human capital in attracting FDI to the host country (Noorbakhsh, et. al., 2001 and Omanwa, 2013). Therefore, a positive and significant relationship is expected for the case of Kenya and Tanzania

*Hypothesis 1c: The greater the ratio of skill levels in Kenya and Tanzania to the home country the more the FDI flows from home country to both Kenya and Tanzania.*

### *3.3.1.3. Labour Costs*

Variances in production efficiency between host and home countries have great effect on FDI location decision making. Besides, market size and growth, labour cost is another key determinant of FDI flows, particularly for vertical efficiency seeking FDI (Zheng, 2009). High labour costs imply higher cost of production and is expected to limit the FDI flows (Sichei and

Kinyondo, 2012). An economy, especially the developed ones, Newly Industrialised Economies (NIEs) in Asia and emerging economies with higher labour costs is likely to relocate labour intensive production to another economy (Kinuthia and Murshed, 2015) with low labour costs. Therefore, it is anticipated that high labour costs in the home country are positively associated with more FDI outflows to the host country with low labour costs.

*Hypothesis 1d: The lower the ratio of Kenya and Tanzania to the home country's cost of labour, the higher the flow of FDI from home country to both Kenya and Tanzania.*

#### *3.3.1.4. Trade Openness*

Trade openness is considered a key determinant of FDI and much of FDI is export oriented and may also require to be complemented by imports since volume of trade is enhanced (Vijayakumar et. al., 2010). The importance of relationship between trade and FDI flows has been suggested by discussions on internalisation (Bevan and Estrin, 2004). Studies such as Asiedu's (2002) and Aizenman and Noy's (2006) found that the more open a country, the more FDI it received. The sum of export and import as a percentage of GDP was commonly used as an indicator for trade openness in the literature in which it is suggested that trade (imports plus exports) complemented rather than substituted for FDI.

MNEs' investments tend to flow to trade partner markets with which they are familiar and perhaps with cultural closeness. High volumes of trade might be a sign of a high economic integration between the countries (Zheng, 2009). Imports from the subsidiaries located in the host country may be used to supply the parent company in the home country while exports may be used to supply subsidiaries in the host country.

The impact of a host country's involvement in free trade agreements, customs unions, and supra-national economic structures has been emphasized by literature on trade and FDI, since transaction costs between foreign production and exports is affected by such a move (Bevan and Estrin, 2004). Based on literature survey, greater bilateral trade will attract FDI flows to the host country. This study will use the sum of exports and imports as a percentage of GDP to measure trade. A positive and significant correlation is expected for the case of Kenya and Tanzania

*Hypothesis 1e: The greater the ratio of quantity of exports from Kenya and Tanzania to the home country the more FDI will flow from the home country to both Kenya and Tanzania.*

*Hypothesis 1f: The higher the ratio of increased imports to Kenya and Tanzania relative to the home country will attract more FDI from the home country to both Kenya and Tanzania.*

#### *3.3.1.5. Exchange Rate and Inflation*

FDI inflows may be influenced by weaker exchange rates in the host country (Aliber, 1970). Conversely, FDI inflows will be deterred by host countries that have strong currencies as this would make investing much costlier (Scott-Green & Clegg, 1999 and Kariuki, 2015). This is because relative wealth and relative labour costs on FDI can be determined by exchange rates hence the relative wealth of foreign firms will be increased by depreciation of a country's exchange rate which will lead to an increase in foreign purchases of domestic assets. Consequently, capacity inflows will result from depreciation of country's foreign exchange as foreign countries try to take advantage of relatively cheaper domestic labour (Anyanwu, 2012). Thus, exchange rate changes might be related to the type of FDI.

Equally, high inflation rate reduces the expected return on investment hence the volume of investment because of the uncertain economic environment. Thus, FDI inflows will be deterred by economies that have higher inflation rates since the home currency will be depreciated by inflation in such a way that the same amount invested will mean less value in terms of the currency of the host economy, lower purchasing power and capacity in the host country (Zheng, 2009 and Mhlanga et. al., 2010). This study tests the effect of exchange rate and inflation of both home and host countries have on FDI flows using official exchange rate between home and host country and inflation rate (Consumer Price Annual %) of the host economy. The expected effect of exchange rate and inflation on FDI is to be positive and negative respectively for the case of Kenya and Tanzania.

*Hypothesis 1g: The higher the ratio of Kenya and Tanzania to the home country's exchange rate, the greater the flow of FDI from home country to both Kenya and Tanzania.*

*Hypothesis 1h: The higher the ratio of inflation rate in Kenya and Tanzania relative to the home country will deter FDI from home country to both Kenya and Tanzania.*

#### *3.3.1.6. Infrastructure Development*

Literature has generated a rather mixed effect of infrastructure as a determinant of FDI, for instance Hailu (2010) in extension of Nnadozie and Osili's (2004) earlier work suggested that there was no robust evidence to support the quality or amount of infrastructure in the host country as a determinant of FDI flows from USA to Africa. Elsewhere, Asiedu (2002) had

presented a similar suggestion of infrastructure having no effect on FDI flows to Sub-Saharan Africa. In contrast, several authors such as Sekkat and Veganzones-Varoudakis (2007) and Seetanah and Khadaroo (2010) produced findings that robustly availed evidence in support of infrastructure as a determinant of FDI flows to Sub-Saharan Africa.

Indeed, infrastructure is a vital cost factor that affects FDI. A reliable infrastructure system needs to be in place to allow movement of output and input from source to production point to port of shipment (Kinuthia, 2012). By extension, inward FDI is discouraged by inadequate infrastructure development (Osei, 2014). However, the nature and the motive of FDI may be determined by different factors such as whether increased FDI is predominantly manufacturing or service as well as the source country such as China that can moderate the effect of infrastructure on FDI flows.

It has also been argued by Kinoshita and Campos (2003) that for foreign investors to operate successfully, regardless of FDI type, availability of good hard and soft infrastructure is necessary. This was consistent with Omanwa's (2013) study on FDI flows to Kenya which suggested that there was an indirect increase in the productivity of other factors of production with an increase in infrastructure stock. For instance, provision of reliable and efficient source of power such as electricity, could yield positive productivity effects on firms as it improved investment environment for other businesses which explained why infrastructure had the potential to reduce operational costs and encourage investment.

Therefore, this study will investigate the effect of infrastructure on FDI to the host country using internet users per 100 people and mobile cellular subscriptions per 100 people (Biswas, 2002 and Cleeve, 2008) as measures for the availability of infrastructure and communication facilities in Kenya and Tanzania. These two measures were chosen because one, as much as some studies such as Wekesa et. al. (2017) used transport infrastructure, communication infrastructure, water and waste infrastructure as measures of infrastructure variable in a similar study in Kenya, this study did not find credible data for the same measures for both Kenya and Tanzania. This difference could be attributed to the fact that Wekesa et. al. (2017) focused on a single country (Kenya) while this research is on Kenya and Tanzania and also, a good number of countries in the non-OECD group of home countries had gaps in their data for most measure of infrastructure including those used by Wekesa et. al.'s (2017). Two, Wekesa et. al. (2017) variables are closely linked to manufacturing type of FDI and this study's objectives do not include investigating the type of FDI flows. Three, foreign investors view the two proxies as

vital pre-requisites for their investments as well as necessary in facilitating communication between home and host country. The same variables have been used by prior FDI studies in Africa (Biswas, 2002; Calderón, Odawara & Servén, 2008; Cleeve, 2008 and Anyanwu, 2012). Consequently, a positive and significant relationship is expected for the case of Kenya and Tanzania.

*Hypothesis 1i: The higher the ratio of better-quality hard infrastructure in Kenya and Tanzania relative to the home country, the more FDI will be encouraged to flow from home country to both Kenya and Tanzania.*

*Hypothesis 1j: Availability of better-quality soft infrastructure in the host country relative to the home country, will encourage FDI from home country to both Kenya and Tanzania.*

### *3.3.1.7. Total Natural Resources*

Historically, natural resources have been the key pull factor for the resource-seeking FDI into developing world, particularly in Africa where the common perception is that FDI in SSA is largely driven by resources (Asiedu, 2002). This perception seems to be consistent with data on FDI inflow to SSA because the three largest recipients of FDI are Angola, Nigeria and South Africa (Asiedu, 2006). This idea was supported also by Onyeiwu and Shrestha (2004). Similarly, Hailu's (2010) and Mohammed and Sidiropoulos' (2010) studies in Africa found that countries which were endowed with natural resources attracted more FDI than those without.

Equally, Morisset (2000) observed that natural resources were the principal determinants of the capacity of African countries to attract FDI. This view was supported by Asiedu's (2006) study in developing countries that measured natural resource endowment variable as the share of minerals and oil in total exports. In support of this, Hailu (2010) argued that firms sought Africa for its abundance of resources. Elsewhere, Okafor et.al.'s (2017) study on the US' FDI into 23 SSA countries concluded that availability of oil was a primary factor for positive influence on FDI flows.

As suggested by Dunning (1977 and 1993), total natural resources rent as a percentage of GDP and the availability (proven reserves) of crude oil and gas were mainly used to measure resource-seeking motives for FDI inflows to countries such as Kenya and Tanzania. As such, huge rent generated from natural resources is seen by resource-seeking FDI as an indication of the abundance and low cost of national resources in the host country's total exports as a

measure of natural resources availability. As such, positive results are expected for the case of Kenya and Tanzania.

*Hypothesis 1k: The higher the ratio of the amount of natural resources in Kenya and Tanzania relative to the home country, the higher FDI flows from home country to both Kenya and Tanzania.*

#### *3.3.1.8. Agglomeration Economies*

Emergence of agglomeration economies occurs when there are benefits from co-locating near other economic units which can result into positive externalities. Existence of other foreign investors in a given location may attract other foreign investors to that location. Investor may therefore consider other investment decisions by others as a good sign of favourable conditions and emulate the decisions to minimise uncertainties from their lack of knowledge of local environment of the host country (Kinoshita and Campos, 2003).

Some of the sources of positive externalities that lead to the spatial clustering of investors are; Firstly, foreign investors across various industries can share technology spillover amongst themselves. Secondly, when firms in the same industry draw on a shared pool of skilled labour and specialised input suppliers then industry-specific localisation is observed. Thirdly, backward and forward linkages as a source of agglomeration are emphasized by the theory of new economic geography. Agglomeration effects and the use of industrial estates as development policy have a significant positive effect on location choice of firms (Barrios et al., 2003) thereby determine spatial distribution of FDI in transition countries (Pusterla and Resmini, 2007).

Use of one year lagged FDI flows, an approach widely used in literature (Cheng & Kwan, 2000 and Kinoshita & Campos, 2002) can assist in measuring the agglomeration effect and this is the approach adopted by this study. It is expected that the agglomeration effect will encourage the inflow of FDI to Kenya and Tanzania.

*Hypothesis 1l: The higher the ratio of agglomeration economies in Kenya and Tanzania relative to the home country the greater the positive impact it will have on FDI from home country to both Kenya and Tanzania.*

### **3.3.2. Social Cultural Factors' Effect on FDI Inflows**

#### *3.3.2.1. Cultural Distance*

Cultural distance is one way of measuring the distance between home and host country. Business will be made easier at less cost by the proximity in the cultural, colonial and linguistics ties between the host and home countries. Makino and Tsang (2011) measured cultural distance by the difference between FDI host country and home country based on Hofstede's (1980) cultural dimension scale and on Kogut and Singh's (1988) formula.

Similar culture, history and official languages as the home country would be expected to attract more FDI to the host economy (Zheng, 2009 and Demir & Im, 2019). Both Kenya and Tanzania are former colonies of Britain with English as their official language. Therefore, this study measures the effect of similar culture, history and linguistic ties between home and host countries on FDI. A positive effect is expected.

Another measure for distance between host and home country is geographical distance. It is anticipated that the further the geographic distance, the less FDI flows as distance will make FDI costlier and inconvenient. Thus, geographic distance and transaction costs are strongly associated with FDI inflows (Buckley & Casson, 1976) and are negatively associated with each other (Zheng, 2009). The top four sources of FDI for Kenya are the UK, Netherlands, the US and China while China, India, the UK and Canada are for Tanzania (UNCTAD, 2017). This study examines the effect of geographical distance between home and host country on FDI measured by the distance between capital cities of home and host countries. Literature suggests that geographic distance and FDI should be expected to be negatively related to each other.

*Hypothesis 2a: Closer cultural ties between the host and home country will attract more FDI inflows from the home country to both Kenya and Tanzania.*

*Hypothesis 2b: The greater geographic distance between the host and home country the smaller the FDI inflows from the home country to both Kenya and Tanzania.*

*Hypothesis 2c: Closer colonial ties between the host and home country will attract more FDI inflows from the home country to both Kenya and Tanzania.*

*Hypothesis 2d: Closer linguistic ties between the host and home country will attract more FDI inflows from the home country to both Kenya and Tanzania.*

### **3.3.3. Political and Institutional Effect on FDI Inflows**

The political and institutional framework might affect the flow of FDI. These may include political stability, quality of institutions and corruption and can affect choice of entry mode,

magnitude of investment, probability of survival and variety of international expansion strategies (Yiu and Makino, 2002 and Bevan and Estrin, 2004)

There is much empirical support (Zheng, 2009 and Osei, 2014) to suggest that political stability raises the probability of a country's selection as FDI location (Huang et. al., 2006), for instance, both Kenya and Tanzania had a relative political stability to other African countries for a long time. However, this all changed for Kenya in wake of country's post-election violence that erupted in 2007 following a disputed result of the presidential election. This violence did not just shake the Kenya's economy but the economies of neighbouring landlocked countries that depend on the Kenyan seaport of Mombasa for their import and export traffic. As a result, investors' confidence in the country was shattered (Omanwa, 2013 and Kinuthia and Murshed, 2015). This example illustrates the significance of political stability factor to investors and therefore FDI inflows.

Although Wang and Swain (1997) and others found a negative significant correlation between political stability and FDI, Dupas and Robinson (2010) found the reverse. Further, Omanwa (2013) observed that in many cases political unrest was coupled by social unrest which also threatened the safety of investors themselves. This study will use political stability and quality of institutions. This choice has been influenced by the location of the host countries and the ability to provide data that can support the quantitative methodology.

Therefore, a lower score implies political instability that is expected to deter FDI. A higher score is expected to attract FDI for the case of Kenya and Tanzania.

*Hypothesis 3a: The higher the ratio of political stability in Kenya and Tanzania relative to the home country, the higher the increase in FDI flows from the home country to both Kenya and Tanzania.*

Additional costs are imposed on FDI by poor quality of institutions such as the cost of dealing with corruption, weak enforcement of law, excessive regulation and bribes as well as low protection of property rights. Literature on FDI determinants demonstrates how the quality of institutions in the host country can promote or deter FDI flows (Globerman & Shapiro, 2002 and Bénassy-Quéré, 2007). Although few studies have investigated FDI determinants to Kenya and Tanzania, even less have extended their analysis to encompass institutional effects.

The judgement on quality of institutions can be a subject of debate because of: One, the way data on institutions quality is collected through local experts, miscellaneous observations or a

survey in one host country (mainly the US). Two, the item selected for inclusion into the government indices and third, the interpretation of some items for example the type of law or the extent of labour market regulations (Bénassy-Quéré, 2007).

This study measures the impact of quality of institutions in a host country on FDI by use of government effectiveness data provided by The World Bank. This measure captures various perceptions such as the quality of public services, the quality of the civil service and the degree of its independence from political pressure and quality policy formulation and implementation and credibility of the commitments of the government to such policies with 0 corresponding to lower rank, and 100 to highest rank (World Bank Governance Indicators, 2018).

This measure is selected because WBGI have been considered as valuable source of data on institutional data. Therefore, the overall effects of institutions quality can be captured by constructing a composed index of these variables (Okafor, 2015). A positive effect is expected for a high-quality institution's impact on FDI into Kenya and Tanzania.

*Hypothesis 3b: The higher the ratio of quality of Kenya and Tanzania's institutions relative to home country the more FDI will be encouraged to flow from the home country to both Kenya and Tanzania.*

Although institutions are key to host country's attractiveness to FDI, researchers that included all institutional factors together such as Cleeve (2008), Mohammed and Sidiropoulos (2010), Anyanwu (2012) and Kariuki (2015) tended to produce insignificant relationship between quality institutions and FDI flows. This is due to factors that make up the institutional variable that tend to offset one another. Thus, corruption is often examined separately. For instance, the negative effects of corruption disappeared and sometimes became positive but statistically insignificant after Al-Sadig's (2009) controlling for other characteristics of the host country such as quality of institutions.

Many authors tend to focus on restrictive corruption which is mainly characterised by distribution of wealth and income in favour of individuals or groups (Omanwa, 2013). However, in what appears to reason against conventional perspective, Kim (2010), argued that countries with high level of corruption in government and low level of democracy have higher FDI inflows while being lower for those with greater political rights. An argument that may support the Chinese FDI inflows to African countries regardless of their high levels of corruption.

This study will use an alternative source of data from World Governing Indicators (WGI) (2018) to measure the control of corruption, which ranks perception of the extent to which public power is exercised for private gain. Percentile rank indicates the country's rank among all countries covered by the aggregate indicator with 0 corresponding to lowest rank, and 100 to highest rank. Like Owusu-Antwi's (2012) and Okafor's (2014) approach, this study expects a negative relationship between corrupt host countries and FDI. However, the type of relationship will depend on the source country. For instance, Chinese firms continue to increasingly invest in Kenya and Tanzania because China is used to dealing with corrupt societies.

*Hypothesis 3c: The higher the ratio of levels of corruption in Kenya and Tanzania relative to the home country the more it will deter FDI inflow from home country to both Kenya and Tanzania.*

#### **3.3.4. Other Factors' Effect on FDI Inflows**

The 2008 financial crisis did not affect Kenya and Tanzania directly but since this study has many countries in OECD that were affected by the financial crisis and they were not able to undertake FDI, it was necessary to include a dummy variable FCRISIS to account for the effect of the crisis on FDI flows into Kenya and Tanzania. Also, there could be other factors that influence FDI flows which could be included in this study, but after surveying the literature, the author did not include them as they were found negligible and infact had already been covered in Hypotheses 1, 2 and 3.

## **CHAPTER 4: RESEARCH DESIGN AND METHODOLOGY**

### **4.1.0. Introduction**

This chapter is an over-arching methodology that discusses the research methods for all three data analysis chapters. However, there will be a short appropriate and specific methodology for every empirical chapter. The chapter is structured in seven main sections namely; a) The research design b) The research philosophy and justification for its choice c) The research approach and justification of its choice d) The research strategy and methodological choice and justification e) Chosen Research Design and Methods f) Sample and data collection and g) The data analytical techniques and justification of their use.

This study is underpinned by a positivist research philosophical perspective which advocates for scientific experimental approach to resolving research problems. Thus, the study adopts a positivist research orientation in exploring and testing the proposed model discussed in chapter 3 (Gill and Johnson, 2002; Baker, 2003, Saunders et. al., 2009 and Creswell, 2014).

### **4.2.0. Research Design**

Research design is a structure for identifying the relationship among the research's variables by outlining the overall structure of the particular research, displaying a logical proof to draw inferences in respect to causal relations among variables being assessed (Bryman and Bell, 2007 and Blumberg et. al., 2008). It is also a detailed plan specifying the type of evidence needed to best answer the research questions or hypotheses with a view to developing a new

theory or test an existing theory accurately (Quinlan et. al., 2019). Research design involves four main areas of research namely philosophies, approaches, strategies and methods which are adopted during the process of investigation (Creswell, 2009). However, the choice of research design highly depends on the research interest. The research interest explains the nature of the problem posed by the research aims and objectives (Walliman, 2017). On the other hand, research design may include the use of multiple types of research methods. For instance, quantitative research design entails descriptive, correlational, quassixperimental and experimental research (Hussein, 2015). In this research design, the researcher adopts methods that provide numerical information that allows the researcher to examine the relationship between variables to enable predictions of and control of outcomes (Hussein, 2015). Therefore, it is expected that the researcher adopts the most suitable research design which has the capacity to answer the research questions under investigations (Bono and McNamara, 2011). This is done by providing the framework for the appropriate research methods on how data will be collected, measured and analysed (Quinlan et. al., 2019)

#### **4.2.1. Research Philosophy**

The research design describes how the researcher views the social world as a way of enquiry. Accordingly, it answers the nature of reality or knowledge (Ontology) and how the researcher understands and acquires knowledge (epistemology) (Hall & Hall, 1996 and Bryman, 2016). Research philosophy is important because it is the basis upon which a researcher chooses a specific research approach, strategy or methods in conducting a piece of research. Any adopted research philosophy in social sciences involves four main elements: epistemology, axiology, ontology and the nature of human behaviour (Bryman and Bell, 2011). Epistemology is a dimension of research philosophy which answers about the most appropriate method of knowledge acquisition. Thus, whether knowledge can be acquired objectively or subjectively (Hall & Hall, 1996 and Bryman, 2012). More significantly, epistemology answers what constitutes an acceptable knowledge. Meanwhile, axiology refers to the values of the researcher and how this is likely to affect the conduct of a piece of research, the research process as a whole and the choice of method of enquiry (Heron, 1996). On the other hand, Ontology refers to the nature of knowledge itself. It questions whether the existence of knowledge is an objective or subjective phenomenon (Bryman, 2012). Finally, human behaviour in research involves numerous assumptions about the ontological differences which exist between social sciences research and that of the physical sciences (Bryman and Bell, 2011). As already mentioned, any adopted research philosophy for a piece of study involves all these elements.

However, Saunders et. al. (2009) argued that despite numerous variations and interpretation of the concept, there are four main research philosophies in social sciences: positivism, interpretivism, realism and pragmatism. The philosophy found relevant to this study is Positivism which is discussed below.

### **Positivism**

Positivism as noted by Gill and Johnson (2002) is a type of research philosophy that adheres to the belief that factual and acceptable knowledge can only be acquired through observation and measurement using human senses. Positivists support ontological realism, the possibility and desirability of objective truth and the use of experimental methodology. Baker (2003) points out that positivism believes that the only way to learn and discover the truth about a research phenomenon is by scientific process. Positivist scholars believe that the scientific process is deterministic, mechanistic, methodical and empirical which makes the researcher independent in the research process. Ultimately, positivism believes that an excessive human engagement in the conduct of a piece of research distorts or dilutes the findings. Therefore, the researcher should be limited to data collection and its interpretation in an objective and observable manner which can be quantitatively analysed (Remenyi et. al., 1998 and Bryman & Bell, 2011).

Positivism is usually criticised on the grounds that it fails to recognise the fact that there is an ontological difference between social science research which involves human engagement and that of natural sciences which involves objects of investigation (Buckingham, 1918). Contrary to natural sciences, social sciences focus on human behaviour which needs to be investigated as to how it behaves the way it does and how it relates to the research results (Laing, 1967 and Gill & Johnson, 2002). As a result, various researchers such as Kennedy (1956), McNemar (1960), Campbell (1978) and Gould (1981) have levelled several criticisms on the positivism approach.

Other critics of positivism argue that it is a pretence to distance the study of social phenomenon from its actors. As such, a researcher who adopts a positivist philosophy cannot be distanced from the phenomenon being investigated (Bryman and Bell, 2011). This implies that the actors' perspective is critical in understanding any study that concerns them. Critics, therefore, conclude that social science cannot fully adopt the natural science principles but rather research in the social sciences should be explained and integrated from the contributions as well as the meanings attributed to it by the actors themselves. Otherwise stated, research in the social

sciences should be understood in relation to the human behaviour of the research participants in the research process.

#### **4.2.1.1. Justification for Research Philosophical Choice**

The researcher believes that there should be objectivity in research whereby research outcomes are not left for subjective interpretation of researchers. Consequently, this study adopts positivism philosophy to investigate determinants and impacts of FDI in Kenya and Tanzania. The choice of this philosophy is justified by; Firstly, several studies in FDI such as Agarwal's (1980), Omanwa's (2013) and Osei's (2014) have adopted qualitative studies, however, they have been criticised for lack of the kind of comprehensiveness which is needed to understand FDI determinants and impacts, hence the call for a quantitative approach which objectively examines various aspect of FDI and its impact on host countries. Therefore, it is important to understand from a quantitative point of view determinants and impacts of FDI in Kenya and Tanzania taking into consideration the various factors that affect attractiveness of the two countries' foreign investments and the impact of FDI on economies and export performance in the two countries. Besides, it has been argued in previous studies such as Gottschalk (2001), Karakaplan et. al. (2005), Dunning (2006; 2008), Zheng (2013), Mijiyawa (2015) and Economou et. al. (2017) that various factors such as market size, growth, openness, human capital, labour, exchange rates, natural resources, institutional framework among others could influence how foreign investors select a location for FDI. Secondly, the study is conducted in scientific nature and the type of data used is secondary and numerical in nature. As such, the research question under investigation demands that positivism research paradigm is adopted to underpin this study. Thirdly, the researcher's belief in the independence of the study from the researcher and hopes this detachment will provide a research that is truly objective.

From the above standpoint, and drawing from studies (Fedderke & Romm, 2006; Sekkat & Veganzones-Varoudakis, 2007, Mateev, 2009 and Ranjan & Agarwal, 2011), it is adopted that the nature of this research lies in the positivist paradigm to fully explore the determinants and impacts of FDI.

#### **4.3.0. Research Approach**

A research approach refers to the process by which theories are generated and tested in social science research (Gill & Johnson, 2002 and Saunders et. al., 2009). It is a general orientation regarding theory and research (Bryman and Bell, 2011). There exist three major broad

approaches in the social science, namely the inductive approach, the deductive approach and the abductive approach. The inductive approach which is qualitative in nature is usually used for theory building whilst the deductive approach which is usually quantitative in nature is used mainly for theory testing. These two approaches can be used to complement each other in any research and that becomes an abductive approach. This study adopts the deductive approach discussed below.

#### **4.3.1. The Deductive Approach**

This approach begins with an existing theory, develops hypotheses, collects and analyses data in order to test a theory (Bryman, 2012). In their approach, the hypotheses are either confirmed or rejected based on the result of the test (Burns & Burns, 2008 and Saunders et. al., 2009). One major strength of this approach is that it helps researchers to determine whether their conclusions are valid or not. However, its weakness lies in the fact that it cannot be used to provide an in-depth understanding of the human behaviour of the actors in research (Popper, 1959 and Bryman & Bell, 2011).

##### **4.3.1.2. Justification for Research Approach Choice**

Having adopted the positivist research philosophy, this study's approach is deductive in that it creates models to represent causal, effect and other relationships drawing on existing theoretical concepts in the literature (Raphael in Monk, and Walsh, 2001 and Wilson, 2010). This approach uses secondary data which this study utilises. As mentioned in chapter 1, this study is investigating determinants and impacts of FDI underpinned by existing theories mainly the OLI paradigm complemented by other models such as investment motivations and the push and pull and demand and supply factors. Regarding impacts of FDI, new growth theories provides ground for empirical assessment of economic growth as do trade theories do same for export performance. This justifies the adoption of the deductive approach in testing the various hypotheses in chapters 3, 6 and 7 regarding the determinants and impacts of FDI.

#### **4.4.0. The Research Strategy and Methodological Choice and Justification.**

A research strategy refers to the general orientation towards a piece of study which is either quantitative or qualitative (Bryman and Bell, 2011). Whilst quantitative strategy is usually associated with quantifications, measurements and analysis of empirical data, the qualitative strategy involves narrative accounts and experiences of numerous actors involved in the study (Flick et. al., 2004). Both quantitative and qualitative strategies have strengths and weaknesses

of which they can be combined creatively to form the mixed strategy and thus serve complementary roles (Denzin, 1970; Denscombe, 2007 and Denzin & Lincoln, 2011). Importantly, any strategy adopted for a particular research should be able to provide direction to the specific methods and techniques that are supposed to be used in the data collection and analysis (Saunders et. al., 2009 and Creswell, 2014).

Research methodology is a key aspect of a study. It refers to numerous procedures and methods that are pursued in conducting a research such as data collection, data analysis and the dissemination of results (Creswell, 2009). For purpose of research replicability, these methods must comply with the scientific process. The quantitative strategy is relevant to this study and was therefore adopted as discussed below.

#### **4.4.1. Quantitative Strategy Paradigm**

A statistical and mathematical approach is taken by quantitative research to measure and analyse causal relationships (correlations or differences) between variables (Gill and Johnson 2002 and Blumberg et. al., 2008). It is a systematic study that entails the use of numerical analysis that provides a narrow and concise description of controlled variables (Muijis, 2011). It is a strategy in research that involves the use of quantification methods in data collection and analysis (Bryman, 2008 and Quinlan et. al., 2019). Quantitative strategy was described by Saunders et. al. (2009) as an enquiry into a human problem or social phenomenon that is based on testing or proving a theory with statistical variables to ascertain whether the theory is true. Polit & Beck (2012) and O'Dwyer & Bernauer (2013) observed that a quantitative study uses a positivist approach of research, which is based on scientific strategy and assumes that realities can be systematically and objectively studied in an orderly manner. According to Punch (2013), one of the advantages of the quantitative strategy is that the findings of the research on which the sample is based could be generalised to a large population. This means that the knowledge gained from the sample of a study can benefit the larger population. In the presence of effective sampling, testing and validating processes, there is a general understanding that quantitative research does contribute to more validated, reliable and generalizable research findings. Good research is characterised by careful sampling, precise measurement, rigorous design and analysis in the test of hypotheses deductively derived from the general to the specific.

This study uses a quantitative strategy because:

- The objective of this study is to establish relationship between FDI and its determinants and impacts, quantitative strategy is most appropriate to establish the relationship. This

approach thus follows the quantitative strategy in some of the previous studies on FDI determinants and impacts such as Asiedu's (2006), Adams' (2009), Zheng's (2009), Anyanwu's (2012), Gui-Diby's (2014), Murshed's (2015), Zhang's (2015) and Economou et. al.'s (2017).

- The proposed models will be able to undergo testing using the quantitative strategy. A quantitative follows the deductive approach drawing from the general to the specific as opposed to the inductive approach, which draws from the specific to the general.
- It will also allow findings of the study to be replicated which can provide a means of checking the extent to which findings are applicable to other contexts.

Having confirmed that the research paradigm determines the type of research to be conducted, the next section considers the various types of data which may be used according to one's worldview (Creswell, 2009).

Data are basically classified as either qualitative or quantitative. This study uses quantitative data. Quantitative data falls in the paradigm of positivism and neopositivism (Adams et. al., 2007). This paradigm is perceived by its proponents as reality in terms of variables and the relationships among them. They therefore approach research with predetermined hypotheses or research questions, conceptual framework and design (Creswell, 2009). One of the main advantages of the quantitative data is that it minimises ambiguity and makes it easier for variables to be ranked and measured as can be seen in disciplines that rely on statistics.

The quantitative secondary data used in this research was collected from multiple data sources and where actual data is not available a proxy was used. Examples of data collection sources for both predictive and control variables entail statistical data released by the central banks and investment authorities which provide official data used by the governments of Kenya and Tanzania for economic planning and forecast. Statistical data from World Bank Economic Indicators was heavily used. The dependent variable dataset was obtained from Kenya Investment Authority (KenInvest) and Tanzania Investment Council (TIC) and the Central Banks of the two countries.

Quantitative secondary data are less likely to be confronted with the problems associated with collecting primary data, for instance data collected using questionnaires, surveys and interviews. Secondary source of information also saves time and resources. Besides, there are far fewer ethical issues to contend with for the researcher, compared to the primary sources. Additionally, this information is generally regarded as more accurate (Adams et. al., 2007).

Analysis and interpretation of secondary data is also relatively easier, since it is usually presented in well-organised and well-presented format to aid understanding, and it is generally peer reviewed.

However, the quality of secondary data for academic research is determined by: Firstly, the reliability of the data (the credibility of the data source). Secondly, the suitability of the data (appropriate for the research enquiry). Thirdly, the adequacy of the data (the data is available adequately for the research period examined) (Quinlan et. al., 2019). As explained above, all the relevant data for this study was collected from reliable sources used by previous empirical studies in IB research. Proxies used for research models are discussed in chapters 5, 6 and 7 to provide justification for their suitability for the research. For data adequacy, all the relevant data was obtained for the period of study with no gaps and any proxies with insufficient data were excluded.

Therefore, secondary sources played an integral part in this study because they provided the basis for the theories and variables as well as data for this research. The purpose of this study was to explore the extent to which the already identified theories and variables explain the determinants and impacts of OECD and non-OECD FDI in Kenya and Tanzania.

#### **4.5.0. Chosen Research Design and Methods**

The choice of research design in business research is determined by the research context, questions, objectives and previous studies within the research discipline (Saunders et. al., 2009). The multi-cultural, multi-dimensional and dynamic nature of the field of IB study lends itself to a broad range of research design, methodologies and methods (Cuerro-Cazurra et. al., 2016). This study draws its research theoretical and philosophical assumptions from the positivist, quantitative and deductive research approach (Burrell and Morgan, 2016). In IB research, quantitative and positivistic empirical methods are well established especially within the area of macroeconomic determinants and impacts of FDI (Fallon and Cook, 2010; Guidiby, 2014; Erdogan & Unver, 2015 and Zhang, 2015). Several authors such as Birkinshaw (2004), Welch and Welch (2004) and Hurmerinta-Peltomäki and Nummela (2006) have observed that leading journals in IB favour quantitative papers compared to qualitative papers. Nevertheless, the same authors have reiterated that IB qualitative research is equally useful (usually at microlevel) exploring the complex plurality of institutional, cultural and organisational factors.

Combining qualitative and quantitative methods in IB however has been criticised mainly for the lack of consistency in the implementation of triangulation approach between studies (Creswell & Creswell, 2017). Furthermore, the impact of any research work depends on the appropriateness and rigour of the methods employed. As such, researchers need to enhance the contextualisation of the research phenomenon to enhance the rigour of IB research and to make IB research more relevant for practitioners (Teagarden et. al., 2018). Advancing IB research goes beyond formulating novel dependent or independent variables, it is about applying the appropriate theories, concepts, data and methods to address the research phenomenon (Cheng et. al., 2009). As mentioned earlier, deductive research approach begins by identifying and reviewing the relevant theory to be tested, develops set of hypotheses from the theory, collects quantitative data for empirical analysis to either accept or reject the hypotheses (Saunders et. al., 2009; Soiferman, 2010 and Wilson, 2010). Deductive research employs quantitative data to test for causal relationships to either accept or reject the hypotheses (Burns and Burns, 2008; Jones, 2014 and Creswell & Creswell, 2017). Therefore, the approach adopted in this thesis supports the choice of quantitative methods to address the research objectives.

#### **4.6.0. Sample and Data Collection**

This research investigates FDI's determinants and impact in Kenya and Tanzania. As discussed in chapter 2 of this study, Table 4.1 shows panel data series set at country level that represent 22 home countries who invested in Kenya and whose investments accounted for 87% (USD. 9,135 million) of total Kenyan inward FDI. The same Table 4.1 shows 23 home countries who invested in Tanzania and whose investment accounted for 85% (USD. 15,792 million) of total Tanzanian inward FDI. Given that the empirical objective of this study is to examine the heterogeneity of investing MNEs linked to their country of origin, the data for both Kenya and Tanzania covers a time period of 21 years, from 1996-2016. All major investing countries have been covered in the two panel datasets. The start date of 1996 was included as no significant FDI amounts were received until after 1995.

The research datasets were organised into three categories. The first group is the Kenyan and Tanzanian pools of all the 22 and 23 home countries respectively. The second category is the OECD countries comprising of 12 for Kenya and 13 for Tanzania respectively. The final category is the non-OECD countries comprising of 10 for Kenya and Tanzania. Originally, the data series covered 28 countries that invested in Kenya and 30 countries that invested in Tanzania. However, due to complications with round tripping and tax havens a total of 6 and

7 tax havens respectively for Kenya and Tanzania were excluded, reducing the dataset to 22 for Kenya and 23 for Tanzania as shown in Table 4.1. This was done to avoid biased results, and to maintain a good number of observations sufficient to produce robust estimates.

**Table 4.1. Sample of Top Home Countries for Kenyan and Tanzanian FDI**

For Kenya			For Tanzania		
Australia	India	South Africa	Australia	India	South Africa
Belgium	Japan	Switzerland	Belgium	Iran	Spain
Canada	Korea Rep.	Tanzania	Botswana	Ireland	Sweden
China	Netherlands	Uganda	Canada	Italy	Switzerland
Egypt	Nigeria	United Kingdom	China	Kenya	Uganda
France	Norway	United States	Denmark	Malaysia	United Kingdom
Germany	Pakistan		Egypt	Norway	United States
Hong Kong	Saudi Arabia		France	Pakistan	

*Source: Created by author based on data from Kenya Investment Authority (KeInvest) and Tanzania Investment Council (T.I.C) Databases.*

#### 4.7.0. Data Analytical Techniques

Data analysis is the process used to summarise, categorise and order data to make meaningful outcome from the data (Burns and Grove, 2007). For this study, the secondary data is analysed quantitatively using panel data analysis. Panel data or longitudinal is a dataset which allows exploration of time series and cross-sectional data. Also, Panel data is seen as the pooling of observations across sections (denoting subscript  $i$ , in this case of investing home countries in Kenya and Tanzania) and overtime (represented by subscript  $t$  in this case 1996-2016). The choice of panel data is associated with the accuracy in estimating parameters. For instance, panel data provides reliable estimates with observation with fewer time-series and cross-sectional dimensions compared to pure time-series and/or cross-sectional dataset (Baltagi, 2008 and Hsiao, 2014). Panel data analyses have been considered to be more robust in controlling the effects of omitted variables in model estimation, which can be associated with the information power of panel database- thus comprising both cross-sectional and time-series data. Additionally, Panel data analysis reduces the likelihood of collinearity among explanatory variables, increases the degree of freedom, given more sample validity, and improves efficiency with smaller standard errors (Baltagi, 2008).

In spite of the well-established advantages of panel data in the literature, the complex structure of panel data also poses some experimental problems (Baltagi, 2008 and Hsiao, 2014). These problems can be minimised by the study model being supported with established theories and

that the data collection is based on valid instruments to minimise the likelihood of attrition. In IB/FDI study, especially in macroeconomic determinant studies, empirical models are analysed using economic and social-political facts that are well established with relevant theories (Erdogan and Unver, 2015 and Zhou, 2016). Drawing on extant empirical studies in developing this study model, will minimise possible problems of measurement errors, selectivity problems and/or attrition.

The generic panel data specification model can be written as:  $y_{it} = \alpha + \beta_1 X_{it} + \beta_2 X_{it} + \dots + \beta_n X_{nit} + \varepsilon_{it}$  .....(1).

In the model above  $i$  indicates the observation units organised into three separate estimation models including: full sample (Kenya and Tanzania) level; and then disaggregated into OECD and non-OECD home countries,  $t$  represents time, thus 2006 to 2016,  $y$  is an indicator for FDI for each observation unit in time  $t$ ,  $X$  is an indicator for the predictive and control variables in the study and  $\varepsilon$  is an indicator for error terms. The above model is made up of two parts; the deterministic parameters and the error term. The error term is made up of two error components thus,  $\varepsilon_{it} = c_i + v_{it}$

$c_i$  is omitted variable peculiar to each individual observation unit and does not change over time (for instance, geographical location, unchanging political and economic factors). However,  $v_{it}$  is an idiosyncratic variable that varies across individual observation unit and overtime. That is,  $v_{it}$  is usually assumed to be well behaved. If;  $Cov(\varepsilon_{i,xit}) = 0$  then the above model can be estimated using ordinary least square (OLS) estimator. OLS was used in test estimations of this study. However, the reported regression results were run on fixed and random forms of panel data due to the uniqueness of data on a combination of several countries and variables. This is because OLS estimator would not account for the uniqueness of such data.

#### 4.7.1. Panel Data Analysis

The use of panel data to estimate econometric models is now widely used due to its advantages (discussed in section 4.7.0 of this chapter) in quantitative studies (Bond, 2002). This study empirically investigates the determinants and impacts of FDI in Kenya and Tanzania at the aggregate country level, OECD and non-OECD home countries. The choice of panel data analysis is that it allows for a more robust analysis with less potential for endogeneity problems (Baltagi, 2008). This study is therefore conducted using normal panel data estimators.

#### **4.7.1.1. Types of Panel Data Models**

Literature presents two options for running panel data regressions, fixed effect (FE) and the random effect (RE) models. An FE value is one that is assumed to be measured without error, it is also assumed that the values of an FE variable in one study are the same as the values of a fixed variable in another study. RE is assumed to be values that are drawn from larger population of values and thus will represent them (Raudenbush and Bryk, 2002). FE are constant across individuals and RE vary. For instance, in a growth study, a model with RE intercepts  $a_i$  and fixed slope  $b$  corresponds to parallel lines for different individuals  $i$ , or model  $y_{it} = a_i + bt$ . Thus, distinguishing between FE and RE (Kreft and De Leeuw, 1998 and Snijders & Bosker, 2011). The FE modelling has been the “gold standard default” due to its frequent use other than RE in fields of economics and political sciences. RE models, also known as multilevel models, hierarchical linear models and mixed models have however gained increased prominence in political sciences and is regularly used in Education and Geography (Jones, 1991; Beck & Katz, 2007 and O’connel & McCoach, 2008).

#### **4.7.1.2. Strengths and Weaknesses of Fixed and Random Forms of Data.**

Researchers use FE when they are interested in analysing the impact of variables that vary over time. The relationship between predictor and outcome variables within an entity are explored and each entity has its own individual characteristics that may or may not influence the predictor variables. When it is assumed that something within the individual may impact or bias the predictor or outcome variables, FE is used, while controlling for this is done. The removal of these effects of those time-invariant characteristics by FE enables the researcher to assess the net effect of the predictors on the outcome variable (Torres-Reyna, 2015).

A strength of RE is that it has greater flexibility and generalizability and ability to model context including variables that are only measured at the higher level. FE on the other hand has a weakness of effectively cutting out of “what is going on” that could be of interest to the researcher, which can lead to misinterpretation. RE models can explain and reveal specific differences between higher-level entities whereas the fixed dummy coefficients in the FE are measured unreliably (Bell and Jones, 2015).

The study intended to use both fixed and random effects as they capture both features hence more appropriate based on the approaches of some researchers such as Akin (2009), Zheng (2009) and Okafor (2014). However, using both effects at the same time may not be suitable to the study, hence the Hausman Test will be run to determine which model is significant and

reliable in each empirical chapter's data. For instance, where null hypothesis is the preferred model (random effect) and alternative hypothesis is the fixed effect, if the test results into null hypothesis is  $<0.05$ , then the study would use fixed effect (Green, 2008). The results of this test are reported in the three individual empirical chapters of this study.

#### **4.7.2. Improving Efficiency and Diagnostic Tests**

Certain assumptions regarding issues of Normality, Multicollinearity, Heteroskedasticity and Endogeneity need to be satisfied before panel data analysis is conducted. A key assumption of regression analysis relates to the symmetry of data distribution (thus, data normally distributed). Improving the symmetry of data distribution, i.e. to minimise or eliminate other potential problems associated with heteroskedasticity and endogeneity (Sekaran & Bougie, 2016 and Wooldridge, 2016)

There are three main situations among others where log transformation is accorded special considerations namely, skewness, nature of the data and mean variation (Schwarz, 2011). Logs are taken to make data conform to normality thus ensure that the relationship between right side variables (RHS) i.e. (independent variables) and left-hand side variables (LHS) i.e. dependent variables are approximately linear. According to Woodridge (2016) the logarithmic transformation is often used when the data are positive and exhibit skewness to the right. However, where the data has negative values, a constant value is added to the dataset to eliminate negative values before log transformation (Woodridge, 2016).

The logarithm acts by squeezing the right tail of the distribution and stretching the left tail, which produces a greater degree of symmetry in data distribution (Schwarz, 2011). The second situation relates to data in which by their nature tends to skew, thus data defined as a ratio (Schwarz, 2011). Data with such values tend to have a common pattern of unequal variation with a large mean and large standard deviations (Wooldridge, 2016). With this pattern of variation, the log transformation can equalise the variation squeezing the groups with the larger standard deviations more than it will squeeze the groups with the smaller standard deviations (Schwarz, 2011). The key point in using logs in the regression analysis is that they allow for the interpretation of coefficients in percentage (%) terms (Brooks, 2008 and Wooldridge, 2016).

It is worthwhile to note that, not all cases do conducting a log transformation make the RHS variables to be normally distributed or the LHS variable to be constant variance (i.e. the variance of the dependent variable is independent of the predictive variables) (Balnaves &

Caputi, 2001 and Schwarz, 2011). Log transformation may not perfectly eliminate asymmetry in data distribution (Schwarz, 2011). In this case, only some of the RHS variables in the model may need to be transformed to meet the normality assumptions (Sekeran & Bougie, 2016 and Wooldridge, 2016). However, the log transformation of all variables (both LHS and RHS) is useful when the input variables have a multiplicative effect on the outcome variable (Wooldridge, 2016). Furthermore, much of the confusion about log transformation is about the form of the logarithmic transformation. For instance, many statistical packages or calculators have differentials between the common logarithm (base 10, or log) and the natural logarithm (base e or ln). The form of log used does not matter as long as the proper back-transformation is applied to the original scale measurement. Consequently, in this study, a log 10 transformation is conducted due to the nature of data (i.e. ratios) and the pattern of mean variations as explained in sections 5.3.1, 6.4.3 and 7.4.3.

### *Multicollinearity*

Multicollinearity exists if the two or more predictors correlates very highly in the regression model. There are numerous ways of scanning the correlation matrix of predictor variable to detect if they are highly correlated, usually above 0.80 or 0.90, or through the value of Tolerance and Variance Inflation Factors (VIF). The rule of the thumb is that the Tolerance value should not be above 0.10 whilst the VIF value should not be above 10 (Cameron and Trivedi, 2010). Another important assumption is that the variance of errors is the same across all levels of the independent variables. Lest, when variance errors differ at different levels of the independent variables, there is heteroskedasticity. In this study, several theoretical and practical checks such as Breusch-Pagan test were conducted to identify and remove heteroscedasticity, linked to omission of variables, non-linearities or aggregation. Each sampled equation was differently tried, and the problem was tested by Levene and the Mackinnon and White tests. However, heteroscedasticity was not identified in any of these tests.

### *Endogeneity Problems*

If there is a correlation between  $X$  and  $\epsilon$ , then the OLS assumption of exogeneity is violated. If this occurs  $X$  is said to be an endogenous variable. The effect is that the coefficient of  $X$  in OLS regression is biased and inconsistent. Endogeneity bias, as noted by Bliese et. al. (2020) could lead to inconsistent estimates and incorrect inferences, which may provide misleading conclusions and inappropriate theoretical interpretations. Also, endogeneity bias could even

lead to coefficients having the wrong sign. It was further argued by Ketokivi and McIntosh (2017) that it is almost impossible to ensure that an endogeneity problem can completely be resolved statistically. As such, there are no direct tests for endogeneity, the options of indirect tests and precautionary measures can help to guide relevant insights and conclusions. However, this study did not test or encounter endogeneity problems.

#### **4.7.3. Data Validity and Reliability**

Researchers need to adopt different strategies to maximise different kinds of validity. In case of this specific research, whose main undertaking is to establish the relationships between FDI and other variables, quantitative methods are more effective in solving the concerned issues.

Therefore, the content validity is optimised and operationalisation of each measurement is checked against the relevant content domain for the construct through extensive literature review. The study also makes efforts to use measures that have been previously tested.

External validity of this research has been achieved by adopting a quantitative research strategy followed by a critical review of all relevant research fields with aim of establishing theoretical foundations and cross-comparison with previous research findings.

Reliability demonstrates that operation of the study can be repeated, and the same results achieved. It is more emphasized in quantitative study (Bryaman & Bell, 2007 and Creswell, 2009) which is the approach in this study. For this research purpose, reliability answers whether the same factors would be identified as the determinants of FDI and impacts in Kenya and Tanzania, if the methodology was repeated at later date.

#### **Ratios**

Drawing on previous studies on determinants and impacts of FDI such as Zheng's (2009), Sanfilippo's (2010) and Anyanwu's (2012), this study changed all variables into ratios to maintain consistency. Nair-Reichert and Weinhold (2001) have submitted several advantages of using relative values. Firstly, growth rates can determine the relationship between variables over time in a specific region. Secondly, use of relative values of the variable is like that the variable will be stationary and avoid the problem of spurious regression.

## **Summary**

This chapter presented an extensive review of the methodological literature reviewing alternative research design, philosophies and paradigms in conducting academic research. It was further revealed that the choice of research methodologies and methods depends on the specific or combination of the different research philosophies and paradigms chosen by the researcher. However, research philosophies and paradigms adopted in conducting research are largely influenced by different cultural and professional assumptions of the research discipline. Owing to its having roots in multicultural and multidimensional field of study, FDI/IB research elects itself to a broad range of research designs, methodologies, and methods. This study employs research design, methodology and methods that are quantitative in nature. The choice of a quantitative research approach is considered appropriate because this study seeks to investigate the causal effects of specific determinants and impacts of inward FDI in Kenya and Tanzania. This approach corroborates with previous studies on FDI determinants and impacts in FDI/IB literature. The quantitative data of the study is analysed using panel data on reviews software.

## **CHAPTER 5: DETERMINANTS OF FDI**

### **5.1.0. Introduction**

This chapter conducts an empirical analysis of specific determinants of FDI flows into Kenya and Tanzania. The analysis will also investigate determinants of FDI in the two countries to consider the heterogeneity of the investing MNEs from home countries grouped into OECD and non-OECD countries. This approach allows for an easy comparison of results to provide greater insight into similarities and differences of determinants of FDI among MNEs investing in Kenya and Tanzania. The study extends our understanding of FDI by providing empirical evidence of the different strategies and the specific factors that attract FDI into Kenya and Tanzania. As such, this chapter focuses on model creation, variable description, the preliminary data analysis and interpretation of the results of FDI determinants synthesized with relevant literature. It aims to test the hypotheses in chapter three and provide reasons behind the acceptance or rejection of each hypothesis.

### **5.2.0. The FDI Location Model and Variable Specifications**

The main part of research design has already been discussed in chapter 4 of the Methodology. However, in the context of determinants of FDI, this is extended further.

As showed in the research analytical framework in Figure 3.1. of chapter 3, this chapter provides empirical evidence based on an analysis of complementary set of hypotheses following a structural approach to modelling of MNEs and FDI determinants between and within heterogeneous home country groups in Kenya and Tanzania. This approach is grounded

in the relevant theoretical and empirical literature in chapter 3 in which the research's main empirical model is developed.

The basic model underlying the multiple regression analysis (MRA) was developed from the FDI location literature (Billington, 1999 and Fallon & Cook, 2014). Table 5.1 details the nature, measures, sources and definitions of variables used in the MRA to estimate the determinants of FDI flows into Kenya and Tanzania. Regarding the study units of analysis, with the exception of dummies, all variables employed are presented in ratio form for Kenya and Tanzania using the following format: host country ÷ home country.

The first stage is to determine the signs of the various explanatory variables. There are variables argued to be positively related to expected attractiveness for inward FDI. From the literature, such variables can be identified as market size, market growth, human capital, labour costs, trade openness, infrastructure development, natural resources, agglomeration economics, cultural distance, colonial ties, political stability and quality of institutions (Asiedu, 2002; Cleeve, 2008; Anyanwu, 2012; Kinyondo, 2012 and Osei, 2014).

There are also variables that are negatively related to attractiveness of a country to foreign investors and from the literature these variables can be identified as inflation and corruption which are deemed to both deter FDI flows as they have often been cited as having a negative impact on FDI (Biswas, 2002; Kinuthia, 2012 and Omanwa, 2013). As mentioned in section 4.7.3 of the methodology chapter, this study has changed all variables into ratios to maintain consistency and enhance compatibility of variables. This draws support from previous IB studies such as (Zheng & Tan, 2011; Zheng, 2013 and Wooldridge, 2016). However, two dummies Colonial Ties (COLT) and Financial Crisis (FCRISIS) were not converted into ratios because of their unit measures that were presented as single numbers.

Therefore, based on theoretical hypotheses presented in chapter three and the structure of Kenya and Tanzanian economies as well as characteristics of FDI flows to the two countries, the estimated model below determining FDI flows to the two countries is shown as:

FDI = f(market size, market growth, human capital, total labour force, trade openness, exchange rate, inflation, infrastructure, total natural reserves, agglomeration economics, cultural distance, colonial ties, political stability, quality of institutions and control of corruption).

Therefore, the panel data model can be written as follows:

$$RFDI_{it} = \alpha + \beta_1 RGDP_{it} + \beta_2 RGGDP_{it} + \beta_3 RHCAP_{it} + \beta_4 RTLFORC_{it} + \beta_5 ROPEX/IM_{it} + \beta_6 RIMP_{it} + \beta_7 REXP_{it} + \beta_8 ROEXR_{it} + \beta_9 RINF_{it} + \beta_{10} RTNR_{it} + \beta_{11} RITN\_100P_{it} + \beta_{12} RMOBL\_100P_{it} + \beta_{13} RAGGL OM_{it-1} + \beta_{14} RCD_{it} + \beta_{15} COLT_{it} + \beta_{16} RQINST_{it} + \beta_{17} RPOLIST_{it} + \beta_{18} CORPTN_{it} + \beta_{19} FCRISIS_t + \varepsilon_{it} \quad 1.$$

In the model above, R denotes the ratio value,  $i$  represents the sample of home countries of MNEs investing in Kenya and Tanzania at time  $t$ . The data for  $i$  and  $t$  are analysed in separate analyses which include Kenya and Tanzania as a whole (also referred to as the full sample), OECD countries (an analysis of only OECD countries) and non-OECD countries (an analysis of only non-OECD countries).  $t$  is an indicator for time i.e. 1996-2016 and  $\varepsilon$  denotes an error term. The specification of dependent and independent (pred

ictors and controls) variables are listed in Table 5.1.

**Table 5.1. The determinants of Inward FDI to Kenya and Tanzania.**

Variable	Proxy	Expected Sign	Source	Definition
FDI (dependent variable)	RFDI		Kenya Investment Authority (KenInvest) for Kenya, Tanzania Investment Centre (TIC) for Tanzania and UNCTAD.	Ratio of annual FDI received by host country from each home country to the total annual FDI received by Kenya and Tanzania (KenInvest, 2018, TIC, 2018 and UNCTAD, 2018).
<b>Economic Factors</b>				
Market Size (predictor)	RGDP	+	World Indicators	Development Ratio of host to home country's GDP Size (WDI, 2018).
Market Growth (predictor)	RGGDP	+	World Indicators	Development GDP growth ratio of host country to home country (WDI, 2018).
Human Capital (Predictor variable)	RHCAP	+	World Indicators	Development Ratio of host to home country's ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of education shown % (WDI, 2018).
Total Labour Force (Predictor)	RTLFORC	+	World Indicators	Development Ratio of host to home country's labour force comprises people ages 15 and older who supply labour for the production of goods and services during a specified period (WDI, 2018).
Openness to Trade (control variable)	ROPEX/IM	+	Ratio of home to host countries' ratio of trade (imports and exports) to GDP (WDI, 2018).	Host to home countries' ratio of trade (imports and exports) to GDP (WDI, 2018).

Imports (Control Variable)	REXP		World Indicators	Development	Ratio of host to home country's imports which is obtained as a % of trade (WDI, 2018).
Export (Control Variable)	RIMP		World Indicators	Development	Ratio of host to home country's exports of goods and services which is obtained as a % of trade (WDI, 2018).
Exchange Rate (Control variable)	ROEXR	+	International Statistics Yearbook	Financial	Ratio of Real effective exchange rate between the host and home country (WDI, 2018).
Inflation (control variable)	RINF	-	World Indicators	Development	Ratio of inflation rate between host and home country (Consumer Prices {Annual %}). (WDI, 2018).
Infrastructure (control variable)	RINFR: 1.Internet users 2.Mobile Cellular Subscriptions	+	World Indicators	Development	Ratio of host to home country's 1.Internet users/100 people 2.Mobile Cellular Subscriptions (per /100 people) (WDI, 2018).
Total Natural Reserves (control variable)	RTNR	+	World Indicators	Development	Ratio of host to home country's total natural resource rents (sum of oil rents, natural gas rents, coal rents and mineral rents) (WDI, 2018).
Agglomeration (control variable)	RAGGLOM	+	UNCTAD Database		Ratio of host to home country's one year lagged FDI stock (WDI, 2018).
<b>Social-Cultural Factors</b>					
Cultural Distance (control variable)	RCD	+	Hofstede's Model of Dimensions of National Culture		Ratio of the bilateral score between host and home country (range of 0-100) Hofstede's Model of Dimensions of National Culture (2018).
Colonial Ties (Dummy)	COLT	+	CEPII Website		Colonial ties: sharing colonial history.
<b>Political and Institutional</b>					
Quality of Institutions (control variable)	RQINST: Government effectiveness	+	World Bank Indicators	Governance	Ratio of host to home country's extent to which the misuse of power for private gain is controlled (WGI, 2018).
Political Stability (control variable)	RPOLIST: Political Stability rating index	+	World Bank Indicators	Governance	Ratio of host to home country's likelihood of government being overthrown or destabilised by unlawful means (WGI, 2018).
Control of Corruption (control variable)	CORPTN: Control of corruption percentile index.	+	World Bank Indicators	Governance	Ratio of host to home country's corruption score) (WGI, 2018).

#### Others

Financial Crisis (Dummy)	FCRISIS	-	Dummy	Financial Crisis of 2008.
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*Source: created by author from literature review.*

### **5.2.1. Variable Descriptors**

This section is a summary of the literature discussion in section 3.3.0. of chapter 3 on all variables used in this empirical chapter, to enable testing of the hypotheses developed.

#### *5.2.1.1. The Dependent Variable*

The dependent variable in this empirical chapter is the ratio of annual FDI received by host country from each home country to the total annual FDI received by Kenya and Tanzania. The choice of the dependent variable was based on data obtained from UNCTAD, KenInvest and T.I.C databases since other similar sources such as FDI Intelligence database did not meet the empirical objective of this study in examining the heterogeneity of investing MNEs grouped into OECD and non-OECD countries. This is because the FDI Intelligence database only uses green field investment. Similar studies such as Asiedu (2002), Zheng (2009 and 2013) and Kinuthia and Murshed (2015) used similar dependent variable in their analysis of FDI determinants in SSA, China and Kenya respectively.

#### *5.2.1.2. The Predictive Variables*

The research investigates the main determinants of FDI using a complementary set of hypotheses developed to model the factors that attract FDI flows from the home country to the host country. In model 1 above, the first predictive variable is market size proxied by Kenya and Tanzania's ratio of GDP size relative to the home country of the foreign MNEs, followed by a similar ratio of market growth proxied by GDP growth rate. As discussed in chapter 3, MNEs relocate their investments to foreign locations with high market potential to produce goods and services for the host market consumption. Other predictive variables used in this empirical chapter and already discussed in chapter 3 section 3.3.0, include ratios of host to home country's human capital and labour costs.

#### *5.2.1.3. The Control Variables*

A number of control variables support the predictive effect of the empirical analysis. These controls include; openness to trade, import, export, exchange rate, inflation, infrastructure, total

natural resources, agglomeration, cultural distance, colonial ties, quality of institutions, political stability and control of corruption.

*Selection of Independent Variable:* The selection of explanatory variables for MRAs was influenced by theoretical issues and data availability. A range of variables reflecting different specific motives for FDI location linked to other explanatory variables was considered in turn for each sample following a procedure by Judd & McClelland (2011) and Fallon & Cook (2014).

### **5.3.0. Data Analysis**

This section provides details of the descriptive and analytical statistics conducted on specific determinants of FDI in both Kenya and Tanzania. The study data series for the full sample covers 22 home countries for Kenya and 23 for Tanzania for a total period of 21 years amounting to 462 and 483 observations for Kenya and Tanzania respectively. The OECD countries include 12 countries for Kenya and 13 for Tanzania for the same period amounting to 252 observations for Kenya and 273 for Tanzania. Non-OECD countries include 10 countries and 210 observations for Kenya and Tanzania.

#### **5.3.1. Pre-Estimation Tests**

Table 5.2 reports the descriptive statistics for the variables used in estimation for determinants of FDI flows to Kenya and Tanzania before log transformation and Table 5.3 after log transformation. The difference of mean of inward FDI flows (RFDI) to the two countries is 0.003, with 0.045 for Kenya and 0.042 for Tanzania respectively. As shown in Table 5.2, it is observed that the datasets for both Kenya and Tanzania have an unequal variation with large means and large standard deviations for one predictor i.e. GDP growth rate (RGGDP) and six control variables namely, rate of exchange (ROEXR), inflation (RINF), mobile cellular subscriptions (RMOBL\_100), internet users (RINTR\_100P), total natural resources (RTNR) and political stability (RPOLIST). To conform the datasets to normality, log transformation was done to equalise the variation squeezing the groups with the larger standard deviations and stretching data with the smaller values and standard deviations as displayed in Table 5.3 (Schwarz & Suedekum, 2011 and Okafor, 2015). Drawing from approaches of similar studies such as Zheng et. al.'s (2013), Model 2 is structured to investigate the log-log relationship of

the impact of the main predictive variables on the dependent variable more directly in terms of elasticity and provides more control over the interaction of the variables. This is consistent with previous studies (such as Kumar, 2001 and Falk, 2014) that have suggested that logs transformation helps to improve the normality of the data series.

**9Table 5.2. Descriptive Statistics Before Log Transformation for Kenya and Tanzania.**

Sample Countries	Kenya				Tanzania			
	Mean	Std. Dev.	Minimum	Maximum	Mean	Std. Dev.	Minimum	Maximum
FDI (RFDI)	0.045	0.026	0.000	0.208	0.042	0.022	0.001	0.139
GDP (RGDP)	0.225	0.522	0.001	2.929	0.248	0.557	0.001	3.171
GDP Growth Rate (RGDP)	1.774	3.578	-9.306	58.994	1.490	10.958	-194.859	37.491
Human Capital (RHCAP)	0.855	0.812	0.230	6.622	0.290	0.222	0.010	1.277
Total Labour Force (RTLFORC)	1.254	1.440	0.016	6.769	3.185	5.080	0.020	25.782
Openness (ROPEX/IM)	1.040	0.552	0.102	3.094	0.804	0.388	0.152	2.407
Imports (RIMP)	1.226	0.610	0.126	3.550	0.938	0.422	0.200	2.816
Export (REXP)	0.884	0.550	0.077	2.852	0.685	0.396	0.103	2.132
Exchange Rates (ROEXR)	32.661	36.595	0.030	149.995	553.515	616.967	0.064	3042.403
Inflation (RINF)	3.746	6.051	-37.760	67.217	3.809	5.513	-25.511	54.857
Internet Users (LRINTR_100P)	0.762	1.378	0.000	8.930	0.111	0.169	0.000	1.456
Mobile cellular subscriptions (LRMOBL_100P)	0.751	3.482	0.000	72.058	0.422	0.454	0.001	3.236
Total Natural Resources (RTNR)	3.435	12.576	0.059	221.726	5.197	9.280	0.148	132.705
Agglomeration (RAGGLOM)	0.074	0.217	0.000	2.341	0.406	0.920	0.000	4.430
Cultural Distance (RCD)	1.158	0.183	0.834	1.542	1.142	0.281	0.272	1.661
Colonial Ties (COLT)	0.591	0.492	0.000	1.000	0.565	0.496	0.000	1.000
Quality of Institutions (RQINST)	0.658	0.540	0.289	3.600	0.564	0.281	0.246	1.431
Political Stability (RPOLIST)	0.719	1.957	0.100	28.000	1.929	7.610	0.219	97.000
Control of Corruption (RCORPTN)	0.447	0.761	0.120	10.000	0.604	0.673	0.138	7.407
Financial Crisis (2008) (FCRISIS)	0.900	0.300	1.000	1.000	0.905	0.294	0.000	1.000

Drawing on previous studies on the determinants of FDI such as Zheng's (2009), Sanfilippo's (2010) and Anyanwu's (2012) and considering the results of the correlation analysis in 5.2, all variables were expressed in natural logarithms except dummies. This transformation, as noted by Baum (2001) and Baltagi et. al. (2005) was meant to reduce the risk related to heteroscedasticity which is nevertheless common in cross-country analysis.

Single equation, multivariate, regression models were developed for each sample of home countries using an estimation procedure based on a Poisson-type model, with FDI (proxied as the ratio of FDI received by host country from home country to the total annual FDI received by Kenya and Tanzania) being used as the dependent variable in each case. The method employed throughout was to regress a range of potential explanatory variables on this

dependent variable until ‘best fit’ models were obtained for both Kenya and Tanzania. Six separate best fit models are estimated, three for each host country representing FDI flows from full sample, OECD and non-OECD respectively.

Therefore, based on theoretical hypotheses presented in chapter three and the results of the correlation matrix in the preliminary analysis, the following is a transformed version of the model in section 5.2.0. It has been developed to bring back the normalcy in the previous model by taking logs.

Therefore, the transformed panel data model can be written as follows:

$$LRFDI_{it} = \alpha + \beta_1 LR GDP_{it} + \beta_2 LR GGDP_{it} + \beta_3 LR HCAP_{it} + \beta_4 LR TLFORC_{it} + \beta_5 LR OPEX/IM_{it} + \beta_6 LR I MP_{it} + \beta_7 LR EXP_{it} + \beta_8 LR OEXR_{it} + \beta_9 LR INF_{it} + \beta_{10} LR TNR_{it} + \beta_{11} LR ITN\_100P_{it} + \beta_{12} LR MOBL\_10 OP_{it} + \beta_{13} LR AGGLOM_{it} + \beta_{14} LR CD_{it} + \beta_{15} LR COLT_{it} + \beta_{16} LR QINST_{it} + \beta_{17} LR POLIST_{it} + \beta_{18} LR CORPTN_{it} + \beta_{19} LR CRISIS_t + \varepsilon_i \quad 2.$$

In the model above, L indicates logged values, *i* is an indicator for the observation units organised into three separate estimation models including: pooled Kenya and Tanzania level; and then disaggregated into OECD and non-OECD home countries, *t* is an indicator for time i.e. 1996-2016 and  $\varepsilon$  denotes error terms.

The log-log model 2 (derived from model 1 in section 5.2.0) will be able to measure the impact of the main predictive variables on the dependent variable more directly in terms of elasticity and provide more control over the interaction of the variables (Zheng, 2013). The model follows Dunning’s (1988 and 2001) proposal that suitable factors in a host country would influence higher FDI flows from the investing MNEs’ home country into the host countries such as Kenya and Tanzania

**10Table 5.3. Descriptive Statistics After Log Transformation for Kenya and Tanzania.**

Sample Countries Variables	Kenya				Tanzania			
	Mean	Std. Dev.	Minimum	Maximum	Mean	Std. Dev.	Minimum	Maximum
FDI (LRFDI)	-3.302	0.758	-7.716	-1.569	-3.332	0.650	-7.287	-1.970
GDP (LRGDP)	-2.999	1.684	-6.727	1.075	-2.956	1.726	-7.128	1.154
GDP Growth Rate (LRGGDP)	0.021	1.261	-3.727	4.077	0.639	0.786	-1.329	3.624
Human Capital (LRHCAP)	-0.401	0.626	-1.470	1.890	-1.514	0.790	-4.632	0.244
Total Labour Force (LRTLFORC)	-0.515	1.425	-4.161	1.912	0.164	1.602	-3.915	3.250
Openness (LROPEX/IM)	-0.123	0.620	-2.285	1.129	-0.345	0.529	-1.884	0.878
Imports (LRIMP)	0.061	0.585	-2.071	1.267	-0.172	0.486	-1.609	1.035

Export (LREXP)	-0.334	0.696	-2.562	1.048	-0.549	0.606	-2.270	0.757
Exchange Rates (LROEXR)	1.985	2.482	-3.517	5.011	5.002	2.458	-2.753	8.020
Inflation (LRINF)	1.086	0.953	-1.882	4.208	0.986	0.962	-1.607	4.005
Internet Users (LRINTR_100P)	-1.739	2.102	-7.633	2.189	-3.339	1.865	-9.328	0.376
Mobile cellular subscriptions (LRMOBL_100P)	-1.713	2.219	-7.962	4.277	-1.861	1.905	-6.887	1.174
Total Natural Resources (LRTNR)	0.345	1.307	-2.837	5.401	1.057	1.133	-1.911	4.888
Agglomeration (LRAGGLOM)	-4.347	1.753	-8.134	0.851	-2.910	1.963	-7.675	1.488
Cultural Distance (LRCD)	0.134	0.159	-0.182	0.433	0.087	0.347	-1.301	0.508
Colonial Ties (COLT)	0.591	0.492	0.000	1.000	0.565	0.496	0.000	1.000
Quality of Institutions (LRQINST)	-0.605	0.538	-1.243	1.281	-0.675	0.431	-1.401	0.358
Political Stability (LRPOLIST)	-1.093	0.965	-2.308	3.332	-0.310	0.988	-1.519	4.575
Control of Corruption (LRCORPTN)	-1.255	0.793	-2.119	2.303	-0.851	0.768	-1.982	2.002
Financial Crisis (2008) (FCRISIS)	0.900	0.300	0.000	1.000	0.905	0.294	0.000	1.000

The correlation matrices in Table 5.4 and Table 5.5 for Kenya and Tanzania respectively, indicates that the predictors and all control variables are not highly correlated with each other hence there is no concern of multicollinearity (Burns and Burns, 2008).

The average Tolerance and Variance Inflators Factors Value (VIF) that was obtained from eviews for the two correlation matrix tables, produced the VIF mean score of 5.01 for Kenya and 4.31 for Tanzania which are well within the tolerance level for VIF score. As such, multicollinearity does not exist in the study's variables. Multicollinearity exists if the study variable correlate very highly, usually above 0.80 or 0.90, when the tolerance values should not be above 0.10 and the VIF value should not be above 10 (Cameron and Trivedi, 2010). Tests for heteroscedasticity did not show any model with problems of heteroscedasticity. Data log transformation was performed for all the study variables to improve the normality of the dataset. This draws support from previous IB studies such as (Kumar, 2001; Zheng et. al., 2013; Falk, 2014 and Okafor, 2014) that have suggested that taking logs helps improve the normality and linearity of the data series. Also, given that some of these variables are interrelated, only one variable will be used at any time in an equation. Therefore, estimations are conducted including and excluding RIMP (ratio of host to home country's import) and REXP (ratio of host to home country's exports) for both Kenya and Tanzania for comparison as a proxy for each other.



**11Table 5.4. The Correlation Matrix for Kenya**

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
1 LRFDI	1																			
2 LRGDP	-0.410	1																		
3 LRGDP	0.049	-0.145	1																	
4 LRHCAP	-0.335	0.691	-0.147	1																
5 LRTLFORC	-0.184	0.431	0.201	-0.180	1															
6 LROPEX_IM	0.085	-0.136	-0.152	0.274	-0.594	1														
7 LRIMP	0.097	-0.202	-0.122	0.213	-0.591	0.970	1													
8 LREXP	0.059	-0.056	-0.190	0.320	-0.555	0.976	0.898	1												
9 LROEXR	0.367	-0.603	0.274	-0.696	0.120	-0.240	-0.185	-0.288	1											
10 LRINF	0.191	-0.483	0.176	-0.526	0.183	-0.230	-0.176	-0.267	0.430	1										
11 LRINTR_100P	-0.219	0.557	0.045	0.797	-0.211	0.153	0.144	0.147	-0.456	-0.433	1									
12 LRMOBL_100P	-0.165	0.416	0.157	0.668	-0.175	0.102	0.111	0.080	-0.321	-0.334	0.898	1								
13 LRTNR	0.252	-0.542	0.164	-0.449	-0.062	-0.190	-0.247	-0.151	0.351	0.422	-0.507	-0.421	1							
14 LRAAGLOM	-0.377	0.840	-0.225	0.741	0.092	0.255	0.203	0.304	-0.785	-0.484	0.556	0.387	-0.547	1						
15 LRCDD	0.324	-0.579	0.243	-0.466	-0.060	-0.088	-0.017	-0.155	0.383	0.458	-0.356	-0.263	0.440	-0.514	1					
16 COLT	-0.142	0.362	-0.207	0.435	-0.135	0.311	0.248	0.356	-0.166	-0.509	0.371	0.277	-0.467	0.306	-0.450	1				
17 LRQINST	-0.319	0.587	-0.213	0.740	-0.242	0.297	0.300	0.289	-0.574	-0.608	0.629	0.458	-0.574	0.677	-0.387	0.456	1			
18 LRPOLIST	-0.294	0.430	-0.311	0.654	-0.384	0.440	0.404	0.466	-0.524	-0.573	0.486	0.343	-0.393	0.600	-0.340	0.468	0.802	1		
19 LRCORPTN	-0.320	0.544	-0.162	0.741	-0.263	0.262	0.239	0.285	-0.584	-0.540	0.618	0.528	-0.474	0.647	-0.351	0.383	0.814	0.714	1	
20 FCRISIS	-0.040	-0.101	0.086	-0.117	-0.024	0.044	0.036	0.048	0.077	0.176	-0.104	-0.160	0.100	-0.046	0.065	-0.033	-0.086	-0.054	-0.010	1
V.I.F. Score	5.01																			

**12Table 5.5. The Correlation Matrix for Tanzania**

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
1 LRFDI	1																			
2 LRGDP	-0.354	1																		
3 LRGDP	0.036	-0.149	1																	
4 LRHCAP	-0.077	0.405	0.020	1																
5 LRTLFORC	-0.317	0.560	0.232	-0.169	1															
6 LROPEX_IM	0.149	-0.248	-0.038	0.265	-0.633	1														
7 LREXP	0.131	-0.159	-0.030	0.355	-0.610	0.971	1													
8 LRIMP	0.154	-0.317	-0.043	0.167	-0.613	0.971	0.888	1												
9 LROEXR	0.284	-0.466	0.325	-0.262	0.112	-0.298	-0.316	-0.274	1											
10 LRINF	0.254	-0.421	0.158	-0.456	0.128	-0.228	-0.296	-0.153	0.487	1										
11 LRINTR_100P	-0.174	0.488	-0.072	0.837	-0.205	0.297	0.376	0.206	-0.376	-0.572	1									
12 LRMOBL_100P	-0.096	0.383	0.049	0.849	-0.202	0.329	0.389	0.253	-0.269	-0.422	0.899	1								
13 LRTNR	0.223	-0.400	0.250	-0.338	0.045	-0.098	-0.117	-0.088	0.517	0.501	-0.389	-0.325	1							
14 Lragglom	-0.306	0.910	-0.180	0.509	0.282	0.024	0.103	-0.047	-0.639	-0.577	0.631	0.506	-0.489	1						
15 LRCd	0.194	-0.664	0.269	-0.477	-0.123	-0.213	-0.303	-0.122	0.657	0.343	-0.432	-0.366	0.458	-0.686	1					
16 COLT	0.231	0.156	-0.142	0.235	-0.181	0.403	0.460	0.312	0.026	-0.273	0.276	0.255	-0.050	0.175	-0.213	1				
17 LRQINST	-0.218	0.455	-0.290	0.486	-0.285	0.345	0.424	0.249	-0.661	-0.701	0.611	0.448	-0.493	0.653	-0.541	0.254	1			
18 LRPOLIST	-0.093	0.326	-0.186	0.650	-0.418	0.504	0.562	0.416	-0.537	-0.533	0.649	0.601	-0.338	0.528	-0.431	0.301	0.758	1		
19 LRCORPTN	-0.135	0.430	-0.161	0.773	-0.265	0.357	0.438	0.261	-0.511	-0.587	0.755	0.719	-0.390	0.594	-0.507	0.208	0.749	0.783	1	
20 FCRISIS	0.007	-0.058	-0.036	-0.178	0.045	-0.049	-0.042	-0.051	0.067	0.155	-0.129	-0.158	0.157	-0.069	0.051	-0.044	-0.126	-0.186	-0.243	1
V.I.F. Score	4.31																			

#### **5.4.0. Diagnostic Tests**

The Hausman Specification Test was conducted in order to compare the fixed versus random effects under the null hypothesis that the individual effects were uncorrelated with other regressors in the model (Hausman, 1978). The null hypothesis was rejected because it was correlated as a random effect model produced biased estimators, violating one of the Gauss-Markov assumptions. However, the covariance of an efficient estimator with its difference from an inefficient estimator was zero which was Hausman's essential result (Green, 2003). Essentially, the Hausman test recommended the use of a random effects model. Tests also revealed no statistical misspecifications of the model and no omitted variable bias. Therefore, the conclusion can be drawn that the results obtained from the random effects estimation are consistent and not spurious.

The regression began with full sample model, followed by the OECD model and then the non-OECD model. A variety of alternative variables, including measures of openness such as exports, imports, natural resources, infrastructure development, cultural distance, colonial ties, political stability, quality of institutions and corruption were successively introduced, and excluded where they lacked explanatory powers.

#### **5.5.0. Research Findings**

In order to test the hypotheses presented in the previous chapter, the multiple linear regression was performed on all variables as shown in Tables 5.6 (Kenya) and 5.8 (Tanzania). The two tables present the empirical results of the log-log Model 2 using panel data in e-views. The F-statistics and the Wild test diagnostic tests for Models one, two and three in Tables 5.6 and 5.8 indicate that the models have sufficient explanatory power to explain the determinants of FDI in Kenya and Tanzania at all the three levels of the full sample, OECD and non-OECD home countries.

The regression analysis used several Models. For example, one of the preliminary regressions contained the measure openness but excluded separate export and import variables. This Model did not perform as well as the one with separate export and import variables and the variable openness was excluded. Model one was the best Model for the assessment of the top 22 home countries of FDI flows to Kenya as it produced the highest number of significant variables with the right signs.

Similarly, both Model two for OECD countries and Model three for non-OECD countries included export and import variables without the openness variable. This combination helped generate the best results as they produced the highest numbers of significant and positive variables for their respective scenarios than Models that had openness without export and import variables. Essentially, 3 regressions per each table are reported from several equations that were executed to test the relationships between all the variables in the proposed Model. The best Models for FDI are discussed in the later sections of this chapter.

Tables 5.6 and 5.8 show the empirical results obtained and cross section random effect. Logs were taken by all the variables to deal with skewed data as well as heteroscedasticity problem and hence make the data more uniform and less affected by outliers. Proxies such as colonial ties (COLT) and financial crisis (FCRISIS) have not been logged because of their unit measures that were expressed as single numbers and cannot be excluded because they are important to the study.

The literature and hypotheses have been developed on the basis of economic, social-cultural and institutional factors beginning with predictors followed by control variables. Therefore, the interpretation of results will follow a similar pattern by analysing the significant variables with the right signs first, then insignificant variables with right signs followed by significant variables with wrong signs and finally variables that are not significant with wrong signs.

The next sections report the findings of the regression analysis of the various Models indicated above.

#### **5.5.1. Main Findings on Determinants of FDI in Kenya.**

The discussion will be largely restricted to Models one, two and three as they show stronger results than other Models that were tried. The adjusted  $R^2$  value for Model one (the top 22 home countries) is 0.56, Model two (OECD countries) 0.34 and Model three (non-OECD countries) 0.43. This implies that the 3 Models can explain the variation in FDI by 56%, 34% and 43% respectively. The F-values showed that all variables together are all significant at 1% level ( $p=0.000$ ). The level of significance is determined by the p-values of the F-statistic.

**13Table 5.6. Results for Kenya**

		Res 1996-2016		
		The Top 22 Home Countries	12 OECD Countries	10 Non-OECD Countries
Variable	Variable Name	Model 1	Model 2	Model 3
Constant		17.09834***	20.25954***	15.88656***
St. Error		(0.302989)	(1.348319)	(0.330604)
LRGDP (H1a)	Market Size		0.025257	0.446109***
			(0.291272)	(0.098298)
LRGGDP (H1b)	Market Growth	0.003413		
		(0.017569)		
LRHCAP (H1c)	Human Capital	-1.092383	-2.370878	-0.254783
		(0.302971)	(0.410162)	(0.126058)
LRTLFORC (H1d)	Total Labour Force (Labour Cost)	-0.154454	-0.263688	-0.451142
		(0.10172)	(0.242945)	(0.056847)
LRIMP (H1e)	Imports	0.817165***	-0.321863	-0.278344
		(0.38258)	(0.201455)	(0.139945)
LREXP (H1f)	Exports	-2.773891		
		(0.306727)		
LRQEXR (H1g)	Official Exchange Rates	-0.025013	0.130373***	0.143250***
		(0.055122)	(0.049941)	(0.040631)
RINF (H1h)	Inflation Rate	0.008593	0.004998	-0.003468
		(0.010391)	(0.007367)	(0.009020)
LRINTR_100P (H1i)	Internet Users as a proxy of Infrastructure Development	0.733469***		-0.098721
		(0.061539)		(0.040453)
LRMOBL_100P (H1j)	Mobile cellular subscriptions as a proxy of Infrastructure Development		0.895774***	
			(0.109145)	
LRTNR (H1k)	Total Natural Reserves	0.150010*		
		(0.088488)		
LRAGGLOM (H1l)	Agglomeration		0.450234***	-0.109271
			(0.121540)	(0.076121)
LRCD (H2a)	Social Cultural (Cultural Distance)	0.583083***	0.373003**	-0.471825
		(0.376917)	(0.167879)	(0.196117)
LRQINST (H3b)	Institutional Factors (Quality of Institutions)	0.781963***	0.892932*	0.229592**
		(0.259639)	(1.218085)	(0.091354)
FCRISIS (H4)	Financial Crisis/ Dummy Variable	-0.318307***	-0.597266***	-0.480028
		(0.203043)	(0.181424)	(0.328735)
Number of Observations		462	252	210
R2		0.574549	0.374871	0.461152
Adj R2		0.566067	0.340661	0.432963

Notes: Standard errors are reported in (.). \*, \*\*, \*\*\* indicate significance at 10%, 5% and 1% level respectively.

### 5.5.1.1. Economic Factors' Impact on FDI Flows from Home to Host Country.

A number of economic factors were included to test their influence on FDI flows. They included market size/growth, human capital, official labour force, imports, export, official exchange rates, inflation, infrastructure, total natural resources and agglomeration discussed in that order, in the analysis below.

#### *Market Size and Market Growth (Market Seeking Factors)*

Two variables were considered as measures of market seeking factor – GDP and GDP growth as shown in the literature (Dunning, 1988, Zheng, 2009 and Anyanwu and Yameogo, 2015). Taking GDP as the measure of market size in the full Model, it did not perform well compared

with GDP growth whereas in the OECD and non-OECD Models GDP growth as the measure of market-seeking factor performed better. In the whole Model (Model 1), even though market growth is the better performing variable and had the correct sign, it still proved to be insignificant.

Hypotheses 1a and 1b tested the importance of market size and market growth respectively. These two variables are largely insignificant in all the estimations with the exception of analysis of non-OECD countries.

The result of market size measured by GDP size in Model three indicates that 1% increase in market size would lead to 44% rise in FDI from non-OECD countries at a significance level of 1%. Kenya's relatively bigger market size compared to some of the non-OECD countries has a significantly attractive effect on FDI from the non-OECD group. It could be argued that FDI from non-OECD countries is more likely to be for market-seeking purposes attracted by GDP size of Kenya. This find is consistent with results of many studies such as Asiedu's (2006), Hailu's (2010) and Sanfilippo's (2010 & 2015) that found market size to be a key determinant of FDI in Africa. Using market size variable in equation one (full sample) reduced the significance of other variables and even altered their signs and therefore it was excluded in the full Model.

When the same variable was considered in the context of OECD countries it had a correct sign as expected but it was not significant. A similar result is observed for the market growth variable measured by GDP growth rate in the full sample. Although the variable has the right sign and improves the performance of the Model at full sample level for Kenya, it is insignificant, suggesting that the two market variables are not key considerations for foreign investors from particularly OECD, when investing in Kenya. This could be due to the nature of Kenyan FDI that is not influenced by market-seeking motive or because the size of the economy is relatively smaller than the majority of OECD member countries and therefore negligible. Similar results were returned by Kyereboah-Coleman and Agyire-Tettey's (2008) study which indicated that, size of economy is not important for Africa and as such most foreign investors do not consider market factors when making decisions to invest in Africa. This outcome contradicts the two hypotheses as well as findings of many other studies on African FDI such as Nnadozie and Osili's (2004) and Anyanwu and Yameogo's (2015) that reported a significant effect of GDP growth on FDI inflows to Africa. When market growth was used in the contexts of both OECD and non-OECD samples, it was negative and not significant. It also

disrupted other variables and was therefore dropped from Models two and three. Therefore, hypothesis 1a (market size) is rejected for the full sample and OECD countries but accepted for non-OECD countries. Hypothesis 1b (market growth rate) is rejected for all the three samples of home countries.

#### *Human Capital*

Hypothesis 1c tested the importance of human capital (as a predictor of FDI flows). This is measured by the ratio of skills levels in the host to home country, measured by percentage enrolment ratio in secondary education for both sexes. It produced negative coefficients and significant results for all the three Models of the full sample, OECD and non-OECD countries. This variable was expected to be positively related to FDI since the presence of greater skilled human capital is usually felt as a relevant pull factor for MNEs. A positive result for human capital was noted by Reiter and Steensma's (2010) and Anyanwu and Yameogo's (2015), however, the results here suggest the contrary, since FDI flows into Kenya are negative. This could be argued that the type of MNEs that relocate to Kenya (for instance Chinese investment in ICT and infrastructure) take along their own staff, perhaps as expatriates and as such, the lower level labour force in Kenya may not need to be highly educated. Consequently, H1c is rejected for all the three samples.

#### *Labour costs.*

Hypothesis 1d tested the significance of labour costs. Data for wage rate in both Kenya and Tanzania was not available. However, a suitable proxy was the size of total labour force measure. The greater the size of the labour force implies a lower wage rate. The coefficient of labour force is negative in all the three groups of FDI which is the opposite of the sign expected for Kenya, considering the abundance of low-cost labour force in the country. This result contradicts the assumption that key resource of developing economies is labour (Shahmoradi and Baghbanyan, 2011) and that labour makes essential to the agricultural and rural economies in all sub-Saharan Africa (Majeed and Ahmed, 2007). It could be argued that the nature of Kenyan FDI is not dependant on labour force because it may not be labour intensive. Furthermore, in this study the total labour force is aggregated, which is not specific to industry. Hypothesis 1d is rejected for all the three samples.

#### *Trade (Export and Import)*

It has been noted earlier that the export and import variables separately provided a better performance than openness in explaining inward FDI to Kenya. Therefore, hypotheses 1e and 1f tested the importance of the trade measured by Import and Exports respectively. Imports appear to have the strongest positive effect on FDI inflows from the full sample of home countries. A 1% increase in imports would raise FDI by 81%, a result significant at the level of 1% which means the more Kenya imports from the home countries, the more FDI Kenya receives at the full sample level. The key commodities imported into Kenya include machinery and transportation equipment, electronics, oil and motor vehicles. They mainly originate from China, the USA and the UK. As part of trade, this is consistent with FDI theory which states that openness is indicative of the host country ease of access to the world market (Nsiah and Wu, 2014 and Anyanwu and Yameogo, 2015).

Although imports are positively significant for the full sample, they have a negative and insignificant impact on FDI flows from OECD countries to Kenya. They also have wrong sign and are not significant for non-OECD countries. The two results suggest that the more imports from home countries to Kenya leads to less FDI from OECD and non-OECD member countries when regressed separately which indicates that import and FDI are substitutes of each other. Care should be taken in the interpretation of this result as this outcome might be caused by Kenya's key imports coming from countries from which it does not receive any FDI.

Exports have a negative and insignificant impact on full sample, indicating that it is not export that attracts FDI to Kenya which negates hypothesis 1f. Therefore, it would be argued that subsidiaries located in Kenya are supplied by exports from the home country which renders exports unimportant for FDI - as parent companies are not supplied by Kenyan exports. Similar results have been produced in studies such as Dollar (1992) and Agosin et. al., (2012) who also intimated that FDI pushes up exchange rates of a host country which makes exports become more expensive. As such, Kenyan currency might have risen in value, making exports become less competitive in all groups of FDI home countries. Using exports variable in both OECD and non-OECD equations, reduced the significance of other variables and even altered the signs and therefore it was omitted from these two Models. Therefore, hypothesis 1e (import) is accepted for the full sample but rejected for FDI from OECD and non-OECD countries. Hypothesis 1f (exports) is rejected for full sample of home countries.

#### *Official Exchange Rates*

The official exchange rate hypothesis (1g) suggests that higher exchange rates are significantly positive at the 1% level for FDI from both OECD and non-OECD countries. A 1% increase in official exchange rate would raise FDI by 13% for OECD and 14% for non-OECD home countries. The result indicates that the higher the ratio of host to home country exchange rate, the greater the FDI from home to host country which argues that the relatively weaker Kenyan currency attracts FDI mainly from countries with stronger currencies. Indeed, this finding corroborates Aliber's (1970) argument that MNEs' investments flowed from strong currency areas to weak currency areas. It also follows previous studies with similar outcome such as Zheng's (2009), Okafor's (2014) and Kariuki's (2015).

However, official exchange rate generated opposite results for FDI for the full sample of home countries to Kenya as it is both insignificant and with a negative sign. This result suggests that unless data is aggregated, exchange rate hypothesis cannot overly influence inward FDI to Kenya as the statistical support in this sample is weak which follows the result of Okafor's (2014) investigation of FDI flows to SSA. Therefore, H1g is rejected for full sample but clearly accepted for both OECD and non-OECD FDI.

### *Inflation*

Inflation was tested in Hypothesis 1h using consumer price annual index (CPI%) measure. Lower relative inflation encourages FDI (Zheng, 2009 and Anyanwu, 2012). It seems to be the case for non-OECD countries and in this case, it is not significant. It is also insignificant and bears the wrong sign for FDI from both the full sample and OECD countries. This can be argued that FDI from the three groups of countries is insensitive to inflation in Kenya. This result goes against what most studies on FDI such as Zheng's (2009) and Mhlanga et. al.'s (2010) which found that FDI will be deterred by economies that have higher inflation rates since the home economy will be depreciated by inflation in such a way that the same amount invested will mean less value in terms of the currency of the host country. Hypothesis 1h is rejected for all the three samples.

### *Infrastructure Development*

Hypotheses 1i and 1j tested the importance of infrastructure development to FDI flows. There are two measures of infrastructure - internet users and mobile cellular subscriptions. The internet users measure was significantly related to FDI within the full sample at a positive influence of 73% at a 1% significance level. When this variable measure was used in the context of OECD, it was negative and not significant, and reduced the explanatory powers of

other independent variables in the same Model. It was therefore dropped. In terms of non-OECD countries, it was the best performing measure even though it was not significant.

An alternative measure to internet users i.e. mobile cellular subscriptions was used and was good for explaining OECD FDI as its coefficient showed that a 1% increase in mobile cellular subscriptions would increase OECD FDI in Kenya by 89% at significant level of 1%. This find is consistent with other results such as Kinoshita and Campos' (2003) and Okafor's (2014). This suggests that FDI flows from OECD countries is positively influenced by mobile cellular subscriptions which corroborates Okafor's (2014). The same measure was however not good in explaining the full sample and non-OECD and reduced the performance of other variables and was therefore excluded from the two equations. It could be argued that infrastructure development does not deter FDI from non-OECD countries as they seem to be mainly driven by market-seeking rather than efficiency-seeking motive. The level of infrastructure development of majority of countries in this group (Model three) could be relatively same as or less than Kenya's. The larger section of literature is of the view that poor infrastructure is one of the reasons Africa has been receiving low levels of FDI in comparison to other regions (Kariuki, 2015). However, not all authors find infrastructure to be a significant variable which may be determined by which measure of infrastructure development was taken (Dupasquier and Osakwe, 2003).

Therefore, H1i (internet users) is accepted for full sample but rejected for non-OECD countries. H1j (mobile cellular suscriptions) is clearly accepted for OECD sample only, for the case of Kenya.

#### *Total Natural Resources*

Total natural resources variable was tested in hypothesis 1k and its coefficient indicated that 1% increase in total natural resources would increase FDI at full sample level in Kenya by 15% at significant level of 10%. This result implies that resource-seeking is one of the important motives of FDI in Kenya within the full sample context which is reflected in recent rise in investments mainly from China in mining and hydrocarbon sectors (UNCTAD, 2017). Similar suggestions have been made by other authors such as Asiedu (2002), Kinoshita and Campos (2003) and Shan et. al. (2018).

This study might have expected natural resources to be positive and significant for both OECD and non-OECD countries. It was actually negative and insignificant for the two groups of home countries. It was also highly correlated with a range of other independent variables reducing

their explanatory powers in the two Models and was therefore excluded from their equations. One explanation of the failure of this variable at OECD level maybe that although data from Kenya shows mining is important (KenInvest, 2018), it is still not important for OECD FDI. The nature of FDI in Kenya is in manufacturing and service sectors and that is why it is not significant for OECD countries. Regarding the unexpected results in non-OECD group, could be due to the fact that China makes 18% of the total FDI flows from non-OECD countries into Kenya. There are 82% from other non-OECD countries who might have their own natural resources and therefore their investments are not reliant on availability of natural resources in Kenya. As a result, while total natural resources factor is accepted for the full sample, it cannot be supported for this data at both OECD and non-OECD levels.

### *Agglomeration*

Agglomeration economies was tested in hypothesis 11 measured by lagged FDI flows which related current FDI to past FDI flows (Cheng and Kwan, 2000). The results from the regression show that the agglomeration effect has a positive and significant relationship with FDI flows from OECD countries into Kenya. A 1% increase in the level of lagged FDI would increase current FDI from OECD countries to Kenya by 45%. The results suggest that agglomeration economies may exist given that foreign investors from OECD countries would be attracted to countries with more existing foreign investments. This indicated that the previous level of FDI inflows contributed positively in explaining the current level of foreign investment flows into Kenya. This therefore confirms agglomeration effect in Kenya. This is consistent with the position held by most researchers on agglomeration effect on FDI such as Wheeler and Mody (1992), Kinoshita and Campos (200) and Anyanwu and Yameogo (2015) who concluded that being less knowledgeable of a country's environment, foreign investors may view the investment decisions by others as a good signal of favourable conditions and invest there too, in order to reduce uncertainty. However, this variable was negative and not significant for non-OECD FDI.

When agglomeration variable was tried at the full sample level, it was negative and insignificant and was disruptive to other variables and was therefore excluded from the full sample Model. Thus, while the OECD sample is accepted in H11, non-OECD is rejected for this data.

#### *5.5.1.2. Social Cultural Factors' Impact on FDI Flows from Home to Host Country.*

To measure social-cultural factors, the variable cultural distance was used because the other related variables of geographical distance and colonial ties affected the results by interfering with signs and significance levels of other variables in numerous regression trials and were consequently excluded from the three reported Models.

Hypothesis 2a tested the cultural distance by measuring the bilateral score of national culture between host and home country. From the results, the cultural distance between host and home country is statistically significant at the 1% level for full sample and OECD FDI in Kenya. Also, a 1% increase in cultural distance score increases FDI from the full sample and OECD countries to Kenya by 58.3% and 37.3% respectively. This reflects the existing connection between Kenya and the former colonial power UK, which is a key player in the OECD group and the leading investor in Kenya. Equally, English is the common language between the two countries as well as the USA – being another prime source of the Kenyan FDI. This finding does not only confirm Makino and Tsang 's (2011) research findings of positive correlation between culture and FDI but also supports results from earlier studies on FDI such as Sumner (2008) and Zheng (2009 and 2011).

In contrast, cultural distance had a wrong sign but was not significant in the context of non-OECD which implied that cultural closeness has a negative and significant relationship with FDI flows from non-OECD countries to Kenya. It would be argued that China tops this category of home countries in foreign investments in Kenya when there exists neither cultural nor colonial ties nor even a common language. Therefore, H2a is accepted in full sample and OECD but rejected in non-OECD countries for the case of Kenya.

#### *5.5.1.3. Political and Institutional Factors' Impact on FDI Flows from Home to Host Country.*

In investigating this relationship, the influence of political and institutional factors on FDI flows is assessed. Three measures of political and institutional factors were tried; quality of institutions, political stability and control of corruption. The one that performed best was quality of institutions for all the three Models. The other two measures were negative and insignificant and reduced explanatory powers of other variables and were therefore excluded from the three Models.

Quality of institutions that uses government effectiveness data as a measure of political and institutional factor was tested in hypothesis 3b and is positive and significant determinant of FDI from the full sample of home countries at confidence level of 1%, non-OECD at 5% and OECD home countries at 10%. Thus, a 1% increase in quality of institutions would lead to an increase of FDI flows from the full sample by 78%, OECD by 89% and non-OECD home countries by 22.9%. This suggests that the type of FDI in Kenya is sensitive to quality of institutions with OECD countries carrying an influence level of 89%, which means investment decisions of MNEs from OECD countries are hugely influenced by the quality of Kenyan institutions. It also goes against the view that non-OECD lack institutional framework at home and would therefore not be bothered by the poor quality of institutions in Kenya.

Most studies have advocated for high quality institutions because as Bevan and Estrin (2004) observed that the quality of institutions impacted on FDI flows since they affected choice of entry mode, magnitude of investment, probability of survival and variety of international expansion strategies. Anyanwu's (2012) had similar results and also argued that institutional quality did not just attract FDI to Africa but also created the conditions under which domestic MNEs emerged and invested abroad. Therefore, hypothesis 3b measured by quality of institutions is clearly accepted for all the three samples for the case of Kenya.

#### *5.5.1.4. Other Factors' Impact on FDI Flows from Home to Host Country.*

The influence of one of the known other factors on FDI flows was the financial crisis (FCRISIS) of 2008 (Weisbrod and Whalley, 2011). A dummy variable was introduced to take care of this variable financial crisis that happened in 2008. This takes the value 0 in the period of study and 1 during the crisis. As expected, the results from the regression show that financial crisis of 2008 had a negative and significant relationship with FDI flows from the full sample and OECD countries at significance of 1% level for both of them. The financial crisis of 2008 decreased FDI flows from the full sample and OECD home countries by -31.8% and -59% respectively. The effect of the financial crisis was strong for full sample and OECD but negative for non-OECD and this reflects that the crisis was more an OECD rather than a non-OECD countries' crisis. Therefore, financial crisis was accepted for both full and OECD samples but rejected for non-OECD sample for the case of Kenya.

**14Table 5.7. Summary of Findings for Kenya**

Determinants of FDI	Expected Sign	Observed Sign		
		Full Sample of Home Countries	OECD	Non-OECD
<b>Economic Factors</b>				
Market Size	Positive	Insignificant	Insignificant	Positive
Market Growth	Positive	Insignificant		
Human Capital	Positive	Negative	Negative	Negative
Total Labour Force	Positive	Negative	Negative	Negative
Exports	Positive	Negative		
Imports	Positive	Positive	Negative	Negative
Official Exchange Rate	Positive	Negative	Positive	Positive
Inflation Rate	Negative	Positive	Positive	Insignificant
Mobile usage & internet users as proxies of infrastructure development.	Positive	Positive	Positive	Negative
Mineral Resource Endowment	Positive	Positive		
Agglomeration	Positive		Positive	Negative
<b>Social Cultural Factors</b>				
Cultural Distance	Positive	Positive	Positive	Negative
<b>Political and Institutional Factors</b>				
Quality of Institutions	Positive	Positive	Positive	Positive
<b>Other Factors</b>				
Financial Crisis	Negative	Negative	Negative	Insignificant

### 5.5.2. Main Findings on Determinants of FDI in Tanzania.

The discussion in this section will be largely restricted to Model one, two and three as they have higher explanatory powers than the other equations.

The adjusted  $R^2$  values in Models one, two and three in Table 5.9 were inspected from the regression results. The  $R^2$  values for Model one (top 22 home countries) are 0.57, Model two (OECD countries) 0.66 and Model three (non-OECD countries) 0.53. This implies that the three Models can explain the variances in FDI by 57%, 66% and 53% respectively.

**15Table 5.8. Results for Tanzania**

		Res 1996-2016		
		The Top 22 Home Countries	13 OECD Countries	10 Non-OECD Countries
Variable	Variable Name	Model 1	Model 2	Model 3
Constant		17.08992***	18.18051***	16.43515***
St. Error		(0.290896)	(1.458899)	(0.395417)
LRGDP (H1a)	Market Size	-0.232506 (0.126129)	-0.217134 (0.307884)	0.048318 (0.373608)
LRHCAP (H1c)	Human Capital	0.733698*** (0.093331)	0.382902** (0.160822)	0.917805*** (0.278782)
LRTLFORC (H1d)	Total Labour Force	0.265234** (0.105938)	-0.249800 (0.379073)	-0.193953 (0.429710)
LRIMP (H1e)	Imports	0.449338** (0.185312)	0.544874* (0.303729)	0.906734** (0.430261)
LREXP (H1f)	Exports	-0.685727 (0.165781)	-0.875245 (0.294317)	-1.113399 (0.469681)
LRROEXR (H1g)	Official Exchange Rates	0.045662 (0.043602)	0.109749*** (0.031631)	3.111783*** (1.086212)
RINF (H1h)	Inflation Rate	-0.002772 (0.005654)	-0.008573 (0.006261)	-0.080485** (0.038946)
LRINTR_100P (H1i)	Internet users as a proxy of Infrastructure Development		0.262548** (0.073600)	
LRMOBL_100P (H1j)	Mobile cellular subscriptions as a proxy of Infrastructure Development	0.062424* (0.036069)		-0.599748 (0.172281)
LRTNR (H1k)	Total Natural Reserves	0.007239 (0.003177)	0.312223** (0.015710)	0.009083 (0.305543)
LRAGGLOM (H1l)	Agglomeration	0.163079** (0.080002)	0.429897*** (0.135086)	-3.417323 (1.146469)
LRCD (H2a)	Cultural Distance	0.012788 (0.311215)	-0.212317 (0.976052)	0.984466 (1.893057)
LRPOLIST (H3a)	Political Stability	0.411570*** (0.069594)		0.116007 (0.207112)
LRQINST (H3b)	Quality of Institutions		-1.200823 (0.327328)	
FCRISIS (H4)	Financial Crisis/ Dummy Variable	-0.018251 (0.098556)	-0.231727* (0.128239)	0.150656 (0.359216)
Number of Observations		483	273	210
R2		0.588762	0.687315	0.631281
Adj R2		0.574624	0.666211	0.531329

Notes: Standard errors are reported in (.). \*, \*\*, \*\*\* indicate significance at 10%, 5% and 1% level respectively.

#### 5.5.2.1. Economic Factors' Impact on FDI Flows from Home to Host Country.

A number of economic factors were included to test their effect on FDI flows. They included market size/growth, human capital, official labour force, imports, export, official exchange rates, inflation, infrastructure, total natural resources and agglomeration discussed in that order, in the analysis below.

##### *Market Size and Market Growth (Market Seeking Factors)*

As noted earlier, there are two measures of market-seeking factors - Market size and market growth measured by GDP size and GDP growth respectively. Although market size performed better than market growth in the three Models it was positive but insignificant for non-OECD countries and negative and insignificant for the full sample and OECD countries. Market

growth variable did not perform well in any Models and was disruptive to other variables and was therefore omitted from the reported results.

Therefore, this result negates the market size and market growth hypotheses by suggesting that FDI from the three group of home countries is not determined by market-seeking factors and this could be because Tanzania's size of economy is small and considered relatively less important. Also, the type of FDI Tanzania attracts is mainly mining and gas industry, as well as agricultural and tourism (TIC, 2018) and this may not depend on the local market size. Although this finding contradicts most arguments that hold market size as important to African FDI possibly due to the alternative measures used in studies such as Bende-Nabende's (2002) and Kinuthia's (2012); it is however like Kenya, consistent with Kyereboah-Coleman and Agyire-Tettey's (2008) study which showed that most foreign investors did not consider market factors when deciding to relocate to Africa, rendering the size of economy insignificant for Africa. Therefore, market size and growth as important determinants of FDI are rejected for the case of Tanzania.

#### *Human Capital*

Human capital that was tested in hypothesis 1c measured by the ratio of skills levels between host and home countries, is clearly important as a determinant of FDI inflows as it is positive and significant for FDI flows from all the three groups of home countries into Tanzania. This was expected and supports the literature on FDI. A 1% increase in Tanzania's human capital would raise FDI from the full sample, OECD and non-OECD countries by 73%, 38% and 91% at significant levels of 1%, 5% and 1% respectively into Tanzania. This result corroborates findings of empirical studies such as Omanwa's (2012) and Mijiyawa's (2015) that demonstrated how availability of quality human capital was important determinant of certain types of FDI particularly in Africa. This assumption can be associated with Tanzanian FDI that seem to be motivated by possibility of tapping into the host Tanzania's human capital pool. Thus, H1c is clearly accepted for all the three samples of home countries.

#### *Labour Cost*

Labour cost was measured in hypothesis 1d by total labour force because, like Kenya, data on costs of wages in Tanzania was not available. Its coefficient indicated that 1% increase in the labour force would increase Tanzania's inward FDI from the full sample of home countries by 26.5% at significant level of 5%. It would be argued that the rise of labour force in Tanzania is a positive and significant determinant of FDI flows from the full sample of home countries into

Tanzania. This result suggests that Tanzania receives particularly vertical efficiency seeking FDI which supports literature especially studies on FDI in developing countries and Africa such as Shahmoradi and Baghbanyan's (2011) and Kinuthia and Murshed's (2015) studies that confirmed how MNEs were attracted to host countries such as Tanzania to exploit abundant and low-cost labour.

However, when the OECD and non-OECD groups were examined separately, the variable was not only insignificant but had the incorrect sign. The result suggested that unlike in the full sample, FDI from the two group of home countries is not influenced by rise in labour force in Tanzania. This result could be alluded to the type of FDI in Tanzania that may not be labour intensive. Consequently, H1d is accepted for the full sample but rejected for both OECD and non-OECD home countries.

#### *Trade (Export and Import)*

As with Kenya imports and exports as separate variables performed better as explanatory variables for FDI than openness. They were tested in Hypotheses 1e and 1f respectively. The two measures produced opposite results. Imports are a significant determinant of FDI from all the three groups of home countries to Tanzania. This variable has a positive relationship with FDI flows into Tanzania. A 1% increase in imports would raise FDI flows into Tanzania from the full sample, OECD and non-OECD countries by 44%, 54% and 90% at significant levels of 1%, 10% and 5% respectively. This might mean that as Tanzania imports greater amounts from home countries, the more FDI Tanzania receives from the home countries. The key imports to Tanzania entail consumer goods, machinery and transportation equipment, industrial raw materials, crude oil, motor vehicles, electronics and plastics. These products are imported mainly from China, the UK and the USA. This follows Aizenman and Noy's (2006) and Zheng's (2009) argument that imports from the home country to the host country may be used to supply the subsidiaries in the host country.

However, the exports variable has a negative and significant impact on Tanzanian FDI from all the 3 groups of home countries implying that it is not export that attracts foreign investors to Tanzania. It could be argued that like Kenya, subsidiaries located in Tanzania are supplied by exports from the home countries, rendering exports less important. Furthermore, the type of FDI to Tanzania such as tourism, infrastructure development and banking (TIC, 2018) may not be influenced by the export factor. Also, Tanzanian currency may have risen in value, making exports become less competitive in all groups of FDI home countries. Therefore, hypothesis 1e

(import) is clearly accepted for all the three samples whereas hypothesis 1f (exports) is rejected for all the three samples.

#### *Official Exchange Rate*

Hypothesis 1g tested the official exchange rate between host and home country which was found statistically significant at the 1% level for both FDI flows from OECD and non-OECD countries into Tanzania. A 1% increase in official exchange rate increases FDI from the OECD and non-OECD member countries to Tanzania by 10.9% and 3.11% respectively. The result indicates that the higher the ratio of host to home country exchange rate, the greater the FDI flows from OECD and non-OECD countries into Tanzania. It could be argued that the weak Tanzanian currency is important and attractive to FDI in the OECD and non-OECD contexts.

However, it was different for FDI from the full sample of home countries to Tanzania as the result for official exchange rate produced the right coefficient sign but not significant. The finding relates to the outcome of Okafor's (2014) study which confirmed that the exchange rate devaluation that is part of most adjustment programs actually deters rather than attracts FDI. Therefore, H1g is accepted for FDI from both OECD and non-OECD but rejected for FDI from full sample of home countries.

#### *Inflation*

Hypothesis 1h tested Inflation, measured by consumer price annual index (CPI %). It is one of the variables that relates negatively to FDI flows (Anyanwu, 2012) and it is statistically significant with the right sign at level of 1% with coefficient of -8% in non-OECD sample but insignificant in full sample and OECD Models. This can be argued that higher inflation rates in Tanzania deter FDI from non-OECD countries. The full sample and OECD countries would be insensitive to changes in inflation in Tanzania. These results suggest that reliable inflation cannot overly influence inward FDI into Tanzania as the statistical support in full sample and OECD countries is weak. Thus, FDI from non-OECD countries is accepted but full sample and OECD FDI is rejected for the case of Tanzania.

#### *Infrastructure Development*

Hypotheses 1i and 1j tested the importance of two measures of infrastructure development relating to FDI flows, internet users and mobile cellular subscriptions. They were found to be significantly related to FDI, but the type of variable differed by each group. Internet users' variable was significant within the OECD context. A 1% increase in internet users would

increase FDI from OECD countries into Tanzania by 26.2% at significance level of 1%. This is consistent with previous results such as Kariuki (2015) who argued that Africa has been receiving low levels of FDI in comparison to other regions due to poor infrastructure. As such, the result has demonstrated that MNEs from OECD countries would move their operations to Tanzania, based on the infrastructure development level as measured by internet users. However, this measure did not perform well within the full sample and non-OECD countries and changed the signs of other independent variables and was therefore dropped from the two Models.

An alternative measure of infrastructure development, cellular subscriptions performed better than internet users at the full sample level. A 1% rise in mobile cellular subscriptions would raise FDI for the full sample in Tanzania at 10% significant level. This suggests that full sample FDI is determined by infrastructure development when measured by mobile cellular subscriptions.

However, although mobile cellular subscriptions improved the non-OECD Model, neither internet users nor mobile cellular subscriptions could be found significant for FDI from this group of home countries in Tanzania. It would be argued that low level of infrastructure development in Tanzania proxied by mobile cellular subscriptions cannot explain FDI from non-OECD countries as they are mainly driven by market-seeking rather than efficiency-seeking motive. Furthermore, the level of infrastructure development of majority of countries in this category could be same as or less than Tanzania's. Also, the nature of Tanzanian FDI might not be sensitive to levels of infrastructure development. Therefore, H1i is accepted for the OECD (internet users). H1j is accepted for the full sample (mobile cell subscribers). The two hypotheses were however rejected for non-OECD home countries.

### *Natural Resources*

Hypothesis 1k tested total natural resources and its impact on FDI inflows. The results show that 1% increase in natural resource would increase FDI from OECD countries to Tanzania by 31.2% at significant level of 5%. This result implies that resource-seeking is one of the important motives of FDI in Tanzania particularly for investors from OECD countries. The TIC (2018) and NEPAD (2018) identified the main type of FDI into Tanzania to be mining and gas industry. Asiedu (2002) among other authors produced similar results in SSA studies.

However, although total natural resource variable returned positive and significant results at OECD level, it was of the correct sign but not significant for FDI for both the full sample and

non-OECD countries. Therefore, total natural resources (H1j) as a determinant of FDI is accepted for OECD but rejected for full sample and non-OECD FDI.

### *Agglomeration*

Hypothesis 11 tested agglomeration measured by lagged FDI flows and it was found to have a positive and significant impact on FDI except the non-OECD group. The Agglomeration effect correlates positively with FDI and it is significant at 1% and 5% in OECD and the full sample contexts respectively. The results indicate that a 1% increase in agglomeration increases FDI flows from OECD and the full sample of home countries by 42.9% and 16% respectively into Tanzania. It would be argued that agglomeration economies may exist given that foreign investors from OECD developed countries would be attracted to countries with more existing foreign investment. This shows that the previous level of FDI inflows contributes positively in explaining the current level of foreign investment inflows in Tanzania. Furthermore, that economies generated from foreign activity in Tanzania has strong effects on FDI flows and especially if the existing foreign investment in the host country is related to the home country of the investor. This therefore confirms agglomeration effect in Tanzania for full sample and OECD home countries but rejected for FDI from non-OECD countries.

#### *5.5.2.2. Social Cultural Factors' Impact on FDI Flows from Home to Host Country.*

As noted earlier in this chapter, the variable that performed best for the social-cultural factor, was the cultural distance. It was tested in hypothesis 2b by measuring the bilateral score of national culture between host and home country. Although coefficients for cultural distance are positive for FDI from the full sample and non-OECD countries, the variable is statistically not significant in all the three groups of home countries for Tanzania. It would be argued that cultural ties between host and home countries, whether combined or disaggregated to OECD and non-OECD, do not influence FDI flows from these countries to Tanzania. This is contrary to some of the literature such as Makino and Tsang 's (2011) and Demir & Im's (2019) studies which argued that cultural ties had a positive impact on FDI flows; such that, UK as a former coloniser and had been the traditional top investor in the country. The result could also be attributed to possible weakening of cultural ties overtime. The same result could also be attributed to the fact that unlike, Kenya, Tanzania was not colonised by Britain only, since Germans were the first occupiers until after the first World War (see chapter 2.). Therefore, the German influence on Tanzanian culture may be affecting the UK's influence and therefore the colonial ties. However, China with no cultural closeness to the host country is now the leading

investor in Tanzania (UNCTAD, 2017). These results suggest that cultural distance cannot overly influence inward FDI as the statistical support in the three samples is weak. Therefore, hypothesis 2b is rejected for all the three Models for the case of Tanzania.

#### *5.5.2.3. Political and Institutional Factors' Impact on FDI Flows from Home to Host Country.*

Three measures of political and institutional factors were tried; quality of institutions, political stability and control of corruption and the one that came out strongest was political stability for all the three Models. The control of corruption measure was highly correlated with other independent variables and was therefore excluded from the all the three Models.

Political Stability was tested in hypothesis (H3a) and returned positive and significant results for the full sample but was positively insignificant for non-OECD sample. A 1% increase in political stability in Tanzania would lead to 41.1% rise in FDI at full sample level at high significant value of 1%. Therefore, unlike non-OECD members that tend to have political instability at home and are less likely to be affected by political stability in the host country, foreign investors at full sample level are attracted to countries such as Tanzania presumably with higher political stability.

Therefore, following the works of Asiedu (2002) and Anyanwu (2012) the case of political stability, especially for African countries is a significant factor in the location decision of MNEs in the full sample context. The result in Model three supports the view that indeed it is different for investors from non-OECD countries such as China and India as they seem unaffected by the political stability in Tanzania, due to similar political stability levels at home and hence this result.

When political stability was used in the OECD equation, it was negative and insignificant and reduced the significance of other variables in the equation and was therefore excluded from the Model. An alternative political and institutional measure (quality of institutions) was used and was also negative and insignificant for OECD countries. The same variable was further tried in the full sample and OECD Models but was still negative and insignificant and disrupted other variables by changing their signs and was therefore omitted from both full sample and OECD Models. Therefore, H3a (political stability) is accepted for full sample but rejected for non-OECD FDI while H3b (quality of institutions) is rejected for OECD FDI.

#### 5.5.2.4. Other Factors' Impact on FDI Flows from Home to Host Country.

The impact of financial crisis factor on FDI was also tested using a dummy variable. This takes the value 0 in the period of study and 1 during the crisis. The result of financial crisis of 2008 test indicates that FCRISIS is negative and significant as expected in Model two but negatively insignificant in Models one and three. Therefore, the crisis decreased FDI flows from OECD countries by 23.1% at 10% significant level.

However, the result suggests that investors from non-OECD countries were still willing to make investments in Tanzania amid financial crisis since the crisis did not affect non-OECD countries. This finding is consistent with Kariuki's (2015) which established that FDI movement within Africa was not affected by the financial crisis of 2008 as the financial crisis was more of a Northern Hemisphere than non-OECD group's problem. Thus, H4 is accepted for FDI from OECD but rejected for full sample and non-OECD.

**Table 5.9. Summary of Findings for Tanzania**

Determinants of FDI	Expected Sign	Observed Sign		
		Full Sample of Home Countries	OECD	Non-OECD
<b>Economic Factors</b>				
Market Size	Positive	Negative	Negative	Negative
Human Capital	Positive	Positive	Positive	Positive
Total Labour Force	Positive	Positive	Negative	Negative
Exports	Positive	Negative	Negative	Negative
Imports	Positive	Positive	Positive	Positive
Official Exchange Rate	Positive	Insignificant	Positive	Positive
Inflation Rate	Negative	Insignificant	Insignificant	Negative
Mobile usage & internet users as proxies of infrastructure development.	Positive	Positive	Positive	Negative
Mineral Resource Endowment	Positive	Insignificant	Positive	Insignificant
Agglomeration	Positive	Positive	Positive	Negative
<b>Social Cultural Factors</b>				
Cultural Distance	Positive	Negative	Negative	Negative
<b>Political and Institutional Factors</b>				
Political Stability & Quality of Institutions	Positive	Positive	Negative	Insignificant
<b>Other Factors</b>				
Financial Crisis	Negative	Positive	Negative	Positive

#### 5.5.7.3. Comparison of Results for Kenya and Tanzania

The comparison of determinants of FDI in Kenya and Tanzania displays some similarities and differences as summarised in Table 5.10 below.

**17Table 5.10. Summary of Combined Findings for Kenya and Tanzania**

Determinants of FDI	Expected Sign	Observed Sign					
		Full Sample of Home Countries		OECD		Non-OECD	
		Kenya	Tanzania	Kenya	Tanzania	Kenya	Tanzania
<b>Economic Factors</b>							
Market Size	Positive	Insignificant	Negative	Insignificant	Negative	Positive	Negative
Market Growth	Positive	Insignificant					
Human Capital	Positive	Negative	Positive	Negative	Positive	Negative	Positive
Total Labour Force	Positive	Negative	Positive	Negative	Negative	Negative	Negative
Exports	Positive	Negative	Negative		Negative		Negative
Imports	Positive	Positive	Positive	Negative	Positive	Negative	Positive
Official Exchange Rate	Positive	Negative	Positive	Positive	Positive	Positive	Positive
Inflation Rate	Negative	Positive	Insignificant	Positive	Insignificant	Insignificant	Negative
Mobile usage & internet users as proxies of infrastructure development.	Positive	Positive	Positive	Positive	Positive	Negative	Negative
Mineral Resource Agglomeration	Positive	Positive	Insignificant		Positive		Insignificant
	Positive		Positive	Positive	Positive	Negative	Negative
<b>Social Cultural Factors</b>							
Cultural Distance	Positive	Positive	Negative	Positive	Negative	Negative	Negative
<b>Political and Institutional Factors</b>							
Political Stability & Quality of Institutions	Positive	Positive	Positive	Positive	Negative	Positive	Insignificant
<b>Other Factors</b>							
Financial Crisis	Negative	Negative	Positive	Negative	Negative	Insignificant	Positive

As might be expected, a comparison of the empirical results for Kenya and Tanzania shows some similarities but also a range of differences. Market growth and export factors do not appear to be important factors for both Kenya and Tanzania for full sample, OECD or non-OECD FDI, which is consistent with similar studies such as Kyereboah-Coleman and Agyire-Tettey's (2008). Market growth was positive but insignificant for Kenya at full sample level, but when tried for Tanzania it was negative and insignificant and displaced all Models. Regarding exports factor, it was also negative and insignificant for both Kenya and Tanzania. The negative relationship between FDI and exports suggests that they are complements rather than substitutes as FDI seems to make products not for export but for local market in the two countries. Although some literature (Asiedu, 2002 & 2006; Zheng, 2009; Hailu, 2010 & Sanfilipo, 2010 & 2015) claim market growth and exports are important, but this study cannot find that in both Kenya and Tanzania.

The import variable is however positive and highly significant in both Kenya and Tanzania at the full sample level which reflects the inward and import-substitution regime for both countries. This is consistent with similar research such as Vijayakumar et. al.'s (2010). Unlike exports, imports and FDI from home countries to Kenya and Tanzania are substitutes rather than complement to one another which supports Aizenman and Noy's (2006) similar findings.

The impact of exchange rates on FDI from both OECD and non-OECD countries into both Kenya and Tanzania is positive and significant which is consistent with some previous results such as Sekkat and Veganzones-Varoudakis' (2007). This implies that the rise in exchange rates between host and home countries, the more FDI flows into Kenya and Tanzania.

Cost of labour is not important in the two host countries for FDI flows from both OECD and non-OECD countries. Although some studies (Sichei & Kinyondo, 2012 and Kinuthia & Murshed, 2015) have argued to the contrary, this study cannot find that at both OECD and non-OECD levels in Kenya and Tanzania. Meanwhile, inflation does not deter FDI growth into both Kenya and Tanzania for full sample. It has a similar effect on FDI flows from OECD into both host countries.

The findings also suggest that infrastructure development is a key determinant of FDI flows into both countries when measured by internet users for Kenya and mobile cellular subscriptions for Tanzania at the full sample level. A similar result was returned for FDI flows from OECD into the two host countries, when measures of infrastructure are swapped i.e. mobile cellular subscriptions for Kenya and internet users for Tanzania. This implies that the full sample and OECD FDI in Kenya and Tanzania is attracted by the level of infrastructure development in both Kenya and Tanzania. However, FDI from non-OECD countries is not sensitive to the level of infrastructure in Kenya and Tanzania, when internet users and mobile cellular subscriptions are used respectively to measure this variable.

In terms differences, the market size variable is significant for Kenya but not Tanzania regarding FDI from non-OECD group. This could possibly be due to the relative higher GDP size of Kenya compared to Tanzania's. It has been argued by Asiedu (2002) and Suleiman et. al. (2015) that a host country is more attractive to FDI if it possesses a large domestic market and potential of being an exporting platform to neighbouring countries. Indeed, it seems Kenya is more attractive to non-OECD FDI than Tanzania because its export-oriented strategy and economic position can offer non-OECD FDI access to its East African Community (EAC) and COMESA markets as well as American and European markets through its regional and international export networks. As such, foreign investors from non-OECD countries prefer Kenya over Tanzania for its market size and easier access to export markets through its American AGOA policy, which might explain why the market size is significant for Kenya and not significant for Tanzania for non-OECD group.

Imports attract FDI from both OECD and non-OECD countries in Tanzania, but the same determinant has a negative effect on FDI in Kenya from both groups of home countries. This indicates that FDI and imports are substitutes in Tanzania but complements in Kenya, possibly due to the nature of FDI being received separately by each country. Although human capital variable is highly significant in Tanzania, it is negative in Kenya at all the three levels of full sample, OECD and non-OECD. This indicates that accumulated stock of human capital is attracting foreign investors into Tanzania than Kenya, which is consistent with similar findings by Noorbakhsh, et. al. (2001) and Omanwa (2013). This suggests Tanzania uses this strategy well to attract FDI flows than Kenya. This could be one of the explanations of why Kenya still lags behind Tanzania in terms of attracting FDI. However, the current type of FDI in Kenya may not require human capital. Meanwhile, the higher the exchange rate between the host and home country, the more FDI flows into Tanzania at the full sample level. It is however, contrary to FDI in Kenya at similar level.

The total labour force is positive and significant for Tanzania but insignificant for Kenya within the full sample context. It is well known both countries have relatively an abundant low-cost labour force compared with OECD countries and some of the non-OECD countries. As a result, Tanzania seems to attract efficiency-seeking (vertical) FDI inflows supporting Dunning's argument that much of the recent FDI has been stimulated by either market-seeking or efficiency-seeking motives. Similar views have been held by Asiedu (2002) and Kinoshita and Campos (2003). This could be another reason for higher volumes of FDI flows into Tanzania than Kenya.

Cultural distance is highly significant in Kenya for both full sample and OECD contexts, which attests to the argument that FDI will be attracted to the host country with similar culture, history, official languages and colonial ties as the home country (Jones, 1996; Zheng, 2009 and Demir and Im, 2019). Cultural distance is however negative in Tanzania in all the three groups of home countries. It is also negative for Kenya for non-OECD FDI. Both Kenya and Tanzania are former colonies of Britain, but the empirical results imply that the cultural distance effect favour Kenya more than Tanzania in attracting FDI inflows from the UK. Perhaps Tanzania's inward import-substituting economic regime, strict FDI policies (red tapes) could overshadow the benefit of cultural ties in attracting FDI. Also, the nature of FDI flowing into Tanzania may not be reliant on cultural, linguistic and colonial ties. The results could also be attributed to maybe weakening of cultural ties overtime as well as the German influence on Tanzania's culture (prior to the British occupation).

Inflation deters FDI flows from non-OECD countries into Tanzania, consistent with Onyeiwu and Shretha's (2004) and Asiedu's (2006) results, but its effects remain insignificant in Kenya for FDI from the same group of home countries.

Availability of natural resources are more important in attracting FDI in Kenya than in Tanzania, when the full sample FDI is considered. However, natural resources become important determinant for FDI in Tanzania when OECD FDI is considered. This supports similar findings by Ajayi (2006) and Kinuthia (2010) and Okafor (2014) that majority of MNEs in Africa are attracted by natural resources particularly those in agro-industry and cement industry in Kenya and mining and gas industry in Tanzania. Regarding non-OECD FDI, the correlation matrix indicates that mineral resources is not a significant determinant of FDI from that group of home countries into either Kenya or Tanzania. This could be because countries in this group possess own natural resources and therefore their FDI is not resource-seeking.

Agglomeration (measured by one-year lagged FDI) variable is significant for Tanzania and not Kenya at the full sample level. This suggests that existence of other foreign investors in Tanzania attracts other foreign investors there. As already mentioned, Tanzania has consistently received higher volumes of FDI inflows than Kenya and it seems foreign investors there, consider investment decisions by others as a good sign of favourable conditions and emulate the decisions to minimise uncertainties from their lack of knowledge of the local environment (Kinoshita and Campos, 2003).

Three measures of Political and institutional factors were tried and the one that came out strongest was quality of institutions for the case of Kenya as it was positive and significant for full sample, OECD and non-OECD contexts. It is therefore a highly significant determinant of Kenyan FDI. The same measure was however negative and insignificant for the case of Tanzania at all levels of FDI. An alternative measure of political and institutional factor i.e. political stability is positive and significant at full sample level in Tanzania. The same measure is however not important for Kenya in all Models suggesting that investors appear to live with lack of political stability in Kenya than in Tanzania. Tanzania has lately been relatively stable politically than Kenya. This could be one of the main reasons Tanzania has consistently received more FDI than Kenya (Omanwa, 2012 and Kinuthia and Murshed, 2015).

The 2008 financial crisis negatively affected FDI flows into Kenya at full sample level but had a positive impact on Tanzania's FDI at similar level. It seems Tanzania received more FDI at full sample level during the crisis than Kenya. Also, the crisis had a negative and significant

impact on FDI flows from OECD in both Kenya and Tanzania. FDI from non-OECD into Kenya was insignificantly affected by the crisis but the same group of home countries had a positive impact on Tanzania.

#### **5.6.0. Summary and Policy of FDI Determinants**

This chapter was developed to explore FDI determinants in Kenya and Tanzania by considering both host and home country characteristics and filled a gap in the existing literature by providing a comprehensive empirical comparison analysis. The empirical tests were based on three sample estimates of FDI; the full sample, OECD and non-OECD home countries. The two panel datasets were employed to identify the determinants of FDI flows into Kenya and Tanzania. The main theoretical and empirical contribution, which is also the main argument of the study, is that the determinants of Kenyan and Tanzanian FDI inflows are contextually changing in line with both host and home countries' characteristics and attributes.

Consequently, the empirical findings suggest that imports, infrastructure development and political and institutional factors are key determinants of FDI flows into Kenya and Tanzania at full sample level. The positive and significant relationship between FDI and imports in the full sample in both countries is consistent with similar findings such as Vijayakumar et. al., (2010) who argued that much of FDI also required to be complemented by imports. It seems therefore, imports from the parent company in the home country of investors are used to supply subsidiaries (Zheng, 2009) in the two countries. Regarding the positive and significant results of infrastructure development that was measured by internet users and mobile cellular subscriptions respectively for Kenya and Tanzania, similar empirical evidence was availed by Seetanah and Khadaroo and (2007) who robustly supported infrastructure as a determinant of FDI in Sub-Saharan Africa. For the positive and significant political and institutional factors that were measured by the quality of institutions for Kenya and political stability for Tanzania, the result is also consistent with Younis et. al.'s (2008) conclusion that political stability raised the probability of a country's selection as FDI location.

Official exchange rates, infrastructure development (measured by mobile cellular subscriptions for Kenya and internet users for Tanzania) and agglomeration, positively and significantly impacted on the FDI flows from OECD economies into both Kenya and Tanzania. Official exchange rate was also and the only important influence upon FDI from non-OECD economies in both countries. It seems consistent with various insights of foreign investors on investment characteristics for developing countries such as Kenya and Tanzania. For instance, high foreign

exchange rate is one of the major pull factors in developing countries (Dunning, 1988). This further confirms Aliber's (1970) assertion that FDI flows from strong currency economies are attracted to economies with weak currencies. As such, Anyanwu (2012) opines that depreciation of local currency will lower costs of local production as investors try to take advantage of cheaper labour.

Natural resources are more important FDI attracting factor in Kenya for full sample FDI. On the other hand, natural resources are more important in attracting FDI from OECD countries into Tanzania than in Kenya. This is consistent with Dunning's (1988) and Dunning and Lundan's (2008) argument that resource-seeking FDI is attracted to the host country to access resources not available at home such as natural resources, which may be similar to what is happening mainly in Kenya (full sample) and Tanzania (OECD).

Cultural distance is a more important FDI attracting factor in Kenya at both full sample and OECD levels than it is in Tanzania. This is supported by similar studies such as Jones (2005), Sumner (2008) and Zheng (2009) who observed that more FDI will be attracted to the host country with similar culture, history and official languages as the home country. Cultural proximity/English speaking skills is one of the most important determinants of Kenya's inward FDI particularly from Britain - an OECD member and overall leading foreign investor in the country.

Meanwhile, human capital is more important in Tanzania than in Kenya within all the three contexts of full sample, OECD and non-OECD. Labour is key to investors in Tanzania than Kenya at the full sample level. Similarly, Wheeler and Moody's (1992) and Mijiyawa's (2015) found that low cost and quality of human capital were important determinants of FDI particularly in Africa and it now seems this is the case with Tanzania. This is also consistent with Dunning's (1988) assertion that one of the major pull factors in developing countries was supply of low-cost labour force in abundance. This is also consistent with similar findings in Africa by Omanwa (2012).

Quality of institutions as one of the measures of political and institutional factors is an important determinant of Kenyan FDI at all levels of full sample, OECD and non-OECD. This is consistent with DiMaggio and Powell's (1983) and Peng et. al.'s (2009) institutional typologies that displayed how OECD firms' decision making was determined by the institutional factors in the host country. As such, FDI from the OECD group is positively and significantly determined by institutional factors in Kenya. Political stability as an alternative

measure of political and institutional factors is key to FDI in Tanzania at full sample level only. This is consistent with Nunnenkamp's (2004) and Buckley et. al.'s (2007) claims that higher political stability in the host country reduced transaction costs and helped positive growth effects of FDI.

OECD FDI in Tanzania is also mainly attracted by imports. Zheng (2009) observed that imports from the parent company in the home country of FDI is used to supply subsidiaries and it seems this is also the case with FDI from OECD countries in Tanzania. The study has also established that Financial crisis of 2008 negatively affected the flow of OECD FDI into both Kenya and Tanzania.

Non-OECD FDI in both countries is attracted by exchange rates. FDI from the same group (non-OECD) is attracted by Kenyan market size for market-seeking purposes. Both OECD and Non-OECD groups have a common interest in political and institutional factors in Kenya measured by quality of institutions. This is consistent with Zheng's (2013) similar findings. Non-OECD FDI in Tanzania is more likely to be stimulated by imports for market-seeking purposes. Tanzanian FDI from non-OECD group is also influenced but negatively by inflation. This is consistent with findings of Onyeiwu and Shretha's (2004) and Asiedu's (2006) comparable studies on Africa. Both OECD and non-OECD groups have a common interest in Tanzanian human capital and higher exchange rates for resource-seeking and efficiency-seeking motives respectively.

### **5.6.1. Implications for FDI**

The challenge for the Tanzanian government is how to sustain their comparable better performance in attracting FDI, while for the Kenyan government, it is how to increase FDI inflows.

With respect to policy implications, both Kenyan and Tanzanian governments need to implement selective targeting approach to maximise the appeal of inward FDI (Enderwick, 2005 and Zheng, 2013). The FDI policies need to be tailored to home countries' characteristics and attributes for attracting more FDI in general and particularly from targeted countries. Specific policies need to be formulated for achieving particular purposes in attracting desirable FDI from specific home countries to maximise potential economic growth.

Based on empirical results of this research, both Kenyan and Tanzanian governments may need to direct their efforts mainly towards sustaining the country's attractiveness to FDI at full

sample level by encouraging more imports from the home countries and improving their country's physical infrastructure (internet users for Kenya and mobile cellular subscriptions for Tanzania). This is because the study revealed that imports and level of infrastructure positively and significantly determined FDI flows to the two countries. This can be sustained by both countries opening up to international trade and reducing indirect and direct taxes on imports and provision of flexible and efficient customs. However, if they reduce import tax, imports will become cheaper and MNEs might not undertake FDI. The tax waiver should be applied to raw materials for already existing FDI. As a result, a rise in import volume will continue to attract market-seeking FDI while improved level of infrastructure to foreign investors should raise the appeal to resource-seeking FDI of both countries at full sample level.

Both Kenyan and Tanzanian governments need to pay more attention to maintaining their high exchange rates and developing infrastructure to sustaining favourable investment environments for agglomeration to thrive in order to sustain their attractiveness to FDI from OECD economies into their countries.

The Kenyan government needs to focus on strengthening its cultural ties with the home countries at both full sample and OECD levels and particularly with the UK. Kenya may also consider moving away from the colonial past to possibly attract FDI from more countries in addition to the UK. Government preferential policies need to be offered to attract large scale resource-seeking FDI in mining and raw materials industries that might open natural resources to foreign investors in a proper regulated business environment for overall FDI. This is because results of the study found cultural distance and natural resources to have a positive and significant effect on Kenyan FDI at full sample level.

Meanwhile, human capital, labour, foreign exchange rates and agglomeration were identified as the determinants of FDI in Tanzania at full sample level. Consequently, there is need for the government to continue raising education levels and thereby improving quality of human capital through adequate funding of learning and training of citizens at both secondary and post-secondary levels. As the Tanzanian government continues to improve skills of its workforce, it (government) needs also to take control of labour costs in order to maintain low cost labour and therefore continue to attract efficiency-seeking FDI. Efforts need to be made to increase agglomeration effects by increasing investments in FDI located areas in the country. Similarly, the Tanzanian government needs to endeavour sustaining high foreign exchange rates to sustain FDI flows at the full sample level.

The importance of determinants of natural resources, cultural distance and quality of institutions for Kenya in attracting FDI from OECD countries is endowed as is the human capital and natural resources for Tanzania. To continue attracting FDI from this group, Kenyan government needs to make efforts to achieve political and social stability through reduction of bureaucracy. As already discussed, Tanzania need to sustain raising the quality of its human capital to maintain its attraction of OECD FDI. Similarly, proactive FDI policies need to be formulated to attract more FDI from OECD as FDI from this group is more likely to invest into Tanzania for efficiency-seeking purposes. Like Kenya, Tanzanian government preferential policies need to be offered to attract large scale resource-seeking FDI in mining and raw materials industries by opening up more natural resources to investors from OECD countries in a proper regulated business environment.

Since market size and quality of institutions are positive and significant determinants of FDI from non-OECD to Kenya, efforts need to be made to enlarge the local market size and offer extensive preferential policies to sustain the FDI flows from this group. Tanzanian FDI from non-OECD countries is sensitive to volume of imports, human capital, inflation and exchange rates. To attract greater FDI flows from this group, the Tanzanian government need to encourage imports from home countries and reduce import tax and also keep inflation low. Both Kenyan and Tanzanian governments need to sustain high exchange rates to maintain their attractiveness to FDI inflows from OECD countries.

The Kenyan and Tanzanian experience can provide a guideline for other developing countries in formulating specific policies and therefore benefit from attracting FDI from specific group of home countries. The study should also trigger follow-up research into other developing countries for comparative results. However, unlike the Tanzanian government, the Kenyan government does not play an active role in its economy which might deter the government from implementing the preferential policies in attracting more FDI from specific group of home countries. Specifically, Kenya's institutional challenges such as bureaucracy and weak regulatory bodies may discourage efficiency-seeking FDI. Therefore, a comprehensive development strategy and favourable business environment for FDI is needed.

This study has established that the determinants of FDI are greatly dependant on the features of both the host and home countries and the investment itself (Dunning, 1983). As a result, this study recommends future research into the types of FDI flows from OECD and non-OECD

countries that could provide more information on the real determinants of FDI in Kenya and Tanzania.

Meanwhile, not only is it important for countries to get FDI, it is also important to know the impact of FDI in the host countries. Consequently, the impact of FDI on economic growth in Kenya and Tanzania is considered in the next chapter.

## **CHAPTER 6: THE IMPACT OF FDI ON ECONOMIC GROWTH IN KENYA AND TANZANIA.**

### **6.1.0. Introduction.**

In theory, capital formation and technological improvement are the engines of economic growth (Balasubramanyan, et. al., 1996; Caves, 1996 and Alfaro & Johnson, 2013). In retrospect, developing countries often find it difficult to exploit the benefits from their abundant resources due to inadequate human and physical capital as well as technological knowhow. These countries are typically constrained by institutional challenges such as weak protection of property rights, corruption, political and economic instability. Such factors constrain their capital accumulation and become impediments to utilising already existing resources. As such, FDI becomes more sought after than other international sources of capital as it arguably offers significant advantages such as providing host developing countries with a relatively more stable flow of funds. It is widely accepted that the positive impact of FDI on growth is driven by FDI transferring assets relating to productivity improvement, or the spillover effect of FDI that increase employment and trade (Gui-Diby, 2014, Iamsiraroj & Ulubasoglu, 2015 and Kotey & Abor, 2019).

Conversely, studies by (Karikari, 1992; Borensztein et. al., 1998; Zhang, 2001; Blomstron & Kokko, 1994 & 2003; Zheng et. al., 2006 and Herzer & Klasen, 2008) have claimed that FDI may negatively impact on economic growth. If a non-competitive market structure results from FDI, then industrial concentration might increase and serious impairment of the degree of competition in the long-run might occur, although competition might be enhanced in the short-run. Domestic investment might be reduced by FDI, leading to the shrinking of indigenous industries. Moreover, if MNEs manipulate market power and use transfer pricing policies then FDI can reduce host country's welfare. Enclave economies and inequality might also be created by FDI in the host countries, widening the income gap, and tilting the host economy towards an inappropriate technology and product mix.

In view of the anticipated benefits of FDI, a substantial amount of literature has been generated by the scholarly works that characterise the issue of impact of FDI on growth with some studies focusing on developing countries, such as Ayanwale's (2007); Herzer and Klasen's (2008) and Yerrabati and Hawkes' (2016), Kotey and Abor's (2019) and Chanegrina, Stewart and Tsoukis' (2020). However, few studies have considered the impact of FDI on economic growth in the

context of Africa and even less in the context of Kenya and Tanzania. Yet successive governments in Africa have laid emphasis on the need to improve investment climate including investment concessions in bids to spur economic growth. This study fills the void in investigating the impact of FDI on economic growth in Kenya and Tanzania and contributes to the literature on relationship between FDI's impact on economic growth in two main ways. First, the focus on specific African countries of Kenya and Tanzania so that the link between FDI and economic growth can be understood in the two countries with seemingly similar social, economic, political and geographical conditions. Second, many authors (Sylwester, 2005; Adams, 2009 and Okafor, 2014) have noted that FDI has different effects on domestic economies and that it has had more impact on some countries than others. This can also be investigated here.

Accordingly, and given the level of significance accorded to inbound FDI on the two countries' economic growth, this chapter conducts an empirical analysis of the impact of FDI on economic growth in Kenya and Tanzania using panel data analysis. The chapter investigates how FDI affects economic growth of the two countries as well as the magnitude of the impact between and within investing MNEs from OECD and non-OECD country groups on economic growth of Kenya and Tanzania, during the period of 1996 to 2016.

The rest of the chapter is therefore organised as follows: section two provides an overview of Kenya's and Tanzania's Economic Growth and Inward FDI, section three reviews previous theoretical perspectives and the main empirical studies on relationship between FDI and economic growth particularly in developing countries and develops hypotheses. Section four develops the research methodology. The fifth Section presents data analysis, section six presents the findings synthesized with the relevant literature and section seven summarises the key conclusions and policy implications.

#### **6.2.0. The Pattern of Kenya's and Tanzania's Economic Growth and Inward FDI.**

Both Kenya and Tanzania have a long history of reliance on FDI for economic development which dates back to the colonial period. However, after making initial gains in GDP growth soon after independence in 1963 and 1962 respectively, the two countries' growth started to deteriorate during the late 1980s and continued during the 1990s.

Like many African countries, both Kenya and Tanzania adopted market liberalisation in the mid-1990s, in order to promote trade as a way of stimulating growth. The governments of the

two countries resorted to full-fledged macro-economic reforms and structural adjustments. The liberalization policy helped increase FDI inflows more into Tanzanian than Kenya economy through the privatisation of national enterprises that led to the expansion of cross-border production by MNEs and their networks as well as affiliates in the two countries.

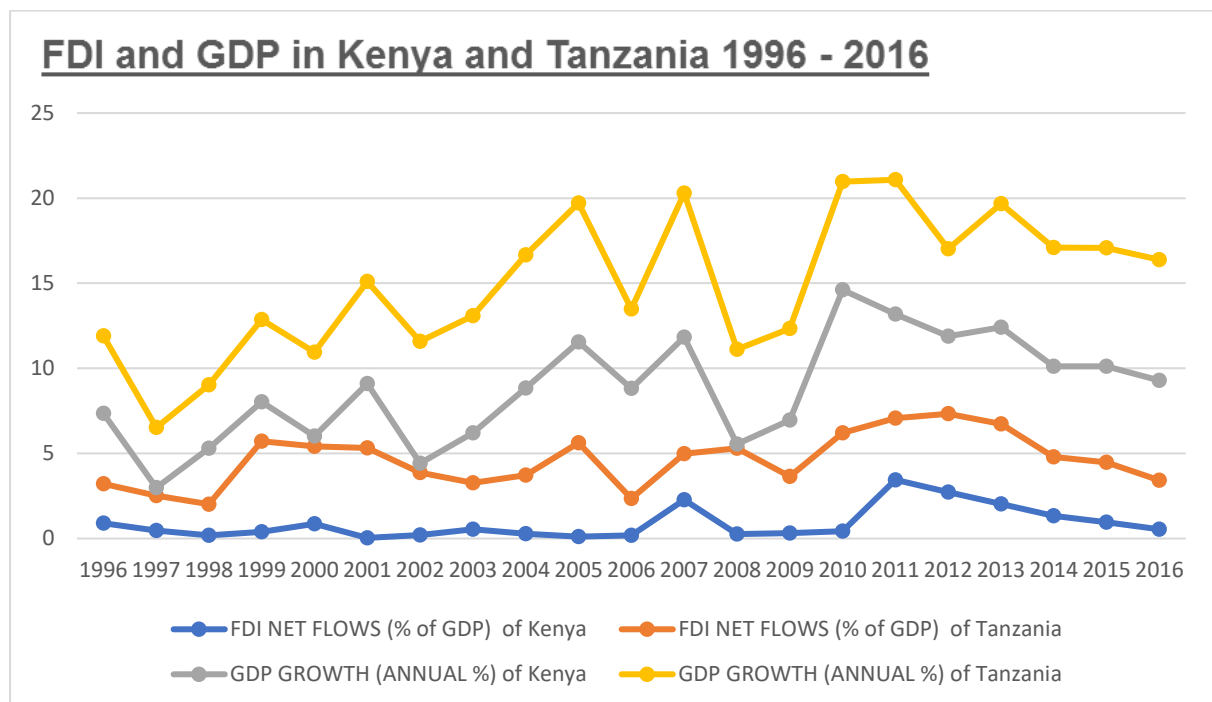
Taking the two economies in context, two specific facts can be highlighted regarding the object of this study in respect to FDI and economic growth. First, FDI inflows rose from an average of 0.074 billion USD to 0.42 billion USD for Kenya and 0.39 billion USD to 1.42 billion USD for Tanzania for the period of 2006 to 2016 (in nominal terms) which represented an average growth rate of approximately 800% and 400% respectively for the overall period. Secondly, the average economic growth rate of the countries changed from 3.76% to 8.2% for Kenya and 6.7% to 12.23% for Tanzania during the same period (KenInvest, 2018 and TIC, 2018).

The sharp decline in the Kenya's growth rate in 2008 was a direct consequence of the post-election upheavals experienced in late 2007 and early 2008. Currently the economy has shown some signs of recovery, albeit below the envisioned growth rate of 10% noted in their Vision 2030 roadmap plan (Kinuthia and Murshed, 2015). Meanwhile, the sharp jump of 1.61% to 5.01% in FDI flows to Tanzania in 1998 coincided with the program of liberalisation and establishment of the Tanzania Investment Centre (TIC) in 1997 and the country had a consistent rise in FDI inflows. The latter was mandated with promoting investments into Tanzania. It was not until 2004 that Kenya established a similar body – The Kenya Investment Authority (KenInvest) with the objective of promoting investments to Kenya.

The growth of FDI in Kenya and Tanzania can be distinguished by three different phases. The first phase – 1990-1994, was rather disappointing. In the second phase, the flow of FDI showed an increasing upward trend due to political and economic changes that occurred in the two countries in the second half of the 1990s. In this period, both Kenya and Tanzania joined the World Trade Organisation (in 1995). Tanzania moved faster with its privatisation program and formed an investment authority to encourage investments into Tanzania and therefore stimulated economic growth. During the third and larger scale of expansion from the year 2000, Tanzania received the third largest FDI in Africa in 2014 and as a result it was the 8<sup>th</sup> fastest growing economy in the world at the rate of 7.1% in 2016 and the highest recipient of FDI in Africa in the 2006-2016 decade (UNIDO, 2018 and UNCTAD, 2018). Regarding Kenya, the decline in volume of FDI inflows and the rate of economic growth continued during the third phase (Kinuthia and Murshed, 2015).

The annual FDI flows and GDP growth rates in Kenya and Tanzania over 1996-2016 are represented in Figure 6.1 below. Using 1996 as the base year, the growth trends of FDI and GDP in Kenya and Tanzania during 1996-2016 are clearly visible. As can be seen, FDI flows rate in Kenya was almost nil between 1996 to 2006, it then had a sharp rise before declining in 2008 due to political upheavals already noted above.

**3Figure 6.1: Comparison of FDI and GDP growth in Kenya and Tanzania 1996-2016.**



*Source: UNCTAD Database (2018), graph has been computed by the author.*

Similarly, there was a subsequent drop in annual GDP growth rate from 2008 and 2012 but at a lower growth rate than FDI flows' which the decline for both was attributed to the global financial and economic crisis. The GDP growth followed similar pattern but at a much lower level. Tanzania had a similar growth rate trend for both FDI flows and economic growth until 2004 when FDI flows grew sharply until the peak of 2013 and 2014 as displayed in figure 6.1. However, the economic growth responded to the growth in FDI flows by maintaining a steady but flat growth rate. The overall picture implies Tanzania has maintained higher FDI inflows and GDP growth rates than Kenya.

The next section reviews literature on FDI and GDP growth.

### **6.3.0. FDI Economic Growth Nexus.**

There have been a number of schools of thought on economic growth. The traditional ones such as the early post-Keynesian growth models, emphasized the role of saving and investment in enhancing growth and the neo-classical models that emphasized technical progress. The more recent endogenous growth models stressed the role of research and development (R&D), human capital accumulation and externalities.

Although the impact of FDI on economic growth is not clearly established, some studies (Alfara et. al., 2006) placed emphasis on the importance of financial development and others (Borensztein et. al., 1998) pointed to the importance of human capital as a means to reduce the constraints. Yusuf (2013) and Rjoub et. al. (2017) delved into the discussion of this challenge by arguing that there was the need of FDI to the developing countries and emphasized on the various factors that increased their inflows and the question of whether FDI leads to growth and development in the host country.

Although there is a debate about the impact of FDI on growth, most studies such as Blomstrom et. al.'s (2000), Fedderke and Romm's (2006), Yabi's (2010), Osei's (2014), Owusu-Nantwi and Erickson's (2019) and Chanegrina et. al.'s (2020) suggest that FDI has a positive direct and indirect impact on economic growth particularly in developing countries. For instance, De Mello (1999) and Kotey and Abor (2019) validated this impact through long-term economic growth via technology upgrading and knowledge spillovers. However, the extent to which FDI was growth-enhancing was determined by host country factors that facilitated growth since FDI itself did not necessarily lead to growth (Buckley et. al., 2002 and Yusuf, 2013). Firstly, neoclassical growth theory, holds that FDI augments the stock of physical capital in the host country. For instance, Solow (1956) model, that utilised the Cobb-Douglas production function and, like all other neoclassical models, was founded on the assertion that long-run economic growth and the steady increase in aggregate output, came from capital accumulation and technological progress and therefore directly affected economic growth. Secondly, endogenous growth theory holds that FDI, encourages human capital development and brings about technological upgrading and affects economic growth indirectly (De Mello, 1999).

Inspite of the positive impact of FDI on economic growth of a host country, there still exist several arguments that question the FDI-led growth effect. For example, dependency theorists such as Singer (1950) and Prebisch (1968) in the 1960s and 1970s were highly critical of the link between impact of FDI and economic growth in host developing economies. They argued

that, firstly, the benefits of FDI were unequally distributed, favouring MNEs at the expense of host developing economies. Secondly, MNEs impeded growth through distortions in the local economies by “crowding out” local firms and market monopolisation (Borensztein et. al., 1998 and Blomstron & Kokko 2001 and 2003). Thirdly, MNEs employed inappropriate technologies which contributed to the plight of rising unemployment. Fourthly, MNEs exploited natural resources therefore full FDI impact would not appear. Fifthly, FDI contributed to uneven income distribution hence widening income gap (Zhang, 2001) and undermined local culture. Consequently, to have a better understanding of impact of FDI on growth, it is necessary to consider factors like the host country characteristics or assumptions on which growth models were developed (Rjoub et. al., 2017).

In contrast to the dependency theories, numerous new growth models have endogenized technological transformation in an attempt to explain the formation of technological knowledge and its diffusion. This provides credible and reliable arguments for FDI as a catalyst for economic growth (Seyoum, Wu and Lin, 2015). For instance, the new endogenous growth theory (Romer, 1986; Lucas, 1988; Murphy, Shleifer & Vishny 1989; Krugman, 1990; Shaw, 1992; Howit & Aghion, 1998 and Kotey & Abor, 2019) saw long-run growth to be a function of technological progress and provider of means in which FDI could permanently raise the rate of growth in the host country through externalities, technology transfer, diffusion and spillover effects.

Accordingly, in new growth theory, FDI was seen to be an important source of human capital augmentation since it promoted the use of more advanced technologies by domestic firms and provided specific productivity-increasing labour training and skill acquisition. Besides technology and capital, FDI usually flowed as a bundle of resources which entailed organisational and managerial skills, marketing know-how and market access through the international marketing networks of MNEs (Kumar and Pradhan, 2002). Thus, FDI played a two-fold function by contributing to capital accumulation and increasing total factor productivity (Nath, 2009). New growth theory provided powerful support for FDI as a potent factor in promoting economic growth in host countries particularly in developing countries (Balasubramanyan et. al. ,1996, de Mello, 1997and Nai-Reichert & Weinhold, 2001).

Unlike the Solow model, these new growth models assumed constant returns to scale to inputs and the level of technology was assumed to be dependent on inputs such as human capital accumulation (Lucas, 1988 and Wang, 1990), investment in capital goods (Arrow, 1962 and

Findlay, 1978) and stock research and development (Romer, 1986). Arguments presented by these models favoured existence of FDI's effect on the level and rate of aggregate output growth, level of human capital and production through a permanent technology and knowledge transfers and spillovers. Subsequently, unlike the neoclassical models due to returns on capital including human capital, economic growth did not necessarily diminish as economy grew but growth went on indefinitely (Romer, 1986 and Lucas, 1988).

Regarding consideration of other factors, the impact of FDI on growth depends on the extent to which it complements or substitutes domestic investment. In a situation where FDI is a perfect substitute for domestic investments like in the neoclassical approach, it will raise the stock of capital and lead to growth. On the other hand, if FDI and domestic investments are complements, there would be a "crowding out" effect and FDI's effect on growth would not be permanent (Mehic et. al.,2013). Considering the host country characteristics, the effect of FDI on growth depends on factors such as trade openness, availability of natural resources, infrastructure development, domestic investments and sound institutional environment.

Given the conflicting theoretical perspectives, numerous empirical studies have investigated the relationship between FDI and economic growth particularly, in developing countries. There are studies that found a positive impact of FDI on economic growth, while another group established a negative impact of FDI on growth and there is also a group for which effect of FDI on growth is neither positive nor negative depending on host country characteristics. For instance, the relevance of Porter's (1990) diamond-shaped framework to the understanding of how FDI impacted on economic growth could include the effect of FDI on the country's market structure demonstrated by two scenarios. One, where FDI crowded in local competitors and improved the market structure or Two, where it adversely affected the structure of the local market by crowding out domestic competitors from the host country's market. However, this would be determined by whether FDI flows created enclave regions of clusters or created upstream and downstream linkages network with related and supporting industries, buyers and governments.

Whether FDI exerted a positive impact on economic growth depended upon a threshold level of income above which FDI had a positive effect on economic growth and below which it did not or was not significant (Blomstrom et. al., 1994). Studies such as Borensztein et. al.'s (1998) postulated that the interaction of FDI with quality of human capital had important impact on

economic growth and observed that the differences in the technological absorptive capability may account for different growth impacts of FDI across countries.

Importantly, Tong and Hu (2003) drawing from the Solow-type standard neoclassical growth model, argued that FDI encouraged the incorporation of new technologies in the production function of the host economy since its technological spillover effects offset the effects of diminishing returns to capital to keep the economy on a long-term growth run.

Similarly, FDI could also be seen to contribute to economic growth through technology transfer (Blomstrom et. al., 2000, Kinoshita, 2000 and Kotey & Abor, 2019). Technology could be transferred by MNEs either directly (internally) to their foreign owned enterprise (FOE) or indirectly (externally) to domestically owned and controlled firms in the host country. It is also worth noting that innovative and social capabilities of the host country as well as the absorptive capacity of other enterprises in the country will determine the pace of technological change in the country (Carkovic and Levine, 2005).

However, one channel through which FDI hindered growth could be if the host government granted significant benefits to the foreign firms such as preferential treatments and concessions. This could cause distortion which have larger negative effects on growth (Easterly, 1993). This view was shared by Borensztein et. al. (1998).

Although FDI has been positively correlated with economic growth, Bengoa and Sanchez-Robles (2003) asserted that host economies required minimum human capital, economic stability and liberalised markets in order to benefit from long-term FDI inflows. An alternative opinion by the endogenous school of thought was that FDI also influenced long-run variables such as human capital and research and development (Romer 1986 and Lucas, 1988).

Blomstrom et. al. (1994) held that the positive impact of FDI on growth was larger in those countries that exhibit higher levels of per capita income. Similarly, Durham (2004) observed that the effects of FDI were contingent on the “absorptive capacity” of host countries. Furthermore, Obwona (2001) argued that FDI affected growth positively but insignificantly perhaps due to the host country’s absorptive capacity. Meanwhile, the other factors that enabled FDI to positively impact on growth entailed political stability as well as quality institutions and infrastructure (Olofsdotter, 1998, Rodrik, Subramanian & Trebbi, 2004 and Tondl & Prufer, 2007).

Similarly, Yabi's (2010) assessment of developing countries found FDI to have a positive impact on economic growth in countries which themselves had previous high economic growth rates but not in those with low economic growth which alluded to heterogeneity of countries. In contrast, Kinoshita and Campos (2003) found that FDI had a significant positive effect on economic growth in central and eastern European and former Soviet transition economies. However, a positive relationship between FDI and the economic growth in East Asian countries existed only in high and middle-income countries but not in low income countries (Kotrajaras, 2010).

An analysis of FDI and economic growth by Ekanayake and Ledgerwood (2010) realised a positive result in 85 developing countries. Meanwhile, Herzer and Klasen (2008) found neither a short-term or long-term FDI effect on growth of majority of the developing countries they investigated. The estimation did not however entail control variables.

Nonetheless, a significant endogenous relationship between FDI and economic growth was identified from mid 1980s onwards by Li and Liu (2005). They argued that not only did FDI directly promote economic growth by itself but also indirectly did so via its interaction terms. The study concluded that the interaction of FDI with human capital exerted a strong positive effect on economic growth in developing countries.

Elsewhere, Iamsiraraj and Ulubasoglu (2015) conclusively documented that FDI flows positively impacted on economic growth. Moreover, they found that this association held globally as strong as in the developing world. They further identified trade openness and financial development rather than schooling as absorptive capacity indicators.

A negative impact of FDI on economies of Southern Mediterranean countries was however revealed by Marc (2011) confirming Borensztein et. al.'s (1998) similar view. This was alluded to the "crowding out" of domestic investment effect and characterised by relative instability and volatility. Equally, Aitken and Harrison (1999) and Djankov and Hoekman (2000) reported negative spillovers for Venezuela and Czech Republic firms respectively.

In terms of regions, the impact of FDI on economic growth was found to be stronger in East Asia than in Latin America (Zhang, 2001). These results were attributed to be the outcome of the FDI host regions' conditions such as types of trade regime and macroeconomic stability. Infact, Zheng et. al. (2006) argued that it was evident that outward and export orientation attracted pro-trade FDI and that inward orientation and import substitution attracted anti-trade

FDI. Ultimately, faster economic growth and structural upgrading in developing economies were effectively achieved by export than import oriented trade regimes.

Balasubramanyam et. al. (1996) found that effects of FDI on growth were more significant in the presence of trade openness and where the host country adopted liberalisation. Notably, Buckley et. al. (2002) and Zheng et. al. (2006) noted that host country conditions strongly influenced the FDI effect on growth and that FDI was the most important factor during Chinese remarkable economic growth. In contrast, a similar research into East Asia's economies by Bende-Nabende et. al. (2003) revealed that direct long-term impact of FDI on output was significant and positive for comparatively economically less advanced Philippines and Thailand but negative in the relatively advanced economy of Taiwan; which suggested that the level of economic development may not be the main enabling factor in FDI growth nexus.

Time was also seen as a factor in terms of FDI and economic growth. Durham (2004) posited that FDI could be beneficial in the short-term but not in the long-term in his study of OECD and non-OECD countries. He however, like other authors such as Borenszstein et. al. (1998) and Obwana (2001) maintained that the effects of FDI were contingent on the "absorptive capacity" of host countries. In contrast, a similar study by Owusu-Nantwi and Erickson (2019) established a long-term relationship between FDI and economic growth in South America.

In the context of Africa, mixed results were generated for instance, FDI was found to enhance economic growth in different host economies and regions such as Uganda (Durham, 2000), South Africa (Fedderke & Romm, 2006 and Moolman et. al., 2006), Ghana (Frimpong and O'teng-Abayie, 2006), Africa (Sharma and Abekah, 2008), SSA (Seetenah & Khadaroo, 2007 and Brambila-Macias & Massa, 2011) and Nigeria (Okudua, 2009). FDI not only provided the country with much needed capital for domestic investment but also created employment opportunities and helped transfer of managerial skills and technology in Kenya (Abala, 2014). The positive impact of FDI on growth was mainly in African countries with greater quantities of natural resources and large market size (Loots and Kabundi, 2012), greater human capital which implied a positive technological spillover from foreign to domestic capital (Lumbila,2005). FDI also contributed to growth 'crowding in' domestic investments in SSA (Ndikuma and Verick, 2008) but the growth impact in Southern Africa was limited (Bezuidenhout, 2009). Furthermore, economic growth in Nigeria was not influenced by FDI (Akinlo, 2004) nor did increased FDI in 1990s increase growth in SSA (Adams, 2009). There was no evidence of positive spillovers from FDI in Morocco (Haddad and Harrison,1993).

Equally, FDI did not generate positive spillover externalities for Tunisia, perhaps due to the host country's absorptive capacity (Belloumi, 2014).

Although the literature suggested that FDI can have either positive or negative impact on economic growth in a host country, the great majority of studies (such as Blomstrom et. al., 2000; Kinoshita, 2000; Li & Liu, 2005; Okudua, 2009; Yabi, 2010; Iamsiraraj & Ulubasoglu, 2015 and Owusu-Nantwi & Erickson, 2019) have shown a positive impact of FDI on economic growth and therefore, the hypothesis that flow in this study is;

***Hypothesis 1: FDI flows from all home countries have a positive impact on economic growth in both Kenya and Tanzania.***

### **6.3.1. FDI From OECD to Non-OECD Countries and its Impact on Economic Growth**

The impact of FDI from OECD to Non-OECD countries on growth of key sectors of non-OECD countries such as Indian automobile, electrical and chemical industries in the post reform era was positive (Banga, 2004 and 2006). For instance, the impact of Japanese affiliated firms' investment on growth in India was explained by efficiency growth while most of the US' affiliated firms' positive effect was explained by technological progress. Further, according to Balasubramanyan and Sapsford (2007) and Kotey & Abor (2019), FDI from the OECD supplemented domestic capital as well as providing technology and skills for existing non-OECD firms. For instance, Malhotra (2014) explained that the firms from OECD investing in non-OECD countries such as the US and the UK helped establish new companies such as Pepsi Co, being the largest beverage plant in India as well as Cadbury's establishment of its facility in the same country respectively.

FDI flows from the OECD with features of resource-seeking such as Japanese firms, impacted heavily on human capital resource and technological growth while others such as the US and European investors had a positive effect on higher labour productivity and general economic activities in the Chinese economy (Zhao and Zhu, 2000).

However, it was argued by Mortimore (2004) that much of FDI from OECD countries created an export platform for MNEs with limited benefits for the host countries. This view was reiterated by Mytelka and Barclay (2004) in the case of Trinidad and Tobago, where FDI has not been leveraged to develop skills and capabilities of local downstream and supporting firms.

In Africa, MNEs from the OECD were found to promote growth by boosting wages, increasing the transfer of technology and enhanced productivity. In contrast to natural resources

availability, good infrastructure, higher income, openness to trade and an educated labour force had a significant positive impact on realising of employment benefits of FDI (Asiedu, 2002). For instance, Ghana benefited from the UK FDI through technology transfer, creation of employment, transfer of management skills, improved productivity and consequently economic growth (Osei, 2014).

The growth effect of FDI from the OECD was expected to have a higher level of human capital and therefore benefited developing host countries (Xu and Wang, 2000). Beugelsdijk et. al. (2008) advanced the same argument after estimating that the growth effects of horizontal (market-seeking) FDI and vertical (efficiency-seeking) FDI from US in 44 host countries that entailed mainly developing economies. A superior growth effect of horizontal over vertical FDI was realised. However, no significant effects of horizontal or vertical FDI were found in developing economies.

Literature that has focused solely on FDI flows from OECD into non-OECD economies has generally produced significantly positive relation between FDI and economic growth thereby confirming the general assumption. As such, this study proposes;

***Hypothesis 2: FDI flows from OECD countries have a positive impact on economic growth in both Kenya and Tanzania.***

### **6.3.2. FDI from Non-OECD Home to Non-OECD Host Countries and its Impact on Economic Growth**

Although Schiff and Wang (2008) found that FDI from OECD to OECD countries was much more effective than FDI from Non-OECD to Non-OECD countries, they agreed that FDI from Non-OECD to Non-OECD countries was effective for increasing domestic productivity and thereby economic growth. Similarly, Demir and Duan (2018) evidenced a positive effect of FDI flows on human capital growth for Non-OECD FDI flows. However, they did not find any productivity growth or convergence effect at the sectoral level, including agricultural, industry or service sectors.

However, FDI from Hong Kong, Taiwan and Macao into China was often market-seeking and impacted positively on export market and technological growth sectors of the economy. Elsewhere, FDI from Singapore and other ASEAN countries had similar effects to Hong Kong's but with a bigger impact on Chinese technology (Zhao and Zhu, 2000).

In terms of Africa, although African economies that exported natural resources benefited from positive terms-of-trade-effects, there was evidence for displacement effects of African firms that supply textiles, footwear or ceramic products due to competition from non-OECD countries particularly China. Henceforth, Chinese FDI did not seem to have a significant impact on African growth (Morrissey & Zgou, 2011 and Busse, Erdogan & Muhlen, 2016).

However, employing Solow growth accounting model, Whalley and Weisbrod's (2012) study found that a significant portion of the accelerated growth in some African economies in the years immediately before and after the financial crisis could be attributed to Chinese FDI inflows. This result however, was not supported by Zhang et. al. (2015). Contrary to Whalley and Weisbrod (2012), Zhang et. al. (2015) established an insignificant impact on African growth by Chinese FDI inflows. However, Seyoum et. al. (2015) found Chinese firms more productive than the Ethiopian firms leading to positive productivity spillovers from Chinese FDI into Ethiopian manufacturing sector. Nevertheless, Kaplinsky and Morris (2009) argued that the growth impact of Chinese FDI in Africa was largely determined by strategic negotiations and the quality of governance on the part of African governments.

While SSA economies benefited from FDI from Non-OECD, there were many reasons to believe that the dynamic benefits were less than they should be. Specifically, Chinese FDI appeared to have few linkages with the local economy as huge amount of FDI tended to be temporary in nature motivated by accessing trade preferences. Although FDI motivated by securing access to resources was long-term, the SSA seldom received the right price (Meyersson et. al., 2008 and Morrissey, 2010). Moreover, the massive Chinese investments in Africa came with certain drawbacks. For instance, they negatively impacted on local trade and commerce and in some cases African labour did not benefit from these investments (Adisu, Sharkey and Akroafo, 2010).

Regarding the impact of Indian FDI on African growth, it was by no means negligible and was more likely to become more important in the foreseeable future. Nevertheless, the ways in which Africa has been affected by Indian FDI differed from country to country. Some, such as Nigeria and Sudan, were important exporters to India hence the impact on them was through growth of exports. On the other hand, the most significant impact on economies of Ethiopia, Kenya, Tanzania and Uganda was because of increased imports from India (Jenkins and Edwards, 2015). Most of the studies that focused on FDI from non-OECD to non-OECD

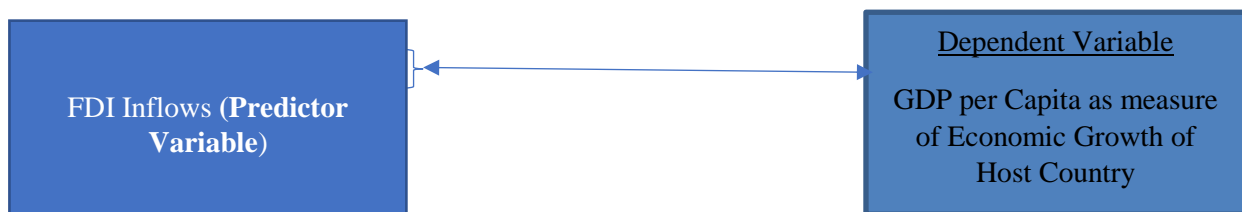
countries found a significant impact of FDI on economic growth. Consequently, this study proposes:

***Hypothesis 3: FDI flows from Non-OECD countries have a positive impact on economic growth in both Kenya and Tanzania.***

### **6.3.3. Conceptual Framework on the Impact of FDI on Economic Growth.**

From the reviewed empirical studies, it can be deduced that a number of these studies (Dunning, 1977; Borensztein et. al., 1998; Blomstom et. al., 2000; Zhang, 2001; Ajayi, 2006; Ayanwale, 2007; Tondl & Prufer, 2007; Liu and Dejphanomporn, 2018 and Owusu-Nantwi & Erickson, 2019) have demonstrated that FDI from all home countries be they OECD, non-OECD countries, have a positive impact on economic growth in host countries as shown in the conceptual framework below.

**4Figure 6.2. Conceptual Framework on the Impact of FDI on Economic Growth.**



*Source: Created by author using materials from Literature on FDI flows' impact on Economic Growth.*

However, the ability of FDI to predict the impact of FDI on economic growth (represented by the GDP per capita) is incomplete without control variables. Drawing support from new growth models supported by the relevant empirical studies mentioned above, FDI's impact on economic growth is facilitated by other interactive variables such as openness to trade, human capital, labour costs, infrastructure development, natural resources, domestic investments, government expenditure and quality of institutions as discussed in the section below and shown in Figure 6.3.

### **6.4.0. The Study Model and Variable Specifications**

For this study to examine potential heterogeneity among the different country groups within the data in this section, the study model was based on the new growth theory (Romer, 1986, Lucas, 1988 and Shaw, 1992). Consequently, GDP/Capita is modelled by means of an extended Cobb-Douglas production function model where FDI is created as an additional production

input along with labour and (domestic) capital. Capital is then broken down into fixed physical capital stock and human capital. The impact of FDI on economic growth can therefore be endogenized by including other variable in the growth model such as FDI expressed as a function of one-year lagged FDI, openness to trade, human capital, total labour force, mobile cellular subscriptions, total natural resources, domestic savings, government consumption and quality of institutions (Zheng et. al, 2006; Petrakos et. al., 2007 and Zhang et. al.,2010). Following the study's hypotheses, FDI is the main predictor variable of interest in this chapter while other variables are considered control variables. As explained in the methodology chapter, the units of analysis and all proxies used in this chapter are presented in relative terms of the Kenyan and Tanzania data to derive the Panel database. Thus, (ratio = host country ÷ home country). This approach follows previous studies such as Nair-Reichert and Weinhold (2001) that submitted several advantages of using relative values. Firstly, growth rates can determine the relationship between variables over time in a specific region. Secondly, the use of relative values of the variable is like that the variable will be stationery and avoid the problem of spurious regression.

The proposed model and its linear version examining the impact of FDI on economic growth are structured below.

GDP per Capita = f (One-year lagged FDI, Openness to Trade, Human Capital, Total Labour Force, Mobile Cellular Subscriptions, Total Natural Resources, Domestic Savings, Government Consumption and Quality of Institutions).

$$\begin{aligned}
 RGDPPCAP_{it} = & \beta_1 RFDI_{(t-1)} \\
 & + \beta_2 ROPEXIM_{it} + \beta_3 RHCAP_{it} + \beta_4 RTLFORC_{it} + \beta_5 RMOBL\_100P_{it} + \beta_6 RTNR_{it} + \beta_7 RGDS_{it} \\
 & + \beta_8 RGGFC_{it} + \beta_9 RQINST_{it} + v_{it}
 \end{aligned}$$

Where R indicates ratio values,  $v$  is a composite term including both intercept and stochastic error term,  $i$  and  $t$  denote the panel format of dataset:  $i$  = individual countries (grouped into Kenya and Tanzania's full sample, OECD and non-OECD countries) and  $t$  represents time period (1996-2016). All variables are in ratio form. RGDPPCAP is the GDP per capita and it denotes economic growth proxied by the ratio of Kenya and Tanzania's GDP per capita to the home country of the foreign MNE. While  $RFDI_{(t-1)}$  represents the ratio of one-year lagged FDI relative to the home country FDI in Kenya and Tanzania. Control variables include ROPEXIM which is the openness as the trade potion of GDP, RHCAP is the human capital, RTLFORC is total labour force representing labour cost, RMOBL\_100P is mobile cellular subscription

representing infrastructure development, RTNR is the total natural resources, RGDS denotes the domestic savings which is a percentage of GDP, LRGGFC is government consumption as a percentage of GDP and RQINST is quality of institutions representing political and institutional factors (these variables are already described in section 6.3.3).

Model 1 above is structured using variables in relative terms to construct the panel data format needed for a panel data analysis. This follows Wooldridge’s (2016) view that use of relative values provides an additional advantage of having a mixture of variables measured in nominal terms. Following endogenous growth model, the main direction of causal effect in models 1 and 2 would thus follow that increased ratio of Kenya’s and Tanzania’s FDI from investing MNE’s home country would influence higher ratio of Kenya’s and Tanzania’s GDP/Capita relative to the investing home country in Kenya and Tanzania. ). Table 6.1 below shows the nature, measures, sources and definitions of variables with the expected signs and the units of analysis.

**18Table 6.1. Description and Sources of Variables**

Variable	Proxy	Expected Sign	Source	Definition
GDP per capita in (log form).  Dependable Variable	RGDPPCAP		World Development Indicators	Ratio of host to home country’s GDP per capita which is obtained as a ratio of GDP to the population (WDI, 2018).
Foreign Investments (lag) (Predictor Variable)	Direct RFDI <sub>(t-1)</sub> : FDI flows from home country to Kenya and Tanzania.	+	Kenya Investment Authority for Kenya and Tanzania Investment Council for Tanzania.	Ratio of one year lagged FDI flows from each home country to the total annual amount of FDI flows into Kenya and Tanzania (KenInvest, 2018, TIC, 2018 and UNCTAD, 2018).
Openness (control variable)	ROPEX_IM	+	WDI	Ratio of host to home countries’ ratio of trade (imports and exports) to GDP (WDI, 2018).
Human Capital (control variable)	RHCAP: Gross Enrolment Ratio both sexes (%)	+	WDI	Ratio of host to home country’s ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of education shown (WDI, 2018).



#### **6.4.1.1. The Dependent Variable.**

The dependent variable represents Kenya's and Tanzania's economic growth (proxied by the ratio of Kenya and Tanzania's respectively to home country of the investing foreign MNEs' annual GDP per capita) obtained from the World Bank Development indicators.

As mentioned in the preceding section, the study has also used independent variables. The independent variables are composed of predictor variables and control variables discussed below and shown in Figure 6.3.

#### **6.4.1.2. Predictor Variable**

The predictable variable is the ratio of one-year lagged FDI flows from each home country to the total annual amount of FDI flows into Kenya and Tanzania respectively. It is the most important factor for the study on impact of FDI on economic growth in a host country. Since previous periods' FDI is likely to impact on current growth, the variable is lagged by one year. Mixed studies made use of both current and lagged FDI as an independent variable. A greater majority of studies (such as Alfaro et. al., 2006; Zheng et. al., 2006 and Kottaridi & Stengos, 2010) employed lagged FDI values, describing lagged FDI as a more consistent measure of impact of FDI than the current measure. However, Iamsiraraj and Ulubasoglu (2015) preferred current FDI because it contributed more strongly to growth than lagged FDI. This study tried current FDI, but it did not perform well as that of lagged FDI. One-year lagged FDI flows value was therefore used as a predictor variable in the equation.

#### **6.4.1.3. Control Variables**

The control variables are discussed under the sub-titles of economic, social-cultural and institutional factors.

##### **Economic Factors' Impact on Economic Growth**

The degree of the host country's openness to trade was captured by trade which is the sum of exports and imports as a percentage of GDP. By use of the ratio of the sum of imports and exports in a host to a home country as a measure and as noted by Balasubramanyam et. al. (1996) and Belloumi (2014), openness to trade is expected to have a positive and significant impact on economic growth.

Human capital has been identified by several studies (Kinoshita, 2000; Narula and Marin, 2003 and Zhang et. al., 2010) as one of the main reasons for the differential response at different

levels of income. This is because a well-educated population can exploit and spread the benefits of new innovations to the whole economy. Education can also lead to higher complementarity between workers that results into higher productivity and economic growth (human capital externalities) which corroborates Blomstrom et. al.'s (2000) view that a certain level of development in education (adequate stock of human capital) helps host countries close the technology gap. Therefore, a positive impact of human capital on economic growth is anticipated.

Although labour is believed to be relatively cheap in Africa, there is nonetheless an overall shortage of skilled labour on the continent (Obwona and Egessa, 2004). This decision is informed by the supply and demand concept in which it is assumed that the higher the level of total labour force a host country can supply, the lower the wages paid. Therefore, a positive impact is expected.

Another factor that may influence the impact of FDI on economic growth is infrastructure as it has been found to raise the productivity of investment and thereby increases economic growth of a host country. Infrastructure is often measured in literature by the number of telephones per 1000 population (Sanchez-Robles, 1998 and Okafor, 2014). This study will measure infrastructure development by use of mobile cellular subscriptions per 100 people. This measure takes care of availability of mobile phones and their usage and a positive impact is anticipated.

Economic growth can be influenced by availability of natural resources especially in developing and less developed countries where demand and industrialisation are low (Sachs and Warner, 1999). Natural resources can also facilitate participation in international trade and help diversify an economy into the productive sectors if prudently managed (Asiedu, 2002, Wu et. al., 2004, Anyanwu and Yameogo, 2015 and Shan et. al., 2018). Therefore, a positive and significant effect on economic growth is expected.

### **Social Cultural Factors' Impact on Economic Growth**

The Harrod-Domar growth model implied that countries could grow faster by saving more because all things being equal, economies with higher rates of domestic savings have more capital per worker, higher per capita income and higher labour productivity (Okafor, 2014). Therefore, a positive impact of domestic investment savings on economic growth is expected.

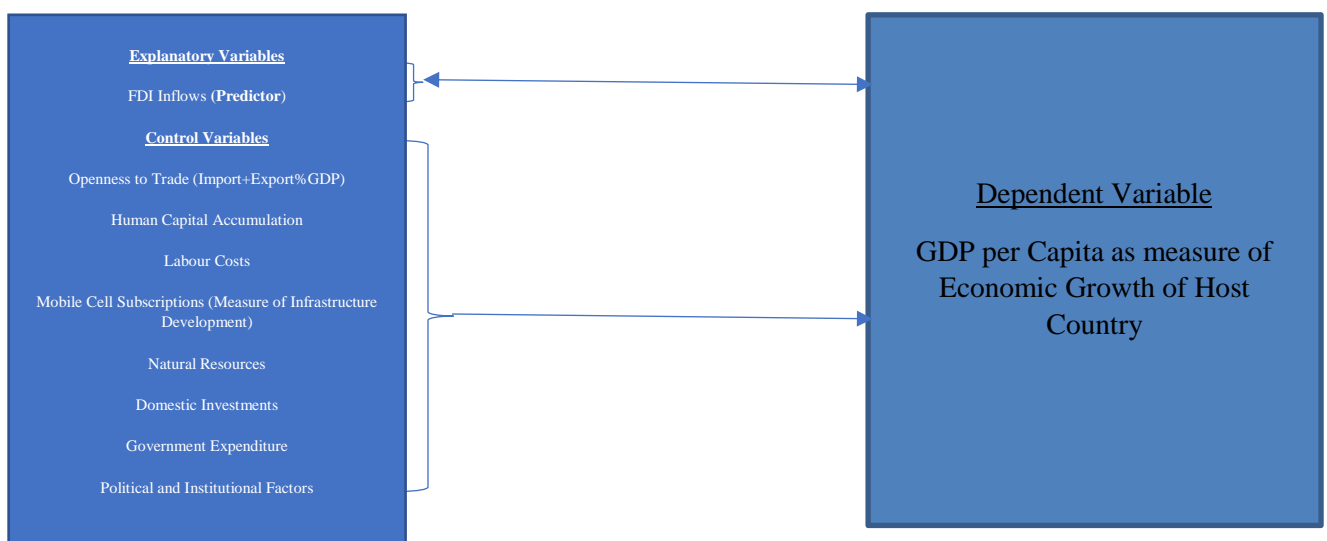
Another factor that may influence the impact of FDI on economic growth is the government consumption which has elicited huge controversies. There are some scholars such as Ghura (1995) who argued that the government provided important public services such as health, education, security and infrastructure which were essential for private investment and hence beneficial to growth. In contrast, authors such as Anwar and Nguyen (2010) argued that increasing government consumption was usually accompanied by raising taxes and raising monetisation of the deficit which crowded out private investment and thus impeded growth. As such, a negative impact of government expenditure on economic growth is expected.

### Political and Institutional Factors

Political and Institutional factors have been identified in the literature as having important roles to play in either improving or slowing down economic growth (Lipset, 1959; Grier & Tullock, 1989 and Lensink, 2001) and also deters FDI. Political stability is usually measured by the likelihood of government being overthrown or destabilised by unlawful means (WGI, 2015). Quality of institutions can be measured by factors such as government refusal to fulfil terms of contract, the rule of law, and corruption (Petraikos et. al., 2007). This study employs this measure and therefore expects political stability and quality of institutions of a host country to be positively related to its economic growth.

These variables are shown in the diagram below.

**5Figure 6.3. The Relationship Between Dependent, Predictor and Control Variables.**



*Source: Created by author using materials from Literature on FDI flows' impact on Economic Growth.*

### **6.4.2. Data Analysis**

The details of the statistical analysis are provided in this section. This research empirically investigates the impact of inward FDI on economic growth of both Kenya and Tanzania by use of panel dataset at the aggregate country-level, considering the level of economic development of the home countries of firms investing in Kenya and Tanzania, grouped into OECD and non-OECD. All data used in this chapter is reported in relative terms (i.e. Kenya and Tanzania as the numerator and home countries as the dominator). Similar to section 5.3.0 in the FDI determinants' chapter, the study data series for the full sample covers 22 home countries for Kenya and 23 for Tanzania for a total period of 21 years amounting to 462 and 483 observations for Kenya and Tanzania respectively. The OECD countries include 12 countries for Kenya and 13 for Tanzania for the same period amounting to 252 observations for Kenya and 273 for Tanzania. Non-OECD countries include 10 countries and 210 observations for both Kenya and Tanzania.

### **6.4.3. Pre-Estimation Tests**

Table 6.2 reports the descriptive statistics for the variables used in the estimation, displaying the key features of the study dataset (in relative terms) prior to log transformation. From the table, the summary statistics for full sample for Kenya had the average GDP per capita of 35.6981 with a maximum of 128.4636 and standard deviation of 31.48659. Similar patterns were observed for the summary statistics for Tanzania had the average GDP per capita of 51.27848 with a maximum of 215.1673 and standard deviation of 46.45578. It is observed, as shown in Table 6.2 that the data for GDP per capita have unequal variation with a large mean and a large standard deviation. To make the dataset conform to normality, logs were taken to equalise the variation squeezing the groups with the larger standard deviations and stretching data with the smaller values and standard deviations as displayed in Table 6.3 (Schwarz, 2011 and Okafor, 2015). Drawing on approaches of similar studies such as Zheng et. al.'s (2006), Model 2 (in section 6.4.3) is structured to investigate the log-log relationship of the impact of the main predictive variables on the dependent variable more directly in terms of elasticity and provide more control over the interaction of the variables.

**19Table 6.2. Descriptive Statistics Before Log Transformation for Kenya and Tanzania.**

Sample Countries Variables	Kenya				Tanzania			
	Mean	Std. Dev.	Minimum	Maximum	Mean	Std. Dev.	Minimum	Maximum
<b>GDP per capital (RGDPPCAP)</b>	35.698	31.48659	0.396842	128.4636	51.27848	46.45578	0.6614	215.1673
<b>Lagged FDI (RFDI<sub>(t-1)</sub>)</b>	0.045	0.026076	0.000446	2081961	0.043478	0.02218	0.001383	1.371881
<b>Openness (ROPEXIM)</b>	1.039	0.552248	0.101791	3.093855	0.804028	0.388203	0.15195	2.407284
<b>Human Capital (RHCAP)</b>	0.854727	0.811556	0.229927	6.622276	0.289515	0.222272	0.009739	1.2765
<b>Total Labour Force(RTLFORC)</b>	1.253547	1.43966	0.015599	6.768887	3.184908	5.079705	0.019933	25.7819
<b>Mobile Cell Subscriptions (RMOBL_100P)</b>	0.750944	3.482498	0.000349	72.05794	0.421721	0.454245	0.001021	3.235798
<b>Total Natural Resources (RTNR)</b>	3.434521	12.57559	0.058605	221.7256	5.197338	9.279528	0.147977	132.7049
<b>Domestic savings (RGDS)</b>	0.959198	0.416431	0.073742	2.126817	1.951445	1.327956	0.225147	7.985316
<b>Government Consumption (RGGFC)</b>	0.912361	0.286138	0.28888	1.661989	1.236205	0.440228	0.461912	3.401823
<b>Political and Institutional Factors (RQINST)</b>	0.657927	0.540042	0.288557	3.6	0.563558	0.280972	0.246305	1.431034

Like in the analysis of FDI determinants' chapter, all variables have been logged to deal with skewness of data as well as reducing heteroscedasticity. By logging, the data is made more uniform and less affected by outliers (Zheng, 2013 and Okafor, 2014). Therefore, equation 2 can be written in the following format:

$$\begin{aligned}
 &LRGDPPCAP_{it} = \beta_1 LRFDI_{(t-1)} \\
 &+ \beta_2 LROPEXIM_{it} + \beta_3 LRHCAP_{it} + \beta_4 LRTLFORC_{it} + \beta_5 LRMOBL\_100P_{it} + \beta_6 LRTNR_{it} + \beta_7 LRGDS_{it} \\
 &+ \beta_8 LRGGFC_{it} + \beta_9 LRQINST_{it} + v_{it}
 \end{aligned} \tag{2}$$

Where L indicates logged values,  $v$  is a composite term including both intercept and stochastic error term,  $i$  and  $t$  denote individual countries and time respectively. All variables are in ratio form. Therefore, the most important variable for this study is the flow of FDI in the previous time-period, hence the dynamic effect of FDI on economic growth has to be taken into account thus, one year lagged FDI is used in equation (2). The log-log model 2 (derived from model 1) will be able to measure the impact of the main predictive variables on the dependent variable

more directly in terms of elasticity and provide more control over the interaction of the variables (Zheng, 2013).

**20Table 6.3. Descriptive Statistics After Log Transformation for Kenya and Tanzania.**

Sample Countries Variables	Kenya				Tanzania			
	Mean	Std. Dev.	Minimum	Maximum	Mean	Std. Dev.	Minimum	Maximum
<b>GDP per capita (LRGDPPCAP)</b>	-2.999	1.684	-6.727	1.075	-2.956	1.726	-7.128	1.154
<b>Lagged FDI (LRFDI<sub>(t-1)</sub>)</b>	-3.296	0.746	-7.716	-1.569	-3.284	0.593	-6.584	-1.986
<b>Openness (LROPEXIM)</b>	-0.123	0.620	-2.285	1.129	-0.345	0.529	-1.884	0.878
<b>Human Capital (LRHCAP)</b>	-0.401	0.626	-1.470	1.890	-1.514	0.790	-4.632	0.244
<b>Total Labour Force (LRTLFORC)</b>	-0.515	1.425	-4.161	1.912	0.164	1.602	-3.915	3.250
<b>Mobile Cell Subscriptions (LRMOBL_100P)</b>	-1.312	1.385	-4.970	1.453	-1.861	1.905	-6.887	1.174
<b>Total Natural Resource (RTNR)</b>	0.345	1.307	-2.837	5.401	1.057	1.133	-1.911	4.888
<b>Domestic savings (LRGDS)</b>	-0.157	0.522	-2.607	0.755	0.456	0.670	-1.491	2.078
<b>Government Consumption (LRGGFC)</b>	-0.146	0.338	-1.242	0.508	0.150	0.354	-0.772	1.224
<b>Political and Institutional Factors (LRQINST)</b>	-1.097	0.963	-2.308	3.332	-0.675	0.431	-1.401	0.358

The correlation matrix results and the VIF values shown in Table 6.4 for Kenya and Table 6.5 for Tanzania indicate that multicollinearity does not exist in the study variables. Multicollinearity exists if the study variable correlates very highly, usually above 0.80 or 0.90, when the tolerance values should not be above 0.1 and the VIF value should not be above 10 (Cameron and Trivedi, 2010). The data was examined in eviews for correlation to check for VIF and the mean scores of 3.05 were produced for Kenya and 1.42 for Tanzania which are well within the tolerance level for VIF score. Tests for heteroscedasticity did not show any model with problems of heteroscedasticity. Data log transformation was performed for all the study variables to improve the normality of the dataset. This draws support from previous IB

studies such as (Kumar, 2001; Zheng et. al., 2006; Falk, 2014 and Okafor, 2014) that have suggested that taking logs helps improve the normality and linearity of the data series.

21Table 6.4. Correlation Matrix (Kenya)

	1	2	3	4	5	6	7	8	9	10	11
<b>1 LRGDPPCAP</b>	1										
<b>2 LRFDI<sub>(t-1)</sub></b>	0.258	0.313	1								
<b>3 LROPEXIM</b>	-0.084	0.566	0.029	1							
<b>4 LRHCAP</b>	-0.479	-0.215	-0.320	0.208	1						
<b>5 LRTLFORC</b>	0.486	-0.304	-0.160	-0.547	-0.156	1					
<b>6 LRMOBL_100P</b>	-0.428	-0.211	-0.238	0.114	0.661	-0.169	1				
<b>7 LRTNR</b>	0.114	0.039	0.108	-0.094	-0.094	0.062	-0.102	1			
<b>8 LRGDS</b>	0.350	-0.221	-0.127	-0.531	-0.415	0.410	-0.310	0.057	1		
<b>9 LRGGFC</b>	0.283	-0.093	0.248	-0.111	-0.351	0.187	-0.186	-0.055	0.181	1	
<b>10 LRQINST</b>	-0.509	-0.219	-0.316	0.163	0.487	-0.251	0.469	-0.113	-0.283	-0.315	1
<b>V.I.F. Score:</b>	<b>3.05</b>										

**Table 6.5. Correlation Matrix (Tanzania)**

	1	2	3	4	5	6	7	8	9	10	11
1 LRGDPPCAP	1										
2 LRFDI (it-1)	0.102	0.325	1								
3 LROPEXIM	0.231	0.495	0.282	1							
4 LRHCAP	-0.167	-0.172	-0.063	0.293	1						
5 LRTLFORC	-0.041	-0.210	-0.187	-0.452	-0.105	1					
6 LRMOBL_100P	-0.055	-0.177	-0.005	0.276	0.628	0.015	1				
7 LRTNR	0.241	0.109	0.050	-0.033	-0.149	0.015	-0.154	1			
8 LRGDS	-0.001	0.015	-0.046	-0.203	-0.517	0.194	-0.279	0.005	1		
9 LRGGFC	0.233	-0.003	-0.067	-0.296	-0.548	0.284	-0.326	0.171	0.307	1	
10 LRQINST	-0.065	-0.187	0.050	0.355	0.540	-0.217	0.562	-0.207	-0.236	-0.495	1
V.I.F. Score:	1.42										

#### 6.4.4. Diagnostic Tests

Fixed effects were used for the investigations. The random effect was rejected as confirmed by the Hausman test and the fixed effect model adopted. Unlike the determinants of FDI, there were no dummies in the models for economic growth because they negatively affected the results and were therefore dropped. The modelling techniques used reduced biased estimates as well as avoided severe misspecification as they allowed for variation in characteristics relating to the sampled countries both cross-sectionally and over time. Use of panel estimation techniques was to rectify unobserved heterogeneity given the huge disparity between variables as revealed in the summary statistics. In-depth discussion on random and fixed effects are in earlier chapters.

A range of variables reflecting different specific impacts on economic growth linked to other explanatory variables was considered in turn for each sample following a procedure by Judd & McClelland (2011) and Fallon & Cook (2014). The regression began with full sample model, followed by OECD model and then non-OECD model. A variety of alternative variables, including measures of openness to trade, human capital, labour costs, mobile cellular subscriptions, natural resources, domestic investments, government expenditure and quality of institutions factors were successively introduced, being excluded where they lacked explanatory powers.

High levels of correlations were expected between LRHCAP and LRTLFORC. Hence, the degree of correlation in each case was estimated by using a correlation matrix (see Tables 6.4 and 6.5). Therefore, only one of the inter-related variables was used in any equation at a time

to reduce multicollinearity between explanatory variables. The worst performing variable in any pair was omitted after being tried separately in each of the regression equations.

Several theoretical and practical checks were conducted to identify and remove heteroscedasticity, linked to omission of variables, non-linearities or aggregation. Each sampled equation was differently tried and the problem was tested by Levene and the Mackinnon and White tests. However, heteroscedasticity was not identified in any of these tests. All variables were calculated as relative values and have been logged to deal with skewness of data as well as removing heteroscedasticity. By logging, made the data more uniform and less affected by outliers and because of the difference in the size as some of the control variables and predictors have a large range and therefore a log was taken as shown in Table 6.3.

Single equation, multivariate, regression models were developed for each sample of home countries using an estimation procedure based on a Poisson-type model, with LRGDPPCAP (proxied as ratio of host to home countries GDP/CAPITA) being used as the dependent variable in each case. The method employed throughout was to regress a range of potential explanatory variables on this dependent variable until 'best fit' models were obtained for both Kenya and Tanzania. Six separate best fit models are estimated, three for each host country representing FDI flows from full sample, OECD and non-OECD respectively.

#### **6.5.0. Research Findings**

This section will discuss the empirical results of the impact of FDI on economic growth in Kenya and Tanzania. The main aims of this section entail (i) to investigate if FDI is a source of economic growth in Kenya and Tanzania and (ii) to examine other factors that have been responsible for the economic growth in Kenya and Tanzania.

##### **6.5.1. Main Findings on Impact of FDI on Economic Growth in Kenya and Tanzania.**

In order to test the several hypotheses presented in literature review section, the multiple linear regression was conducted for several models. The regressions for the variables in this section were conducted on the basis of FDI flows from full sample, OECD countries, non-OECD countries and other control factors. Unlike, in the determinants' chapter, several estimations for equation (2) were conducted using the fixed effect model. Essentially, three regressions for full sample, OECD countries, non-OECD countries per each table were run to test the relationships between all the variables in the proposed model. Only one measure in each model

was used due to some concern that these alternative measures might have better explanatory variables than the alternatives. For instance, there are three measures of infrastructure. The study only used one measure, mobile cellular subscriptions, and also chose the variables that gave better explanatory results. Similarly, quality of institutions was selected as a measure for political and institutional factors because it performed better than the political stability option for both Kenya and Tanzania. Tables 6.6 (for Kenya) and 6.8 (for Tanzania) show the empirical results obtained and cross section fixed effect are similar in both cases for Kenya and Tanzania. The discussion will be largely restricted to results from Models one, two and three.

The interpretation of results will follow a similar pattern to that in the previous chapter by analysing the significant variables with the right signs first, then insignificant variables with right signs followed by significant variables with wrong signs and finally variables that are not significant with wrong signs.

The next sections report the findings of the regression analysis of the various models indicated separately for each host country.

### 6.5.1.1. Main Findings on Impact of FDI on Economic Growth in Kenya.

The empirical results obtained from estimating equation (2) show that most of the independent variables had the expected sign with GDP/Capita and 5 of the 9 explanatory variables in models one and 6 in models two and three are statistically significant.

**23Table 6.6. Results for Kenya**

-	-	<b>Res 1996-2016</b>		
-	-	<b>The Top 22 Home Countries</b>	<b>12 OECD Countries</b>	<b>10 Non-OECD Countries</b>
<b>Variable</b>	<b>Variable Name</b>	<b>1</b>	<b>2</b>	<b>3</b>
Constant		1.030311***	9.305601***	0.500539***
St. Error		(0.123139)	(1.189935)	(0.162767)
LRFDI(t-1) (Predictor) H1, 2, 3	Lagged FDI	0.044010*** (0.013483)	0.192138* (0.100273)	0.032498** (0.014441)
LROPEX_IM (Control)	Openness	0.259576*** (0.050442)	1.362125*** (0.219473)	0.447521*** (0.055836)
LRHCAP (Control)	Human Capital	0.029961 (0.051531)	4.533349*** (0.493074)	0.058834 (0.052390)
LRTLFORC (Control)	Total Labour Force	0.456644*** (0.124817)	0.635531*** (0.191235)	0.348951** (0.138249)
LRMOBL_100 (Control)	Infrastructure Develop. proxied by mobile cellular subscriptions	0.008455 (0.009124)	-0.090468 (0.151951)	0.044828*** (0.009789)

LRTNR (Control)	Total Natural Resources	-0.028294 (0.015421)	0.252895*** (0.077916)	-0.062616 (0.027467)
RGDS (Control)	Domestic savings	0.041359 (0.035684)	0.198398 (0.148173)	0.061867* (0.034042)
LRGGFC (Control)	Government Consumption	-0.133658** (0.066977)	3.221056* (0.276873)	-0.069238 (0.064404)
LRQINST_100 (Control)	Political & Institutional Factors proxied by quality of institutions	-0.243813* (0.043029)	0.342875 (0.365032)	-0.090965** (0.043432)
Number of Observations		462	252	210
R2		0.892947	0.648465	0.893934
Adj R2		0.892438	0.600746	0.893328

Notes: Standard errors are reported in (). \*, \*\*, \*\*\* indicate significance at 10%, 5% and 1% level respectively.

### **FDI flows' impact on economic growth in Kenya.**

Hypothesis 1 tested the impact of FDI flows on economic growth in the host country. The results indicate that FDI flows is an important factor driving economic growth in Kenya. Accordingly, 1% increase in FDI at full sample level would generate a 4.4% growth in Kenya at 1% significant level. The empirical evidence supports the neoclassical and endogenous models which justified the idea that FDI promoted economic growth. In retrospect, the neoclassical economists argued that economic growth was influenced by FDI by increase in the amount of capital per person. This empirical result is also consistent with new growth theory in which the impact of FDI on economic growth was even more pronounced than in the Solow model, because the new growth theory treated technological progress (the engine of economic growth) as at least partly endogenous. This finding is supported by several previous studies such as Balasubramanyam et. al.'s (1996), Bende-Nabende et. al.'s (2003) and Gui-Diby's (2014) and Kotey & Abor's (2019). This study finds that FDI in the full sample have a positive and significant effect on economic growth in Kenya and therefore, H1 is accepted.

### **FDI flows from OECD countries' impact on economic growth in Kenya.**

FDI from OECD countries as tested in hypotheses 2 has both positive and significant impact on economic growth in Kenya. Thus, 1% increase in OECD FDI would lead to 19.2% rise in economic growth in Kenya at 10% significant level. This could be attributed to the huge presence of OECD firms in Kenya since the largest MNEs operating there are predominantly from European countries, and majority of them come from the United Kingdom such as Unilever and Glaxo Wellcome (Fiott, 2010). This form of FDI has had a positive impact on

creation of employment and infrastructure development as EU has been significantly involved in developing Kenya's transport infrastructure, especially when it comes to rehabilitation of existing roads and construction of new ones. This was expected and is consistent with Findlay's (1978) model that was extended by Wang (1990) who presented a model of growth and international capital movements. This model provided that FDI flows to developing economies gave rise to more investment in human capital and / or technological diffusion thereby lowered the development gap between the OECD and the Non-OECD economies. The empirical evidence also supports some previous studies such as those of Zhang (2001) and Zheng et. al. (2006) that also found a positive and significant effect of FDI from OECD on growth in East Asia and China respectively.

It could be argued that effects of OECD investments on Kenyan economy can be found in upgrading and benefiting from forms of technology transfer from the parent company and revenue generation spillover effect (externalities). This is consistent with Das' (1987) model on technology transfer that happened in the form of externalities from the foreign firms to the domestic firms in the host country. As such, H2 is accepted.

#### **FDI from non-OECD countries' impact on economic growth in Kenya.**

In hypotheses 3, the impact of FDI from non-OECD countries on economic growth of the host country was tested. It was also found to be positively significant at the 1% level. Therefore, a 1% increase in FDI flows from non-OECD countries would raise economic growth in Kenya by 3.2% significant level. This can be attributed to narrow technological gap between foreign and local firms which is consistent with Xu and Wang's (2000) and Lin and Liu's (2005) similar findings.

With China having the largest African embassy in the capital of Kenya-Nairobi, the high level of activities of Chinese inward FDI into Kenya have impacted on economic growth in Kenya. For instance, Foitt (2010) revealed that Chinese infrastructure investment in Kenya began in 2006 and by the year 2010 they had built 905.4 kilometres of road at an estimated cost of £316 million. According to Kenya Investment Authority (KenInvest,2012), Chinese companies registered 65 new firms between 2001 and 2006. These businesses range from supermarkets and grain processing. Offshore exploration is now mainly done by Chinese in Kenya. However, the impact is greater for OECD countries. Consequently, H3 is accepted.

## **Other Control Factors' Impact on Economic Growth in Kenya.**

### ***Economic Factors' Impact on Economic Growth in the Host Country.***

In investigating these relationships, the impact of the control variables on economic growth in Kenya, the results indicated that openness impacted positively and significantly on economic growth in all the three groups (the full sample, OECD and non-OECD countries) with a stronger effect for non-OECD than OECD economies. This is consistent with previous results such as Asiedu's (2006) and Ayanwale's (2007) investigations into FDI flows and economic growth in SSA countries.

The impact of human capital on economic growth in Kenya produced positive coefficients but was only significant for OECD countries, confirming the prior expectations. This result suggests the importance of human capital in economic growth in Kenya for OECD countries. This is consistent with the more recent endogenous growth models (Romer, 1986, Lucas, 1988, Krugman, 1990 and Howit & Aghion, 1998), which argued that enhancement of a country's human capital, would lead to economic growth by means of the development of new technological, efficient and effective means of production.

The same variable was nevertheless, positive but insignificant for both the full sample and non-OECD countries. Infact, better educated workforce was important for OECD and the reason it became insignificant in the total is because non-OECD countries overcame its significance in the full sample. It can therefore be argued that education in Kenya has not attained the necessary threshold for general economic growth. This supports Obwona and Egesa's (2004) and Ayanwale's (2007) observation that although Africa appears to provide cheap labour in abundance, there is nonetheless an overall shortage of skilled labour in Kenya and Tanzania. Initially, Bhinda et. al. (1999) had also observed that, insufficient numbers of middle or senior level managers have raised the existing skill gap and many MNEs had resorted to employment of expatriate managers. It can therefore be suggested that the nature of non-OECD induced growth into Kenya may not require such high level of human capital.

The total labour force was used as a proxy for wage rates and had a positive and significant correlation with economic growth in Kenya in all model specifications. The results suggest labour force is an important factor driving economic growth in Kenya perhaps due to the availability of moderately well-educated and cheap labour force. This finding is consistent with

other studies which show that a country's economic growth rate is affected by the size of labour force available in the host economy such as Zheng et. al.'s (2006). This implied that the type of investment from both OECD and non-OECD countries may be labour intensive and thereby require Kenyan labour force.

The results of the level of infrastructure development proxied by the ratio of host to home country's mobile cellular subscribers; indicate that infrastructure correlates positively and significantly with economic growth in Kenya for non-OECD countries only. However, mobile cellular subscriptions measure was insignificant but with the right sign for the full sample and insignificant with wrong sign for OECD group. This might be due to the fact that there might be a better measure but this is the one that worked best for OECD group. This can also suggest that there is need for Kenya to provide the needed infrastructure for economic growth. Unlike non-OECD countries, service and extracting industries from OECD group in Kenya may not need developed infrastructure and thereby economic growth.

The total natural resource variable has a positive impact on economic growth for OECD countries. It however has a negative and insignificant impact on growth for both the full sample and non-OECD estimations. The findings suggest that much of non-OECD investors are not attracted by natural resources. Also, the less natural resources Kenya possess, the greater the impact it has on economic growth at full sample and non-OECD levels. Another possibility could be that opportunities for rent seeking behaviour on a large scale on the part of producers can be created by huge natural resources rents thereby, shifting resources away from more socially and fruitful activity (Asiedu, 2006; Gylfason & Zoega, 2006 and Okafor ,2014). Also, though it is a concept associated with wealthy nations, there could still be a Dutch disease effect.

### ***Social-Cultural Factors' Impact on Economic Growth in Kenya.***

There were two measure of social cultural factors namely, the domestic savings and government consumption. The impact of domestic savings on economic growth in Kenya was measured by the ratio of host to home countries' difference between GDP and total consumption. It was significant and had the right sign for estimation of non-OECD countries consistent with post-Keynesian growth models, which emphasized the role of saving and investment in enhancing growth. It was also consistent with the findings of Zheng et. al.'s (2006). It was however insignificant but carried the correct sign for full sample and was significant with the wrong sign for OECD countries. The wrong sign effect could mean that

domestic saving rates in Kenya are too low to influence the investment and productive capacity to induce growth from OECD group in Kenya.

The relationship between government consumption and economic growth in Kenya was measured by the ratio of host to home country's all government current expenditures for the purchases of goods and services. The variable had the right sign and was significant for the full sample but was insignificant for non-OECD home countries but with the correct sign. It was however insignificant with the wrong sign for OECD group. Contrary to expectations, this result meant that there was "crowding in effect" of government expenditure which raised interest rates that reduced rate of growth at full sample level. This is contrary to the submissions of Akinlo (2004) but in line with findings of Ayanwale's (2007) and Okafor's (2014).

### ***Political and Institutional Factors' Impact on Economic Growth in Kenya.***

As noted earlier, quality of institutions was used to measure political and institutional factor. The tests revealed that quality of institutions is negative but significant with economic growth at the full sample and non-OECD levels but positive and insignificant within OECD context. The results imply that quality of institutions maybe not important for economic growth in Kenya regardless of sources of investments in the country. This is contrary to findings of Rodrick et. al.'s (2004) and Adams' (2009) similar works. It could be argued that some of the leading investors in Kenya are emerging economies such as China and India that have similar weak institutions to Kenya's and therefore the political and institutional factors would not deter their effect on economic growth in Kenya.

**24Table 6.7. Summary of Findings for Kenya**

Factors impacting on Economic Growth	Expected Sign	Observed Sign		
		Full Sample of Home Countries	OECD	Non-OECD
<b>Economic Factors</b>				
FDI <sub>(t-1)</sub>	Positive	Positive/Significant	Positive/Significant	Positive/Significant
Openness	Positive	Positive/Significant	Positive/Significant	Positive/Significant
Human Capital	Positive	Positive/Insignificant	Positive/Significant	Positive/Insignificant
Total Labour Force	Positive	Positive/Significant	Positive/Significant	Positive/Significant
Infrastructure Development	Positive	Positive/Insignificant	Negative/Insignificant	Positive/Significant
Mineral Resource Endowment	Positive	Negative/Insignificant	Positive/Significant	Negative/Insignificant
<b>Social Cultural Factors</b>				
Domestic Savings (1% GDP)	Positive	Positive/Insignificant	Positive/Insignificant	Positive/Significant

Government Consumption Negative Negative/Significant Positive/Significant Negative/Insignificant  
(% GDP)

**Political and Institutional Factors**

Quality of Institutions Positive Negative/Significant Positive/Insignificant Negative/Significant

**6.5.1.2. Main Findings on Impact of FDI on Economic Growth in Tanzania.**

The empirical results obtained from estimating equation (2) show that most of the independent variables had the expected relation with GDP/Capita and 3 of the 9 variables in Model one, 5 in Model two and 6 in Model three are statistically significant.

**25Table 6.8. RE Non-Cross-Section Results for Tanzania**

-	-	<u>Res 1996-2016</u>		
-	-	<u>The Top 22 Home Countries</u>	<u>12 OECD Countries</u>	<u>10 Non-OECD Countries</u>
<u>Variable</u>	<u>Variable Name</u>	<u>2</u>	<u>4</u>	<u>6</u>
Constant		2.952352***	1.365786***	4.389933***
St. Error		(0.186778)	(0.468543)	(0.442868)
LRFDI(t-1) (Predictor) H1, 2, 3	Lagged FDI	0.032837 (0.021995)	0.006377 (0.025903)	0.224987** (0.104336)
LROPEX_IM (Control)	Openness	0.050421 (0.068349)	0.176987* (0.099540)	-0.817493 (0.203846)
LRHCAP (Control)	Human Capital	0.169694*** (0.044897)	0.055027 (0.051222)	-1.453867 (0.190558)
LRTLFORC (Control)	Total Labour Force	-0.873211 (0.170249)	0.573802* (0.300974)	-1.173951 (0.107181)
LRMOBL_100 (Control)	Infrastructure Develop. proxied by mobile cellular subscriptions	-0.012989 (0.013791)	-0.085581 (0.021559)	0.524241*** (0.083686)
LRTNR (Control)	Total Natural Resources	0.053532*** (0.019572)	0.047498** (0.019768)	1.080475*** (0.070759)
RGDS (Control)	Domestic savings	0.192390*** (0.041896)	-0.007670** (0.068617)	0.780828*** (0.131685)
LRGGFC (Control)	Government Consumption	-0.031552 (0.063572)	-0.136245 (0.093727)	-0.656371*** (0.317943)
LRQINST_100 (Control)	Political & Institutional Factors proxied by quality of institutions	0.017286 (0.066297)	0.263228** (0.112066)	0.271523** (0.105251)
Number of Observations		483	273	210
R2		0.887691	0.893567	0.787659
Adj R2		0.886816	0.893001	0.752071

Notes: Standard errors are reported in (). \*, \*\*, \*\*\* indicate significance at 10%, 5% and 1% level respectively.

**FDI flows' impact on economic growth in Tanzania.**

In hypotheses 1, the impact of FDI flows on economic growth in Tanzania was tested. The variable had the correct sign but not significant. Similar results have been produced for FDI in the growth models such as Carkovic and Levine's (2005) which observed that innovative and social capabilities of the host country as well as the absorptive capacity of other enterprises in the country would determine the pace of technological change in the country. This confirms the fact that although the FDI has potential to encourage growth, it has not been doing so significantly. The possible explanation for this could be that Tanzania has not fully attained the required human capital level to benefit from the spillover effect of FDI. Contrary to theoretical predications, this result supports Iamsiraroj and Ulubasoglu (2015) who found no evidence that FDI benefited developing countries significantly more than countries in the developed world. Consequently, both hypotheses H1 is rejected.

#### **FDI flows from OECD countries' impact on economic growth in Tanzania.**

The impact of FDI flows from OECD group on economic growth was tested in Hypothesis 2 and the variable was positive but not significant. It can be argued that FDI from OECD countries is not one of the important factors that promote economic growth in Tanzania. This result suggests that the hypothesis predictions regarding FDI's impact on economic growth in Tanzania seem to rest a great deal on the absorptive capacity of the host economy. It is consistent with Obwona's (2001) report that found similar result in the neighbouring Uganda which was attributed to the absorptive capacity of the host country.

It could also be seen that for the period investigated, the type of FDI from OECD countries that Tanzania has attracted is not growth inducing such as cheap labour and raw materials. Similar findings were produced by Lall and Narula's (2004) study. Perhaps the insignificant result could be due to MNEs impeding growth through distortion of the local economy by crowding out local firms (Blomstron and Kokko, 1994). Furthermore, contrary to theoretical predications, this result supports Kotrajaras' (2010) argument that positive relationship existed only in high and middle-income countries but not in low income countries. Consequently, H2 is rejected.

#### **FDI flows from non-OECD countries' impact on economic growth in Tanzania.**

The impact of FDI flows from non-OECD countries on economic growth was tested in Hypothesis 3. The coefficient on FDI is positive and statistically significant showing that 1% increase in the FDI flows from the non-OECD home countries to Tanzania would lead to 22.4% rise in economic growth at significant level of 5%. It can be argued that FDI from the non-

OECD economies is one of the important factors driving economic growth in Tanzania. This could be possibly due to the small gap between home and host economies' absorptive capabilities. This finding resonates with Borensztein et. al (1998), Carkovic and Levine (2005), Gui-Diby (2014) and Iamsiraroj and Ulubasoglu's (2015) which suggested that FDI's positive effect on growth seemed to rest a great deal on the absorptive capacity of the economy. This effectively implies that Tanzanian economy has absorptive capacity for type of FDI from non-OECD than that from OECD countries. Consequently, H3 is accepted.

### **Other Control Factors' Impact on Economic Growth in a Host Country.**

#### ***Economic Factors' Impact on Economic Growth in the Host Country.***

For OECD group, openness is both positive and significant, implying that it encourages the growth of Tanzania's economy. This is in line with expectations because more trade is expected to lead to growth in the economy. This is consistent with Ayanwale's (2007) and Belloumi's (2014) assertions of the importance of openness as a vehicle for technological spillovers. Through importation of capital equipment from trade partners in developed world, Tanzania can improve her own stock of knowledge. Indeed, her leading trade partners are the USA and the UK which are OECD member countries. The positive relationship between openness to trade and economic growth in Tanzania for full sample is positive but insignificant. However, contrary to expectations the effect is negative and insignificant for non-OECD home countries. Similar negative results were generated by Zhang's (2001) and Iamsiraroj & Ulubasoglu's (2015). The impact is likely to be positive if the MNEs were replacing imports as doing so reduce the likelihood of crowding out due to the surplus of supply.

The impact of human capital on economic growth in Tanzania was found to be positively significant with positive coefficients for full sample. The implication of this result is that the quality of human capital in Tanzania is important for growth. This is in support of Caves' (1996) and Zhang's (2001) arguments that a key benefit created by MNEs to host countries is technology transfer and spillover effect, both in terms of labour training and skills acquisition. The benefit, however, does not automatically occur but is determined by host countries' absorptive capability, which is positively related to human capital. The model provides a rationale for other studies such as Romer (1986), Cohen and Levinthal (1989) and Borensztein et. al (1998) that found a positive effect of human capital in the host economy. However, human capital is not significant for economic growth in Tanzania for both OECD and non-OECD groups, having the right sign for OECD countries and the wrong sign for non-OECD countries.

These disparities may be explained by Savvides'(1995) argument of poor quality on educational statistics in Africa. Nevertheless, these results seem to suggest that OECD and non-OECD countries have been oriented mainly towards companies in the primary sector with a low level of human capital requirement or a high level of physical and financial capital intensity in Tanzania. Another possible explanation for the insignificant impact for OECD and non-OECD economies is that education in Tanzania has not attained the necessary threshold to absorb benefits of OECD investments.

The total labour force was used as a proxy of wage rate since high labour supply could mean lower wage rates. It has a positive and significant relationship with economic growth in Tanzania for OECD countries only. This could be due to the nature of investments from OECD countries into Tanzania being labour intensive than those from non-OECD economies. This is consistent with Kosack and Yobin's (2006) similar findings. The results suggest that FDI from OECD countries targets cheap labour in Tanzania compared to the cost of labour back home. This provides employment in the host country thereby raising the purchasing power of citizens which impacts on economic growth in Tanzania. Labour force was however negative and insignificant in full sample estimation and non-OECD countries. This implied that the type of investment from non-OECD countries may not be labour intensive or some studies (Adisu, Sharkey and Akroafo, 2010) found that investors such as Chinese firms bring along their own workforce which may be the case for Tanzania.

Infrastructure development measured by mobile cellular subscriptions has a positive and significant relationship with economic growth in Tanzania for non-OECD countries. This is consistent with results of similar research such as Olofsdotter's (1998) that emphasised the importance of infrastructure to economic growth. The implication of this result could mean that the type of investments from non-OECD countries would require developed infrastructure in Tanzania. The negative and insignificant infrastructure's impact on economic growth in Tanzania for both full sample and OECD countries could mean that their investment is not dependant on infrastructure development. For instance, majority of natural resource's extracting firms are from OECD countries and are more interested in the minerals than the low-quality infrastructure.

Natural resources variable has a positive and significant impact on economic growth in Tanzania in all three estimations (the full sample, OECD and non-OECD). This is consistent with previous studies such as Asiedu's (2006), Gui-Diby's (2014) and Loots & Kabundi's

(2012) that found countries that had natural resources were more attractive than those without. It could be argued that the positive and significant impact of natural resources on host country's economy has been impressive because MNEs have been primarily involved in extracting and exportation of raw material and commodities in Tanzania. However, these activities do not require a high level of knowledge or huge absorptive capacity. As a result, and according to Gui-Diby (2014) the main elements contributing to economic growth may entail revenues, income of workers in the primary sector and expenditures of Tanzanian government resulting from exportation of natural resources

### ***Social-Cultural Factors' Impact on Economic Growth in the Host Country.***

As for Kenya, there were two measure of social cultural factors namely, the domestic savings and government consumption. The domestic savings variable was significant and had the right signs for two estimations of full sample and non-OECD countries. It was however negative and significant for OECD countries. This empirical evidence is consistent with the Harrod-Domar-Model (Harrod, 1939 and Domar, 1947) which predicted that given a constant capital output, the higher the savings rate, the higher the rate of growth. In contrast, the negative effect of savings on OECD countries could mean that domestic saving rates in Tanzania are too low to influence the investment and productive capacity to induce growth from OECD group. This assumption confirms findings of Okafor (2014) on economic growth in SSA.

The government consumption variable turned out to be significant with right sign for only non-OECD countries. Though with the right sign, it was insignificantly related to economic growth for both full sample and OECD countries. The lower the level of government consumption the more it reduces the crowding out and therefore economic growth at Non-OECD level. This is consistent with Iamsiraroj and Ulubasoglu's (2015) similar findings.

### ***Political and Institutional Factors***

The impact of quality of institutions as a measure of political and institutional factors is positively significant on economic growth in Tanzania for OECD and non-OECD economies. This finding corroborates Rodrick et. al.'s (2006) and Adams' (2009) study which showed that a host country's economic growth rate is affected by the quality of institutions. Tanzania has a relatively better business environment than most of her neighbours. This could be the reason why quality of institutions variable has a positive and significant impact on growth for both OECD and non-OECD countries separately. It is however, an insignificant result for the full sample.

**26Table 6.9. Summary of Findings for Tanzania**

Factors impacting on Economic Growth	Expected Sign	Observed Sign		
		Full Sample of Home Countries	OECD	Non-OECD
<b>Economic Factors</b>				
FDI <sub>(t-1)</sub>	Positive	Positive/Insignificant	Positive/Insignificant	Positive/Significant
Openness	Positive	Positive/Insignificant	Positive/Significant	Negative/Insignificant
Human Capital	Positive	Positive/Significant	Positive/Insignificant	Negative/Insignificant
Total Labour Force	Positive	Negative/Insignificant	Positive/Significant	Negative/Insignificant
Infrastructure Development	Positive	Negative/Insignificant	Negative/Insignificant	Positive/Significant
Total Natural Resources	Positive	Positive/Significant	Positive/Significant	Positive/Significant
<b>Social Cultural Factors</b>				
Domestic Savings (1% GDP)	Positive	Positive/Significant	Negative/Significant	Positive/Significant
Government Consumption (% GDP)	Negative	Negative/Insignificant	Negative/Insignificant	Negative/Significant
<b>Political and Institutional Factors</b>				
Quality of Institutions	Positive	Positive/Insignificant	Positive/Significant	Positive/Significant

### 6.5.1.3. Comparison of Results for Kenya and Tanzania

The purpose of this chapter has been to examine the impact of FDI on economic growth in Kenya and Tanzania. It has been noted that there are other control factors that affect growth. The emphasis here is on FDI which is the main variable. The comparison of impact of FDI on economic growth in Kenya and Tanzania displays some similarities and differences. The findings support the view that FDI has a positive impact on economic growth but not always significant.

The results obtained for the impact of FDI flows are positive and significantly related to economic growth in Kenya in all the three model specifications of full sample, OECD and non-OECD countries. Several studies (Zheng et. al., 2006, Gui-Diby, 2014, Lumbila, 2005 and Chanegrina et. al., 2020) support these findings. However, it is only FDI from non-OECD countries that has a positive and significant effect on the economic growth in Tanzania. The possible reason for the differences could be that Kenya has the absorptive capacity for all FDI flows while Tanzania has the capacity to absorb spillovers of FDI only from non-OECD countries only. Various studies (Obwona, 2001 and Okafor, 2014) support this assumption.

Another reason could be the differences in type of FDI, since Kenya tends to attract FDI mainly in manufacturing (Abala, 2015) while Tanzania's is predominantly in extractive industry (Lumbila, 2005) of which the extracting industry has less growth impact than manufacturing. Also, 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, 2015). This seems the case with type of FDI flows into Tanzania. Similarly, the two countries' difference in openness to trade (exports plus imports) might be another reason for the significance differences in the effect of FDI on economic growth. While there is a widespread belief that FDI can influence economic growth in a host country, the empirical results confirm the positive and significant impact for Kenya but fails to confirm this for Tanzania. Therefore, it seems that though with lesser FDI flows, the type of FDI in Kenya is more growth-enhancing than that in Tanzania.

**27Table 6.10. Summary of Combined Findings for Kenya and Tanzania**

Factors impacting on Economic Growth	Expected Sign	Observed Sign					
		Full Sample of Home Countries		OECD		Non-OECD	
		Kenya	Tanzania	Kenya	Tanzania	Kenya	Tanzania
<b>Economic Factors</b>							
FDI <sub>(t-1)</sub>	Positive	Positive/Significant	Positive/Insignificant	Positive/Significant	Positive/ Insignificant	Positive/Significant	Positive/Significant
Openness	Positive	Positive/Significant	Positive/Insignificant	Positive/Significant	Positive/Significant	Positive/Significant	Negative/Insignificant
Human Capital	Positive	Positive/Insignificant	Positive/Significant	Positive/Significant	Positive/Insignificant	Positive/Insignificant	Negative/Insignificant
Total Labour Force	Positive	Positive/Significant	Negative/Insignificant	Positive/Significant	Positive/Significant	Positive/Significant	Negative/Insignificant
Infrastructure Develop.	Positive	Positive/Insignificant	Negative/Insignificant	Negative/Insignificant	Negative/Insignificant	Positive/Significant	Positive/Significant
Total Natural Resources	Positive	Negative/Insignificant	Positive/Significant	Positive/significant	Positive/Significant	Negative/Insignificant	Positive/Significant
<b>Social Cultural Factors</b>							
Domestic Savings (1% GDP)	Positive	Positive/Insignificant	Positive/Significant	Positive/Insignificant	Negative/Significant	Positive/Significant	Positive/Significant

Government Consumption (% GDP)	Negative	Negative/Significant	Negative/Insignificant	Positive/Significant	Negative/Insignificant	Negative/Insignificant	Negative/Significant
<b>Political and Institutional Factors</b>							
Quality of Institutions	Positive	Negative/Significant	Positive/Insignificant	Positive/Insignificant	Positive/Significant	Negative/Significant	Positive/Significant

### **6.6.0. Summary and Policy Implications of Impact of FDI on Economic Growth.**

The Chapter considered the impact of FDI on economic growth in Kenya and Tanzania at full sample, OECD and Non-OECD levels both within and between the two host countries. Similarly, it assessed other factors' impact on economic growth in the same countries. The empirical findings confirm that FDI is one of the most important factors driving Kenya's economic growth at all the three levels of full sample, OECD and Non-OECD home countries. The finding is consistent with arguments presented by new growth models (Findlay, 1978, Romer, 1986 and Lucas, 1988) that FDI is a potent factor in promoting economic growth in host countries. Meanwhile, the study confirms that only FDI from Non-OECD has a positive and significant impact on economic growth in Tanzania. This could be attributed to the relatively narrow gap in development between Non-OECD countries and Tanzania as well as a closer absorptive capability between these home countries and Tanzania. In contrast, FDI from both full sample and OECD countries is positive but not significant which is consistent with Blomstrom et. al.' (1994), Borensztein et. al.'s (1998) and Bengos & Sanchez-Robles' (2003) similar conclusion. This could be ascribed to the low absorptive capability for FDI from OECD countries and the type of FDI Tanzania attracts. Furthermore, the FDI flows from OECD countries to Tanzania seem to be mainly resource-based with interest in extracting industry as well as cheap labour, which renders their impact on economic growth in Tanzania insignificant.

The study further confirms that other factors responsible for Kenya's economic growth include openness and total labour, for all the three samples of home economies. This result is consistent with Kojima's (1973) and Ozawa's (1992) assertion that increase in trade had a significant impact on economic growth. At the same time, the labour force is another important engine for the rapid economic growth which revealed that Kenya's economy was still at the stage in which GDP growth mainly relied on the labour-intensive industries. The empirical result supports neoclassical growth model (Abramovitz, 1956 and Solow, 1956). However, the role of human capital differs at the FDI level among the three samples, being very important for OECD countries but not so for Non-OECD countries. For non-OECD countries, infrastructure and domestic savings were responsible for economic growth in Kenya.

The study also confirms that only availability of natural resources impacted positively and significantly on the economic growth in Tanzania across all the three samples of home countries. This could be possibly due to Tanzania's better management of the wealth generated

from these resources than Kenya. This seems to confirm similar assumptions by Papykaris and Gerlagh (2004). At the same time, domestic savings had a positive and significant effect on economic growth in Tanzania for FDI from full sample and Non-OECD countries while Kenya had similar effect at non-OECD level only. This empirical revelation confirms Harrod's (1939) and Domar's (1947) model. Similarly, quality of institutions was a key factor driving economic growth in Tanzania for FDI from OECD and non-OECD home countries. This empirical revelation corroborated Tondl and Pruffer's (2007) and Abala's (2014) research that found factors such as political stability and quality of institutions enabled FDI to positively impact on growth. Contrary to findings on Kenya, openness and total labour force had a positive and significant effect on economic growth in Tanzania for OECD countries only. Human capital and infrastructure too positively and significantly impacted on economic growth in Tanzania but only for the full sample and non-OECD countries respectively. This supports a section of literature which argues that the economic growth could be limited by absence of absorptive capacity in the host country (Borenszstein et. al., 1998 and Gui-Diby, 2014) and as such Tanzania may not have the best conditions to benefit from spillover effect due to inadequate human resource accumulation.

Unlike in Kenya, the total labour force is only important for economic growth in Tanzania at OECD level. Meanwhile, human capital positively and significantly impacted on economic growth in Tanzania but for only the full sample and Non-OECD countries respectively. This supports a section of literature which argues that the economic growth could be limited by absence of absorptive capacity in the host country (Borenszstein et. al., 1998; Carkovic & Levine, 2005 and Gui-Diby, 2014) and as such, Tanzania may not have the best conditions to benefit from spillover effect due to inadequate human resource accumulation.

The quality of institutions impacted positively and significantly on economic growth in Tanzania for both OECD and non-OECD economies. The study also found that although total labour impacted positively and significantly on growth in Kenya in all the three groups of home countries, it had a negative impact on growth in Tanzania for the full sample and non-OECD countries.

The results of this research suggest that while FDI increases growth, the full benefits of FDI might not be realised in the absence of higher levels of international trade, human capital, productivity of labour, infrastructure development and quality of institutions in the host countries. Therefore, policymakers in Kenya and Tanzania may aim to improve local

conditions to attract FDI inflows, since better local conditions not only attract foreign firms but also allow host economies to maximise the benefits of foreign investments.

Based on empirical results of this research, the strength of impact of FDI on economic growth in both Kenya and Tanzania is in non-OECD but OECD too has a significance effect. Kenya needs to concentrate on getting FDI, regardless of the source, but Tanzania should concentrate on attracting Non-OECD FDI. This is because OECD FDI is not significant in Tanzania, but it is less significant in Kenya and would not be significant if the author went for less than 10% significance level. FDI from OECD in both Kenya and Tanzania has a weaker impact on economic growth. It may be due to the type of FDI that does not match skill levels in the two host economies. However, FDI from Non-OECD countries is low skilled oriented and therefore requires lower quality skills which might be connected to supply chains from Non-OECD countries to Kenya and Tanzania. In contrast, integration of supply chains linkages may be less for OECD as the investors from this group of countries tend to focus solely on local cheap labour and raw materials, which may not necessarily lead to significant levels of economic growth in the host country (Zhang, 2001).

While this study has investigated the impact of FDI flows on economic growth, it could not examine the nature of FDI that flows into Kenya and Tanzania. It has however established that the net effect of FDI on economic growth is greatly dependant on the features of the investment itself. As a result, this study recommends future research into the types and quality of FDI flows from OECD and Non-OECD countries that could provide more information on the real impact of FDI on economic growth in Kenya and Tanzania.

## **CHAPTER 7: THE IMPACT OF FDI ON EXPORT PERFORMANCE IN KENYA AND TANZANIA.**

### **7.1.0. Introduction.**

There is a broadly shared view that FDI promotes export performance of host countries by (i) augmenting domestic capital for exports (ii) helping transfer of technology and new products for exports (iii) facilitating access to new and large foreign markets (iv) providing training for indigenous workforce and (v) upgrading technical and management skills (Balasubramanyam, Salisu & Sapsford, 1996; Caves, 1996; Fosfuri & Saggi, 2002; Barrios et. al., 2003; Ruane & Sutherland, 2005, Sun, 2009 and Zhang, 2015). By absorbing the technology of marketing and production practices of foreign enterprises, domestic firms become more competitive in global export markets. Export upgrading might occur by increasing export volume (the intensive margin effect), the number of exported products (the extensive margin) and the quality of exported products. This is made possible by MNEs' ability to engage in production of new and more sophisticated goods as well as contribution to positive spillovers on domestic firms, reducing their entry costs in foreign markets (Blomström, Kokko & Zejan, 2000; Harding & Javorcik, 2012 and Amighini & Sanfillipo, 2014 and Fetai & Morina, 2019).

As a result, a number of studies such as Zheng et. al.'s (2004) and Zhang's (2005) have argued for "outward oriented" government policies to entice foreign firms to invest in developing countries. Export-based trade strategy can play a vital role in the growth process of developing countries. The following points have supported these arguments: Firstly; the growth of developing countries significantly depends on industrialisation but the level of domestic demand which underlies industrialisation in most developing countries is low. Hence, the understanding of connection between FDI and export performance is vital. Secondly, exports not only made growth easier but also have a longer term effect on growth because they lead to more savings, higher technological advancements and easier access to foreign loans.

However, some authors (for example, Caves, 1996; Zhang, 2015 and Mohanty & Sethi, 2019) have argued that FDI may (i) lower or replace domestic savings and investment for indigenous exporting enterprises (ii) transfer technologies that are at a low level or inappropriate for the host country's factor proportions due to the developing status of a country and the country's own technological capabilities (iii) target primarily the host country's domestic market and thus not increase exports (iv) inhibit the expansion of indigenous firms that might become

exporters and (v) not help develop the host economy's dynamic comparative advantages by focusing solely on local cheap labour and raw materials.

In light of the expected benefits from FDI and exports, a number of studies have found a positive and significant impact of FDI on export performance. However, much of these have been in the context of developing countries, fewer in Africa and even less in Sub-Saharan Africa. This chapter's main objective therefore fills the void in examining the impact of FDI on export performance in Kenya and Tanzania.

An empirical assessment of the role of FDI in a host country's export performance is important, since exports are one of the main means of generating foreign exchange required to finance the imports of goods and services and to learn from experience in international markets. Exports can also serve as a measure of competitiveness of a country's industries in a globalised world (Zhang, 2005 and Prasanna, 2010). The focus on impact of FDI on export performance is vital however, from both an economic development perspective and for policy formulation purposes. To do this, panel data analysis is used to explore the effect of FDI on exports across two countries over the period 1996-2016. This analysis enables the study to make a comparison of its findings with those of similar studies.

This research contributes to literature on the impact of FDI on export performance in a host developing country in two ways. First; having the focus on specific African countries of Kenya and Tanzania bearing similar social, economic, political and geographical conditions may help policy makers better understand and contrast the link between FDI and exports in the two seemingly similar countries. Second; numerous studies have indicated that FDI influences export performance of host countries differently and that it has had more effect on some countries than others (Amighini and Sanfillipo, 2014). The use of country-specific data of Kenya and Tanzania in a comparative setting will help to better explain the impact of FDI on export performance in the two economies and subsequent development of recommendations to the governments of Kenya and Tanzania and the relevant policy makers.

This chapter therefore investigates how FDI directly influences export performance of Kenya and Tanzania as well as the magnitude of the impact both between and within investing MNEs from OECD and non-OECD country groups. The chapter is structured in seven main sections as follows: Section one presents introduction. Section two describes patterns of FDI and export performance in Kenya and Tanzania since the economic reforms of mid 1990s. These patterns are important for testing and understanding the impact of FDI on export performance of the

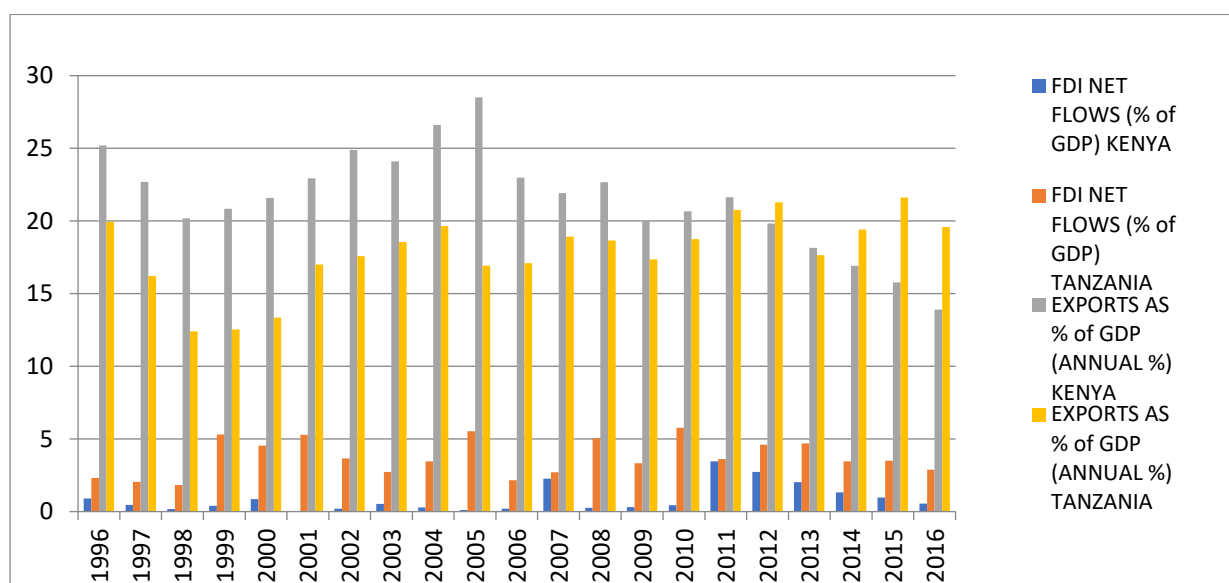
two countries being investigated. Section three reviews previous theoretical and empirical studies on the impact of FDI on export performance particularly in developing countries and develops hypotheses. Section four develops the research methodology. The fifth Section presents data analysis, section six presents the findings synthesized with the relevant literature and section seven summarises the key conclusions and policy implications.

#### **7.2.0. The Pattern of Kenya's and Tanzania's Export Performance and Inward FDI.**

In the second half of 1990s, Kenya and Tanzania experienced economic and social changes. Thus, the two countries liberalised their economies following the limited access to finance for years that constrained their domestic investments. Subsequently, the inflow of foreign private capital has since played an integral role in the two East African economies. FDI flows into Kenya increased from \$1.087 million in 1996 to \$393 million in 2016. Comparatively, FDI flows into Tanzania increased from \$1.50 million to \$1.36 billion over the same period. However, exports constituted 25% of GDP in Kenya in 1996 but had declined to 13.9% of GDP by 2016. Conversely, Tanzania's exports were 19.93% share of GDP in 1996 but remained fairly constant in 2016 at 19.59% of the GDP (KenInvest, 2017, TIC, 2017 and WDI, 2018).

Moderate growth in export earnings was more than offset by the fast-growing import bill, for both countries. The opening up of the two countries to FDI has seen a significant transformation in the structure of Tanzania's exports compared with Kenya's. The two countries do export however different commodities. Kenya focuses on agricultural produce such as Tea and cat flowers, Tanzania on minerals, nuts and tobacco. Therefore, based on these figures, regardless of steady flows of FDI into the two countries, Kenya's export performance seems to be on the decline whereas Tanzania's reflects a consistent growth as shown in the appendix 2 and Figure 7.1 below.

**6Figure 7.1. FDI and Exports as Annual Percentage of GDP in Kenya and Tanzania (1996-2016).**



Source: Graph computed by the author based on data from World Bank Database (2018).

Kenya’s top ten exports accounted for about two-thirds (65.5%) of the overall value of its global shipments in 2017. This was attributed to improved international sales of titanium ores and concentrates. Tanzania’s top ten exports accounted for almost a four-fifths (78.9%) of the overall value of its global shipments in 2017(World Bank, 2018).

Although Kenya’s strongest engine is domestic consumption which accounted for 75% of GDP, its weak engine remained its exports, which have been declining sharply as the main exports have not been sufficient to pay for oil and other imports. The growth in merchandise exports has been slow and volatile. Agriculture (primarily coffee and tea) continues to be the dominant driver of Kenyan merchandise exports. The main export partners are high income OECD countries such as Europe, Japan and USA.

Although Tanzania’s domestic consumption is equally high at 71% of GDP, unlike Kenya, its volume of exports has maintained a consistent growth pattern boosted by mining and tourism that were the leading sectors in Tanzania in terms of export earnings. Manufacturing was second to mining in FDI stock although it ranked lowest with agriculture in terms of export earnings. This suggests weak linkages and integrations within and between FDI laden sectors and the rest of the economy, hence the dominance of unprocessed or low value-added exports. The top export destination for Tanzanian exports are India, South Africa and China (UNIDO, 2017 and World Bank, 2018).

### **7.3.0. FDI Export Performance Nexus.**

A vast body of literature exists on the impact of FDI on the host country's trade flows, with specific focus on exports. These philosophies are drawn from both the macroeconomics of international trade and investment as well as from the microeconomics of firm and industrial behaviour in the globalization process (Lechenko and Erickson, 1997, Sun, 2001 and Zheng et. al., 2004). Nonetheless, there is absence of a generally accepted and rigorous theory linking international investment and international trade flows (Sun, 2001).

When FDI flows into a country at macro level, it can alter the factor endowments of the country and hence the structure and direction of its trade through FDI's transmission of the package of capital, technology and managerial know-how (Kojima, 1973 and Kojima and Ozawa, 1984). Superior production functions may be transferred to host countries through this transmission, leading to productivity increases. Kojima (1973) stated that local firms would also experience productivity increase as superior methods "spilled over" from foreign subsidiaries to the host economy in general. Further, Kojima (1973) and Kojima and Ozawa (1984) argued that inflows of FDI into developing countries that are typically characterised by labour-intensive industries which hold comparative advantages, will do most to stimulate exports. The technology gap between the host and investing country is lower in these industries than in capital-intensive industries thereby enabling easy transfer of technology.

With respect to the macro level literature, the study of potential links between FDI and trade flows involves the assessment of the impact of FDI on the underpinning of trade and export potential. The Ricardian (1817) (cited in Morrow, 2020) and Heckscher-Ohlin (1919) theories tried to explain the high-level heterogeneity and specialisation of production patterns as exhibited by countries around the world. The Ricardian model of international trade predicted that countries specialised in goods in which they held greater comparative advantage in total factor productivity (TFP). The differences in TFP across industries were ignored by the Heckscher-Ohlin model when it assumed that all countries possessed the same production function in a given industry. In Heckscher-Ohlin-Samuel (1949 and 1953 as cited in Batra and Casas, 1976) model, the basis of international trade was the difference in resource endowments and factor proportions between countries. International flows of factors tended to bring factor prices closer and reduced differences in factor endowments between countries because to some degree, factor movements were a substitute for trade and vice versa. Thus, factor mobility and goods were substitutes when the cause of trade was factor endowment differences. They may

also be complements for other causes of trade, such as differences in preferences, technology and production functions.

Economic resources and productive capacities are globally reallocated by FDI, based on the relative costs of production in different countries. Conversely, a dynamic change in comparative advantage leading to shifts in the structure and pattern of international trade is expected to be caused by this reallocation (Dixit and Woodland, 1982, Markusen, 1983, Wong, 1986 and Sun, 2001).

As for the relevant microeconomic literature, the exports of foreign subsidiaries themselves are considered to be the direct effects of FDI whereas the impact of FDI on the export performance of indigenous firms are indirect effects (Caves, 1996; Zhang and Song, 2001 and Zheng et. al., 2004).

The direct impact of FDI can be explained by the theory of multinational firm itself which stipulates that multinational firms hold ownership advantages in terms of marketing skills, technology, distribution networks and management practices (Dunning, 1993). These advantages may be combined with low-cost labour to create new competitive advantages in international markets (Sun, 1999). This may explain, for instance according to Zheng et. al. (2004), the significance of “export processing” to many foreign firms in China.

Indirect impacts of FDI on the export performance of host countries include; One; “demonstration effects” by which host country firms can learn from observing the export activities of MNEs operating in their country (Haddad and Harrison, 1993). Thus, “learning by watching” and by taking advantage of the infrastructure that develops to support export-oriented activities of MNEs in terms of utilising the structure of transport, communication and financial services that develop to support those activities. Two; spillover effect involves the influence of FDI on the competitiveness of domestic firms’ exports and the diffusion of new technologies. MNEs’ advanced product-process technology, management and marketing competence may increase competition in the host country’s markets and force adoption of more efficient methods. Three; further spillovers are related to the linkage between foreign and local firms. If export-oriented foreign subsidiaries increase their purchase of inputs from local firms as the subsidiary matures, host country’s exports increase (UNCTAD, 2017).

FDI alters comparative advantage in favour of the host country, in such a way that it produces items it never produced before or makes existing production even cheaper because of the improved efficiency. The potential to export in the world market is therefore improved.

However, this effect assumes that both domestic and foreign firms compete in the same market (Zheng et. al., 2004).

The export potential of the host country's firms may be increased by both intra-industry and inter-industry spillover effects from FDI. Technologies and or management practices may be "copied" by the local firms in the same industry with foreign firms generating improved efficiency (Sun, 1999, 2001 and Zhang, 2005). Spillover effects from inter-industry may also play a vital role. Backward linkages with supplier firms in the host country may be formed by foreign firms, creating demand for improved local products. Consequently, MNEs may share important technologies with their suppliers enabling them to upgrade their products, thereby improve their own export potential and possibly that of other domestic firms who purchase their now superior or lower-cost products as imports. Another potential occurrence may be the forward linkage by which foreign firms may pass on their efficiency through price reductions and superior products to domestic customer firms. This may result into improved export potential of these firms. These "induced exports" through backward and forward linkages bear an important portion of exports from domestic firms in the host country (Markusen and Venables, 1999).

The contributions of foreign affiliates to host country's exports entailed the following four issues. First; exports occur through processing and assembling: when domestic firms import unfinished and intermediate goods. Generally, these exports are organised by MNEs within vertically integrated international network and most of FDI created by MNEs take this format (Zhang and Markusen, 1999). Second; exports through conversion of import-substituting industries: Many developing countries restrict imports of manufacturing products but may allow FDI in these sectors. With well-designed policies, host countries can start and increase exports of import-substituting products by combining their cheap labour and advanced technology embodied in FDI – mainly with home appliances and the automobile industry (Zhang, 2005). Third; exports of new labour-intensive final products: for example, FDI provided links to final buyers, particularly in the developed markets. Fourth; exports of local raw materials processing: Foreign affiliates may possess better export potential than indigenous firms in the processing of locally produced raw materials because of their business contacts abroad, marketing skills and superior technology. These are found in product and processes, and greater general know-how. Developing countries lack these assets and FDI may be the only means of increasing exports (Li and Liu, 2005).

Moreover, FDI promoted exports by facilitating host country's access to new and larger markets. This entailed foreign affiliates' privileged access to not only MNEs' international production systems, but also MNEs' intra-firm markets and access at arm's length to MNEs' customers in global and home country markets. Furthermore, the linkage to the world is extended to suppliers and other domestic firms. In addition, as it happened in the US, the host country benefits from the lobbying activities of MNEs in their home countries for favourable treatment of exports from their affiliates abroad (Blomstrom et. al., 2000).

FDI further helped exports by investing capital in the exploitation of host country's low-cost labour, particularly when domestic investment is limited by financial constraints. Such FDI bridges the resource gap and takes the risk of developing new exports. The provision of additional capital is crucial for host countries to build up their initial base for labour-intensive manufacturing exports (Li and Liu, 2005).

FDI also provides the host economy with competitive assets for export-oriented production in technology intensive and dynamic products in the world trade. Such assets are normally firm specific, expensive and difficult for domestic firms to acquire independently. Such assets' transfer by foreign affiliates or non-equity partners in host country through training, skills development and knowledge diffusion; which opens up prospects for further dissemination to other enterprises and the economy at large. Hence, more firms (even domestic companies) can develop their exports while the factors underlying competitiveness get rooted in the host economy (Zhang and Song, 2001).

Export-oriented foreign affiliates provide training for the local workforce and upgrade technical and managerial skills that benefited the host country's exports. This particularly happened to export-oriented investments in advanced technological capabilities. The strategic challenge facing host countries is that their future competitiveness depended on host government's ability to boost the human capital and technological infrastructure. In return, MNEs feed benefits back into local skill and technology systems, providing information, assistance and contracts (Zhang, 2005; Ahmed, Sun, 2009 and Cheng & Messinis, 2011 and Sun, 2015).

However, there are studies such as Barrios et. al.'s (2003) and Ruane and Sutherland's (2004) that found no evidence of export spillovers to local firms from existence of MNEs in Spain and Ireland respectively. Indeed, literature has emphasized the need for recipient economies to be endowed with a certain level of absorptive capacity to benefit from the spillover, even in the

presence of the most favourable conditions (Crespo and Fontoura, 2007). The sectoral distribution of FDI in Africa is mostly concentrated in primary industries and low level of absorptive capacities at both firm and country levels, usually translated into few benefits rather than truly positive spillover effects as intended by extant literature. As a result, the effect of FDI on export performance may be either positive or negative, or both at the same time (Sun, 2001).

Studies such as Zhang's (2005) and Ayanwale's (2007) have argued that foreign investments failed to adjust to local capabilities and needs by providing too few or the wrong kind of resource and assets for a particular economy. For instance, MNEs may import the largest portion of higher value-added intermediate products, restricting purchase from domestic firms to low value-added products.

In terms of the impact of FDI on export supply capability, Sharma (2003) observed that the success of the East and South Asian countries suggested that FDI was an important and significant factor in their export promotion. Prasanna (2010) also found that FDI had a positive and significant effect on export performance in India. Similar results were found by Tadesse and Shukralla (2013) when they assessed the effect of FDI on horizontal export diversification in developing and emerging economies. Their results provided useful insights into the circumstances under which FDI aided or inhibited the horizontal expansion of export.

Regarding quality of exports, Harding and Javorcik's (2012) concluded that FDI inflows offered potential for raising the quality of exports in developing countries. However, the effective happening of such spillovers was nonetheless, according to Crespo & Fontoura (2007) and Narula & Driffield (2012) influenced by the nature of the investment determined by a range of factors such as the motivation or the entry mode.

A similar study in China by Zheng et. al. (2004) found that FDI had less effect on export performance of indigenous firms. Their findings implied that linkages between the foreign and domestic sectors needed to be improved for FDI to boost export competitiveness of domestic firms. Further, Zhang (2005) revealed that FDI's export-promoting effect was much greater than that of domestic capital, and as expected, its effect was larger in labour-intensive industries.

Similarly, Zhang (2015) found that: One; FDI was a key a driver of China's export success. Two; FDI seemed to contribute more to export capacity than export upgrading, particularly in labour-intensive/low-tech products. Three; high-tech FDI from the OECD developed

economies seemed to be more conducive to export upgrading than low-tech FDI from non-OECD developing economies.

The review of literature suggests that the impact of FDI on export performance is industry specific and varies across different host countries. For instance, Sun (2001) and Zhang (2015) argued that the impact of FDI on export performance was expected to be different between countries due to not only geographical features but also by social and economic characteristics such as the level of economic openness, industrial structure, factor endowments and economic policies.

Although the literature suggested that FDI can have either positive or negative impact on export performance of a host country, the greater part of literature suggested a positive impact of FDI on export performance and the hypothesis that flows in this study is;

***Hypothesis 1: FDI flows from all home countries have a positive impact on export performance in both Kenya and Tanzania.***

### **7.3.1. Impact of FDI from OECD and Non-OECD Economies on Export Performance of A host Country.**

FDI from OECD economies has best potential to promote exports in a host country in a complex or branded products and services while FDI originating from non-OECD countries or smaller MNEs (low-tech FDI) is unlikely to enhance export upgrading but their advantages can be drawn from either marketing skills or the adaptation of mature technologies to more labour-intensive contexts and to local raw materials (Sun, 2009 and Zhang, 2015). This study has grouped the origin of FDI into OECD and non-OECD countries in the next sections.

#### **7.3.1.1. FDI From OECD Home Countries to Non-OECD Countries and Impact on Export Performance**

A few studies investigated effects of FDI on export performance of emerging and developing countries. It is believed that firms, through their internalisation of their supply chain process, may choose to set up subsidiaries close to the source of their raw materials (Hill, 2007). Most non-OECD countries are enthusiastic about attracting export oriented FDI (Musila and Sigue, 2006). For instance, a UK firm, Blue Skies Limited is currently located close to the sources of their raw materials in Ghana, South Africa, Egypt and Brazil. The firm processes fresh cut fruits from these countries and exports them to European markets (Osei, 2014). This has positively impacted on export capacity and performance of these countries.

Similarly, free economic zones in developing and emerging economies such as Kenya, Ghana and Tanzania are designed to increase exports from these countries by FDI from mainly EU and North American companies. As much as 70% of products from companies operating in the free zones are exported. This condition is designed to increase exports performance of the host countries and their access of international markets (Osei, 2014).

Contrary to the above assessment, the impact of FDI through Export Processing Zones (EPZs) on the long-term export performance is unclear. A once-for-all increase in exports based on low wages is not the same as sustained upgrading of skills and capabilities. The generous use of incentives to attract FDI to EPZs often raised doubts about the net contribution of EPZs to the country (Prasanna, 2010). Their sole benefit often lies in the employment of low-wage, low-skilled labour, with little spillover to domestic firms or to skill and technology development. A transition from labour-intensive assembly with very low value added to more value-added activities and deeper local linkages may not occur. Where it does, it takes time. For instance, in Bangladesh where garment exports from EPZs began in the 1970s, it was not until the late 1990s and early 2000s that there were signs that the industry was moving beyond the simple assembly of shirts (Van Heerden, 1999 and Prasanna, 2010).

However, there are numerous cases where EPZs have deepened their linkages and technological levels over time. For example, electronics exporters in Malaysia have attracted other MNEs to deepen backward linkages and have also increased sourcing from domestic firms. They have upgraded their technological activities and enlarged their product range, but such development is not automatic, much depends on policies for upgrading skills and attracting the right kind of investor. Singapore has been successful mainly due to careful targeting of industries such as electronics, which accounts for over a half of exports and to inducements for MNEs to upgrade their technologies. This was possible because of government investment in skills, infrastructure and support institutions (Van Heerden, 1999 and Prasanna, 2010).

In China, a high proportion of locally made materials and parts were used by foreign firms from mainly OECD countries to produce products that were export-oriented, thereby creating a stimulus to promote their own exports (Sun, 1999). However, Young and Lan (1997) failed to establish strong linkages between foreign and domestic firms in China. They found that technology transfer was neither emphasized by the motives of local partner firms nor those of foreign investors and that domestic firms were mainly interested in the incentives offered by

host country government to set up joint ventures with foreign firms and access knowledge. With respect to the relevant microeconomic literature, Zheng et. al. (2004) found that direct effects of FDI on China's exports were stronger than the indirect effects. However, Sharma (2003) observed that "the success stories" of East and South East Asian countries suggested that FDI was a powerful tool for export promotion through improvement of export opportunities and taking advantage of comparative advantage of a country. For instance, Zhang and Song's (2001) study across China found that FDI led to a rise in exports and thereby export performance.

Utilising data from Brazil, Bonelli (1999) showed that increase in FDI inflows from mainly the OECD economies raised Brazil's competitiveness as measured by export performance. In the same perspective, the leading export markets for Kenya and Tanzania is the OECD countries such as the US and the UK, who have invested in mining of mainly gold and diamonds that are exported to both the EU and the North American countries (Fiott, 2010). This however contradicted Ayanwale's (2007) findings in Nigeria that FDI mainly from OECD countries limited exports to competitors and confined production to the needs of MNEs in oil industry. Another perspective was developed by Zhang (2015) who found that high-tech FDI from OECD countries seemed to be more conducive to export upgrading than low-tech FDI from non-OECD countries.

In the same stream of literature, a strong evidence of a positive impact of FDI on diversification of host economy's exports horizontally, was produced by Banga's (2006) firm's level analysis of FDI from the US and Japan to India. This occurred in non-traditional sectors as the result was determined by the fact that foreign firms in such sectors were more export-oriented than local ones.

Whilst literature review presents mixed results on impact of FDI on export performance, majority of the studies (Bonelli, 1999; Zhang and Song, 2001; Sharma, 2003; Fiott, 2010; Prasanna, 2010 and Osei, 2014) have confirmed a positive and significant relationship between the two variables. Building on these empirical findings, this study proposes;

***Hypothesis 2: FDI flows from OECD countries have a positive impact on export performance in both Kenya and Tanzania.***

### **7.3.1.2. FDI From Non-OECD Home Countries To Other Non-OECD Countries**

While OECD group of countries are the dominant source of FDI, non-OECD countries have emerged as a new investor accounting for a group share of 47% of global FDI inflows in 2017 (UNCTAD, 2018). It matters whether FDI originates from an OECD or another non-OECD economy in respect to potential impact on export performance. Although FDI from traditional sources is still prevalent, the emergence of new wave of investors from non-OECD has increased the relative volume of FDI from non-OECD to other non-OECD countries, particularly at intra-regional level (UNCTAD, 2017).

In the context of export performance, Amighini and Sanfilippo (2014) argued that FDI from non-OECD to non-OECD economies impacted on export performance in African countries differently from FDI from OECD to non-OECD countries, due to the absorptive capacity of the host countries. Their argument supported the view that diversification in key low-tech industries such as agro-industry and textiles, raised the average quality of manufacturing exports, while importing from the non-OECD increased the ability to expand the variety of manufactured exports and to introduce more advanced goods in less-diversified economies.

While comparing FDI from OECD to non-OECD countries and FDI from non-OECD to non-OECD countries, Lipsey & Sjöholm (2011) argued that FDI from non-OECD to non-OECD countries potentially impacted positively much more on exports in the host countries; given that firms from non-OECD economies were likely to supply goods and services that were more accessible to other non-OECD economies. This provided more effective technological spillovers attributed to smaller technology gap at the same time. This standpoint was corroborated by other authors (Mlachila and Takebe, 2011; Dixit, 2012 and Amighini & Sanfilippo, 2014) when they observed investments from other non-OECD countries could compensate for low domestic savings and contribute to capital accumulation in other non-OECD countries especially those in which traditional investors were reluctant to invest in because of their weak institutions. This was particularly important if FDI was accompanied by infrastructure development as was often with investments from non-OECD countries, especially from the BRICS countries such as China.

Regarding Chinese investments' effect on exports growth in Africa, Renard (2011) found a significant effect on exports of extractive industry in mainly Angola, South Africa, Sudan and Republic of Congo. The high-country concentration of these countries exports to China in part was reflected in the importance of crude oil. Similarly, Fiott (2010) reported that Chinese firms

in Kenya had exported solar panels, bicycles and coffee among other items which might have turned Kenya into an export-oriented economy that benefited from FDI inflows. Furthermore, Chinese FDI flows into Sub-Saharan Africa impacted positively on the export performance of these countries (Kaplinsky and Morris, 2009). Sanfillipo (2010) revealed that in the case of FDI from non-OECD countries to Africa, particularly those in light manufacturing sector, took advantage of relocation of production activities in the continent, often motivated by the need to set up export platforms to third markets such as Asian FDI in textiles or the first processing of natural resources for re-export such as investments in Agriculture as well as mining by mainly China.

However, FDI from non-OECD countries to non-OECD countries particularly Chinese FDI has caused competition in external markets from export-oriented industry in SSA. African producers cannot compete with Chinese companies even in African markets since Chinese producers have low production cost and market prices (Adisu et. al., 2010). Furthermore, there has been negative impact of Chinese competition on African enterprises and exports. For instance, local textile factories in Nigeria have been crowded out of the export market and therefore forced to close (De Lorenzo, 2007).

The review of the above literature suggests mixed results of studies conducted on effect of FDI from a non-OECD country on export performance of another non-OECD country. This selection of studies however, generally produced significantly positive relation between FDI and export performance. Therefore, this study proposes;

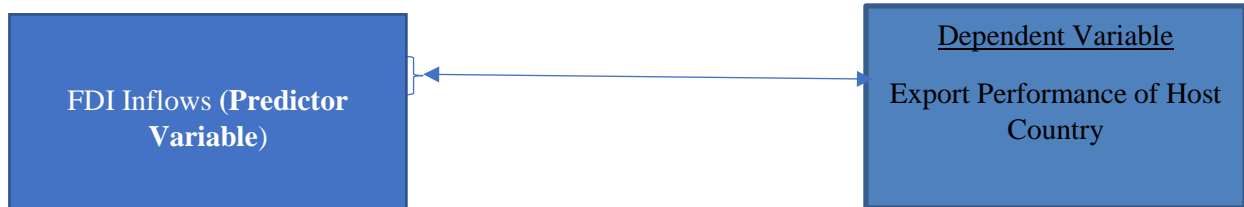
***Hypothesis 3: FDI flows from Non-OECD countries have a positive impact on export performance in both Kenya and Tanzania.***

### **7.3.2. Conceptual Framework on the Impact of FDI on Export Performance.**

Drawing from trade theories and related extant empirical studies in the prior sections of this chapter, FDI flows have been found to impact on export through a number of mechanisms (Zhang and Song, 2001). There is a group of studies that support FDI induced export growth through intra-firm relations that involve exporting of intermediate goods to foreign subsidiaries as inputs for foreign production (Zheng et. al., 2004 and Banga, 2006). Another group of studies suggest that FDI spurs positive spillover effects on domestic firms' productivity which in turn induces international trade (Harding and Javorcik, 2012).).

A similar perspective by Anwar and Sun (2017) revealed that although FDI reduced indigenous firms' domestic revenue, it increased their export revenues, irrespective of the origin as shown in the proposed framework below.

**7Figure 7.2: Conceptual Framework on the Impact of FDI on Export Performance.**



*Source: Created by author using materials from Literature on FDI flows' impact on Export Performance.*

However, Li and Liu (2005) had argued that not only did FDI directly promote exports by itself but also indirectly did so via its interaction terms. Therefore, the impact of FDI can be estimated by including other variables into the trade model, such as GDP, human capital (RHCAP), labour force (RTLFORC), domestic investment (RDI) and exchange rate (ROEXR). Like in the Economic growth chapter and in line with the study hypotheses, FDI is the main predictive variable of interest in this chapter, while other variables are considered control variables as discussed in the next section and shown in Figure 7.3.

#### 7.4.0. The Study Model and Variable Specifications

The study model follows much of the theoretical framework in Zheng et. al. (2004 and 2006), Sun (2009) and Zhang (2015) and supporting literature such as Fosfuri and saggi (2002), Banga (2006), Ayanwale (2007) and Naudé and Krugell (2007). According to these studies, the impact of FDI on export performance can be endogenised by including variables such as GDP, human capital (RHCAP), labour force (RTLFORC), domestic investment (RDI) and exchange rate (ROEXR).

Exports = f (FDI, GDP, Human Capital, Labour Force, Official Exchange Rate, Domestic Investment,)

Therefore, equation 1 can be written in the following format:

$$REXP_{it} = \beta_1 RFDI_{(t-1)it} + \beta_2 RGDP_{it} + \beta_3 RHCAP_{it} + \beta_4 RTLFORC_{it} + \beta_5 ROEXR_{it} + \beta_6 RDI_{it} + u_{it} \quad (1).$$

Where  $REXP_{it}$  denotes exports (proxied by the ratio of export of Kenya and Tanzania respectively to that of the home country of the investing MNE),  $RFDI_{(t-1)}$  represents the lagged FDI (proxied by Kenya and Tanzania's ratio of one year lagged FDI relative to home country), RGDP denotes the gross domestic product, RHCAP represents the human capital, RTLFORC denotes the total labour force, LROEXR is the official exchange rate and RDI is the domestic investments. R represents the ratio values. The subscripts '*i*' and '*t*' denote the panel data format of the database i.e. *i* = number of sample home countries (full sample, OECD, and non-OECD countries), *t* is the number of time-periods (1996-2016) individual countries and time respectively and *u* represent the error term.

Model 1 above has been structured using variables measured in relative terms to construct the panel data format needed for a panel data analysis. Nair-Reichert and Weinhold (2001) provided several advantages of using relative values discussed in the two previous chapters. Also, Wooldridge (2016) noted that the use of relative values provided an additional advantage of having a mixture of variables measured in nominal or real terms. Therefore, having all variables transformed into relative values provides consistency and compatibility of variables. This draws support from previous IB studies such as Nair-Reichert and Weinhold (2001), Zheng et. al. (2006) and Wooldridge (2016). Table 7.5 details the nature, measures and sources of variables, expected signs used in the MRA to estimate the impact of FDI and other factors on export performance in Kenya and Tanzania.

**28Table 7.5. Description and Sources of Variables**

Variable	Proxy	Expected Sign	Source	Definition
Exports from Kenya and Tanzania as a% trade (log form).	REXP		World Development Indicators	Ratio of host to home country's exports of goods and services which is obtained as a % of trade (WDI, 2018).
Dependable Variable				
Foreign Direct Investments (lag) (Predictor Variable)	$RFDI_{(t-1)}$ : FDI flows from home country to Kenya and Tanzania.	+	Kenya Investment Promotion Authority for Kenya and Tanzania Investment Council for Tanzania.	Ratio of host to home country's foreign direct investment flows from home to the host country (KIPA, 2018, TIC, 2018).
GDP Domestic Product (GDP) (Control Variable).	RGDP	+	World Development Indicators	Ratio of host to home country's GDP Size (WDI, 2018).

Dependable  
Variable

Human Capital (control variable)	RHCAP: Gross Enrolment Ratio both sexes (%).	+	World Development Indicators	Ratio of host to home country's ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of education shown (WDI, 2018).
Total Labour Force (Control)	RTLFORC	+	World Development Indicators	Ratio of host to home country's labour force comprises people ages 15 and older who supply labour for the production of goods and services during a specified period (WDI, 2018).
Official Exchange Rate (control variable)	ROEXR	- +	World Development Indicators	Ratio of host to home country's real exchange rates (WDI, 2018).
Domestic Investments (Control Variable)	RDI	+	World Development Indicators	Ratio of host to home country's Gross capital formation (% of GDP) (WDI, 2018).

*Source: Created by author using materials from Literature on FDI flows' impact on Export Performance.*

#### **7.4.1. Variable Descriptors**

This section defines the variables, their measures and proxies used in this empirical chapter to facilitate testing of the hypotheses developed in section 7.3.0. Like in the previous two chapters, the study used a dependent, a predictor and various control variables discussed in the next section.

##### **7.4.1.1. The Dependent Variable.**

The dependent variable represents Kenya's and Tanzania's exports (proxied by the ratio of export of Kenya and Tanzania respectively to that of the home country of the investing MNEs), obtained from the World Bank Development indicators.

##### **7.4.1.2. Predictor Variable.**

The predictor variable is the ratio of one year lagged FDI flows from each home country to the total annual amount of FDI flows into Kenya and Tanzania respectively. It is the most important factor for the study. This lag could vary from one year to two years. Several studies (Zhang & Song, 2001; Zheng et. al., 2004; Prasanna, 2010 and Zhang, 2015) have used one year-lagged FDI and agreed that there is a lagged effect from inward FDI on export

performance of a host country. One year lagged FDI flows was therefore used as a predictor variable in the equation.

#### **7.4.1.3. Control Variables.**

The selection of the following control variables for MRAs was influenced by theoretical issues and data availability.

#### **Economic Factors' Impact on Export Performance.**

The annual GDP size was included as a proxy for supply capacity of a host economy following models by Redding & Venables (2004) and Domician (2008). Several studies (Rodrik, 1999 and Hsiao, 2014) found that GDP growth raised export performance in developing countries such as Sub-Saharan Africa and East South Asian Economies. Therefore, a positive and significant impact of GDP growth on export performance is expected because export performance is a function of supply capacity.

Human capital increases the capability and productivity of an industry through helping technological progress. As such, higher levels of human capital can enhance the growth in export performance in a host country. A host country with more skilled workforce, as measured by education levels would be expected to compete more favourably in terms of competitiveness of exports (Zheng et. al., 2004; Amighini and Sanfilippo, 2014 and Zhang, 2015). Therefore, the study expects high quality workforce measured by the ratio of host to home country's skills level to have a positive effect on export performance in the host country.

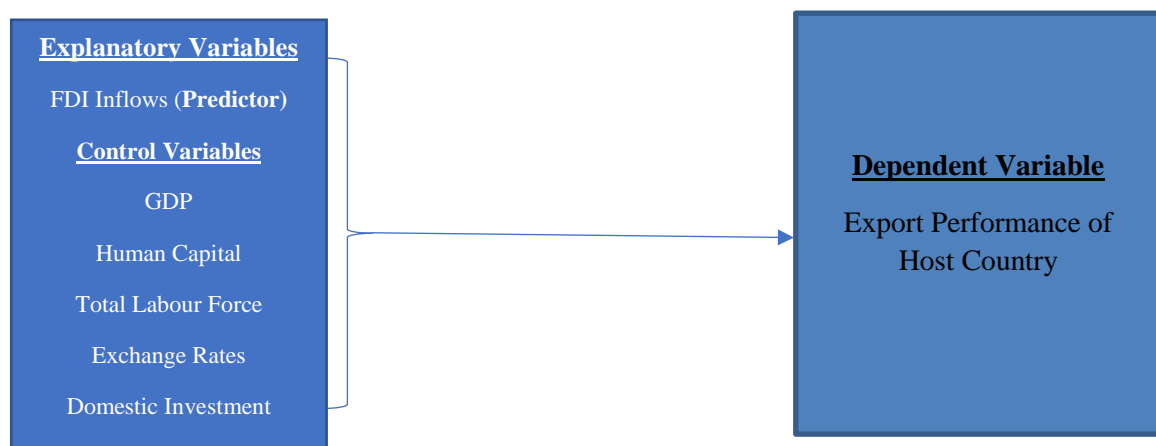
Exchange rate policies also matter, considering for instance that an appreciation of the local currency can reduce the profitability of exporting, with negative consequences on export performance (Dollar, 1992 and Agosin, Alvarez & Bravo-Ortega, 2012) as Kenya's and Tanzania's exports become less competitive. Depreciation of local currency on the other hand, will increase export profitability and hence export performance as well as lower costs of local production as investors try to take advantage of cheaper labour (Anyanwu, 2012). Using the ratio of real exchange rates of home to host country as a measure, this study expects higher ratio of exchange rate to positively influence export performance in Kenya and Tanzania.

#### **Social-Cultural Factors' Impact on Export Performance.**

A variable representing domestic investment in both Kenya and Tanzania was included following the work by Leichenko & Erickson (1997) and Sun (2001). It has been argued by

Zhang (2005) that DI had a significant influence on the capability and competitiveness of an industry and therefore its export performance. Accordingly, more domestic capital could enhance production capacity in a host country and thereby increase their exporting capability. Zheng et. al.'s (2004) findings suggested that DI was as important as FDI in explaining export performance. This was alluded to the fact that DI in China had not been “crowded out” by FDI. Therefore, like FDI, it is expected DI would have a positive and significant impact on export performance in Kenya and Tanzania.

**8Figure 7.3. The Relationship Between Predictable, Control and Dependant Variables.**



*Source: Created by author using materials from Literature on FDI flows’ impact on Export Performance.*

#### 7.4.2. Data Analysis

This research empirically investigates the impact of inward FDI on export performance of both Kenya and Tanzania by use of panel dataset at the aggregate country-level, considering the level of economic development of the home countries of firms investing in Kenya and Tanzania, grouped into OECD and non-OECD. As in the economic growth chapter, the study data series for the full sample amounts to 461 observations for Kenya and 483 for Tanzania. For the OECD countries, the observations amount to 251 and 273 for Kenya and Tanzania respectively. The non-OECD data observations amount to 210 for both Kenya and Tanzania.

Studies such as Naudé and Krugell (2007) and Fallon & Cook (2014) have proposed a number of variable measures which are often interrelated and only one can be used at a time in regression analysis due to collinearity between them. In practice, a choice is often influenced by availability of data.

### 7.4.3. Pre-Estimation Tests

Table 7.1 for Kenya both Kenya and Tanzania present the descriptive statistics, displaying the key features of the study dataset (in relative terms) prior to log transformation. From Table 7.1, the summary statistics for full sample for Kenya had the average labour force of 0.099502 with a maximum of 28.00000 and standard deviation of 1.956879. Similar patterns were observed for the summary statistics for Tanzania that had the average labour force of 1.929419 with a maximum of 97.00000 and standard deviation of 7.610201. It is observed, as shown that the data for labour force have unequal variation with a large mean and a large standard deviation. To make the dataset conform to normality, logs were taken to equalise the variation squeezing the groups with the larger standard deviations and stretching data with the smaller values and standard deviations as displayed in Table 7.2 (Schwarz, 2011 and Okafor, 2015). Drawing from approaches of similar studies such as Zheng et. al.'s (2006), Model 2 (in section 7.4.3) is structured to investigate the log-log relationship of the impact of the main predictive variables on the dependent variable more directly in terms of elasticity and provides more control over the interaction of the variables.

**29Table 7.1. Descriptive Statistics Before Log Transformation for Kenya and Tanzania.**

Sample Countries Variables	Kenya				Tanzania			
	Mean	Std. Dev.	Minimum	Maximum	Mean	Std. Dev.	Minimum	Maximum
<b>Exports (REXP)</b>	0.883	0.549	0.077	2.851	0.684	0.396	0.103	2.132
<b>Lagged FDI (RFDI<sub>(t-1)</sub>)</b>	0.045	0.026	0.000	0.208	0.043	0.022	0.001	0.137
<b>GDP (RGDP)</b>	0.854	0.811	0.229	6.622	0.289	0.222	0.009	1.276
<b>Human Capital (RHCAP)</b>	1.253	0.228	0.185	1.163	0.027	0.102	1.595	0.834
<b>Labour Force (RTLFORC)</b>	0.099	1.956	0.099	28.000	1.929	7.610	0.218	97.000
<b>Exchange Rate (ROEXR)</b>	0.185	0.228	0.918	1.163	0.027	0.102	1.591	0.834
<b>Domestic Investment (RDI)</b>	0.833	0.235	0.390	2.116	1.045	0.353	0.346	2.354

Like in the analyses of FDI determinants and economic growth chapters, all variables have been logged to deal with skewness of data as well as reducing heteroscedasticity. By logging, the data is made more uniform and less affected by outliers (Zheng et. al., 2013 and Okafor, 2014). Therefore, a log-log function form of (1) is adopted to measure directly the impact of the explanatory variables on the dependant variables in terms of elasticity. As such, the

proposed model and its log-log version investigating the impact of FDI on export performance are structured in equation 2 below.

$$LREXP_{it} = \beta_1 LRFDI_{(it-1)} + \beta_2 LR GDP_{it} + \beta_3 LRHCAP_{it} + \beta_4 LRTLFORC_{it} + \beta_5 LROEXR_{it} + \beta_6 LRDI_{it} + u_{it} \quad (2).$$

Where L indicates logged values,  $v$  is a composite term including both intercept and stochastic error term,  $i$  and  $t$  denote individual countries and time respectively. All variables are in ratio form. Therefore, the most important variable for this study is the flow of FDI in the previous time-period, hence the dynamic effect of FDI on economic growth has to be taken into account thus, one year lagged FDI is used in equation (2). The log-log model 2 (derived from model 1) will be able to measure the impact of the main predictive variables on the dependent variable more directly in terms of elasticity and provide more control over the interaction of the variables (Zheng, 2013).

**Table 7.2. Descriptive Statistics After Log Transformation for Kenya and Tanzania.**

Sample Countries Variables	Kenya				Tanzania			
	Mean	Std. Dev.	Minimum	Maximum	Mean	Std. Dev.	Minimum	Maximum
<b>Exports (LREXP)</b>	-0.334	0.696	-2.562	1.048	-0.549	0.606	-2.270	0.757
<b>Lagged FDI (LRFDI<sub>(t-1)</sub>)</b>	-3.296	0.746	-7.716	-1.569	-3.284	0.593	-6.584	-1.986
<b>GDP (LRGDP)</b>	-2.999	1.684	-6.727	1.075	-0.013	0.342	-1.059	0.856
<b>Human Capital (LRHCAP)</b>	-0.401	0.626	-1.470	1.890	-2.956	1.726	-7.128	1.154
<b>Labour Force (LRTLFORC)</b>	-0.515	1.425	-4.161	1.912	-1.514	0.790	-4.632	0.244
<b>Exchange Rate (LROEXR)</b>	-3.229	2.506	-9.296	0.518	-7.701	2.510	-11.051	-0.180
<b>Domestic Investment (LRDI)</b>	-0.220	0.278	-0.940	0.750	0.164	1.602	-3.915	3.250

The summary statistics in Table 7.3 (for Kenya) and Table 7.4 (for Tanzania) show that the correlation matrix and the VIF values indicate multicollinearity does not exist in the study variables. Multicollinearity exists if the study variable correlates very highly, usually above 0.80 or 0.90, when the tolerance values should not be above 0.10 and the VIF value should not be above 10 (Cameron and Trivedi, 2010). The data was examined in eviews for correlation to check for VIF and the mean scores of 1.70 were produced for Kenya and 1.42 for Tanzania which are well within the tolerance level for VIF score. Tests for heteroscedasticity did not show any model with problems of heteroscedasticity. Data log transformation was performed

for all the study variables to improve the normality of the dataset. This draws support from previous IB studies such as (Kumar, 2001; Zheng et. al., 2013; Falk, 2014 and Okafor, 2014) that have suggested that taking logs helps improve the normality and linearity of the data series.

**31Table 7.3. Correlation Matrix (Kenya)**

	1	2	3	4	5	6	7
1 <b>LREXP</b>	1						
2 <b>LRFDI_T_1_</b>	0.066	1					
3 <b>LRGDP</b>	-0.106	-0.425	1				
4 <b>LRHCAP</b>	0.299	-0.351	0.682	1			
5 <b>LRTLFORC</b>	-0.580	-0.180	0.452	-0.167	1		
6 <b>LROEXR</b>	-0.246	0.369	-0.537	-0.667	0.121	1	
7 <b>LRDI</b>	0.019	-0.027	0.178	0.121	0.293	0.129	1
<b>Average</b>							
<b>V.I.F. Score</b>	1.70						

**32Table 7.4. Correlation Matrix (Tanzania)**

	1	2	3	4	5	6	7
1 <b>LREXP</b>	1						
2 <b>LRFDI_T_1_</b>	0.195	1					
3 <b>LRGDP</b>	0.120	0.009	1				
4 <b>LRHCAP</b>	0.051	-0.211	-0.192	1			
5 <b>LRTLFORC</b>	0.327	-0.005	0.463	0.103	1		
6 <b>LROEXR</b>	-0.126	-0.225	-0.102	-0.071	-0.044	1	
7 <b>LRDI</b>	-0.614	-0.371	0.167	0.062	-0.138	0.210	1
<b>Average</b>							
<b>V.I.F. Score</b>	1.42						

#### 7.4.4. Diagnostic Tests

All regressions were conducted with fixed effects because assumptions for OLS pooling and random effects were rejected as confirmed by the Hausman test. Unlike the determinants model of FDI, there were no dummies in the models for export performance because the dummies obscured all the results and were therefore dropped. Like in the economic growth model, fixed effect model was adopted.

The modelling techniques used reduced biased estimates as well as avoided severe misspecification as they allowed for variation in characteristics relating to the sampled countries both cross-sectionally and over time. Use of panel estimation techniques was to

rectify unobserved heterogeneity given some disparity between variables as revealed in the summary statistics. In-depth discussion on pooled and fixed effects are in earlier chapters.

A range of variables reflecting different specific impacts on export performance linked to other explanatory variables was considered in turn for each sample following a procedure by Judd & McClelland (2011) and Fallon & Cook (2014). The regression began with full sample model, followed by OECD model and then non-OECD model. A variety of alternative variables, including measures of human capital, domestic investments, exchange rates and political and institutional factors were successively introduced, being excluded where they lacked explanatory powers.

High levels of correlations were expected between two independent variables Human Capital and total labour force. Hence, the degree of correlation in each case was estimated by using a correlation matrix (see Tables 7.3 and 7.4). Therefore, only one of the inter-related variables was used in any equation at a time to reduce multicollinearity between explanatory variables. The worst performing variable in any pair was omitted after being tried separately in each of the regression equations. As such, only one measure in each model was used due to some concern that these alternative measures might have better explanatory variables than the alternatives. For instance, due to high internal consistency between GDP and GDP growth rate, the latter variable was dropped in favour of GDP as a measure of size of home and host countries' economies based on previous studies such as Zheng et. al. (2006) and Zhang (2015). Similarly, there are three measures of political and institutional factor. The study only used one measure, quality of institutions, because it performed better than political stability and corruption.

Several theoretical and practical checks were conducted to identify and remove heteroscedasticity, linked to omission of variables, non-linearities or aggregation. Each sampled equation was tried in a number of forms and the problem was tested by Levene and the Mackinnon and White tests. However, heteroscedasticity was not identified in any of these tests. By logging all variables, the data was made more uniform and less affected by outliers and because of the difference in the size as some of the control variables and predictors have a large range and therefore a log was taken as shown in Table 7.2.

Single equation, multivariate, regression models were developed for each sample of home countries using an estimation procedure based on a Poisson-type model, with LREXP (proxied as annual exports from host countries) being used as the dependent variable in each case. The

method employed throughout was to regress a range of potential explanatory variables on this dependent variable until ‘best fit’ models were obtained for both Kenya and Tanzania. Six separate best fit models are estimated, three for each host country representing FDI flows from full sample, OECD and non-OECD respectively.

### 7.5.0. Research Findings

This section will discuss the empirical results of the impact of FDI on export performance in Kenya and Tanzania. The main aims of this section are, (i); to investigate if FDI is a source of export performance in Kenya and Tanzania and (ii); to examine control factors that have been responsible for export upgrade in Kenya and Tanzania.

#### 7.5.1. Main Findings on Impact of FDI on Export Performance in Kenya and Tanzania

In order to test the several hypotheses presented in literature review section, the multiple linear regression was performed on all variables as shown in Table 7.6 (for Kenya) and Table 7.8 (for Tanzania). The regression analysis was conducted for 3 models for each host country. All the measures used are the ones that had the greater predictive power.

The literature and hypothesis have been developed on the basis of economic, social-cultural and institutional factors and therefore, the interpretation of results will follow a similar pattern by analysing the significant variables with the right signs first, then insignificant variables with right signs followed by significant variables with wrong signs and finally variables that are not significant with wrong signs. The overall performance of all the models in Tables 7.6 and 7.8 is satisfactory.

##### 7.5.1.1. Main Findings on Impact of FDI on Export Performance in Kenya

The empirical results obtained from estimating equation (2) show that most of the independent variables had the expected sign in relation to export performance. Thus, three variables in model 1 (the full sample), two in model 2 (OECD countries) and two in model 3 (non-OECD countries) respectively are statistically significant.

**Table 7.6. Results for Kenya**

		<b>Res 1996-2016</b>		
		<b>The Top 22 Home Countries</b>	<b>12 OECD Countries</b>	<b>10 Non-OECD Countries</b>
<b>Variable</b>	<b>Variable Name</b>	<b>1</b>	<b>2</b>	<b>3</b>
Constant		0.650124***	0.527978*	1.170899***
St. Error		(0.112668)	(0.317016)	(0.107827)

LRFDI(t-1) (Predictor) H1,2,3	Lagged FDI	0.388680*** (0.027585)	0.239027*** (0.044282)	0.423544*** (0.022213)
LRGDP (Control)	GDP	-0.324605* (0.033324)	0.549739 (0.349620)	0.060087 (0.037172)
LRHCAP (Control)	Human Capital	0.214625*** (0.066869)	0.383650 (0.183394)	-0.294143 (0.055675)
LRTLFORC (Control)	Labour Force	-0.168991 (0.024805)	-0.540577 (0.029798)	-0.378040 (0.023213)
LROEXR (Control)	Exchange Rates	0.045447 (0.012966)	0.108912*** (0.019180)	0.035516 (0.016308)
LRDI (Control)	Domestic Investments	0.570303*** (0.084991)	-0.774524** (0.166626)	0.430690*** (0.065921)
Number of Observations		461	251	210
R2		0.690	0.712	0.825
Adj R2		0.671	0.680	0.814

Notes: Standard errors are reported in (). \*, \*\*, \*\*\* indicate significance at 10%, 5% and 1% level respectively.

### **FDI flows' impact on export performance in Kenya.**

Hypothesis 1 tested the impact of FDI flows on export performance measured by the ratio of host to home countries' lagged FDI. The variable was positive and significant at the 1% level. The estimate implied that a 1% increase in FDI results will raise exports from Kenya by 38.8%. This empirical evidence is broadly consistent with the shared view that FDI promotes export performance of host countries (Fosfuri & Saggi, 2002, Sun, 2009. Tadesse & Shukralla, 2013, Tang and Zhang, 2016, Fetai & Morina, 2019). The finding also supports results of Bonelli (1999) which confirmed that increase in FDI flows increased competitiveness of a host country as measured by export performance. The results also support other similar studies such as Banga's (2006) and Mohanty & Sethi's (2019) that produced a strong evidence of a positive impact of FDI on export performance. This occurred in non-traditional sectors as the result was determined by the fact that foreign firms in such sectors were more export-oriented than local ones which may be similar to what is happening in Kenya. Therefore, H1 is accepted.

### **FDI flows from OECD countries' and its impact on export performance in Kenya.**

Hypothesis 2 is positive and statistically significant showing that 1% increase in the FDI flows from OECD countries to Kenya would lead to 23.9% rise in export performance at a significance level of 1%. This finding is consistent with similar studies such as Liu et. al.'s (2001) and Zhang (2005) who argued that FDI had a greater effect than domestic investments. Similarly, Prasanna's (2010) established that FDI from OECD countries had the potential to upgrade exports from non-OECD countries.

The finding is further consistent with the fact that the impact of FDI derived not only from additional capital but possibly also technology managerial knowhow that MNEs bring with

them, along with access to the global market. It seems that the nature of FDI from OECD has effective spillovers effect on Kenyan firms and their motive is mainly resource-seeking for export purposes (Narula and Driffield, 2012). Based on the findings of this analysis, H2 is accepted.

### **FDI flows from non-OECD countries' impact on export performance in Kenya.**

FDI variable in hypotheses 3 was positive and significant. Thus, a 1% increase in the FDI flows from the non-OECD countries to Kenya would lead to 42.35% rise in export performance. It can be argued that the FDI from non-OECD economies is one of the key drivers of export performance in Kenya, perhaps due to the narrow gap between home and host economies' absorptive capabilities. This resonates with Amighini and Sanfilippo (2014) who suggested that theoretical predictions regarding FDI's positive effect on growth seemed to rest a great deal on the absorptive capacity of the economy. The empirical finding was also consistent with previous results such as Balasubramanyam et. al.'s (1996) which showed FDI enhanced export growth in the host countries. Indeed, Fiott (2010) found that Chinese firms in Kenya had exported solar panels, bicycles and coffee which demonstrated the direct positive impact of non-OECD FDI on export performance in Kenya. This finding also suggests that the recent surge of economic integration among 'Non-OECD' countries has brought some positive impact on the export performance in African economies. Indeed, this is consistent with the more recent evidence which highlighted that Non-OECD to Non-OECD' exports were more diversified (Regolo, 2013), more sophisticated, and better connected than exports to the OECD countries. This is also consistent with Kaplinsky and Morris' (2009) findings as well as the fact that non-OECD FDI in traditional industries such as textiles and agro-business are market oriented and focus on the first-stage processing of raw materials (cotton or food) to be exported back to the home country or third markets. Consequently, H3 is accepted.

### **Other Control Factors' Impact on Export Performance in Kenya.**

#### ***Economic Factors' Impact on Export Performance in the Host Country.***

The impact of the five economic control factors on export performance was mixed. Although the coefficient for GDP variable is positive for both OECD and non-OECD groups, there is no statistical evidence to claim that GDP improves export performance in Kenya at the full sample level due to its insignificance. It even had a negative and significant coefficient for the full sample. This is inconsistent with expectations. It is however consistent with Domician's (2008) previous findings in Tanzania. This negative impact of GDP's effect on export performance

may be explained by the preceding disproportion and imbalances between sectoral export performance and GDP contributions.

The impact of human capital on export performance in Kenya was measured by home to host country's ratio of secondary school gross enrolment. The results indicated that human capital had a positive and significant impact on export performance in Kenya for the FDI from full sample. This empirical finding lends support to the view that human capital promoted export performance. It seems absorptive capacity is crucial in capturing benefits from investments, as suggested by this evidence in favour of complementarity between export performance and domestic human capital. The estimate of this variable is consistent with theoretical prediction and widely held belief by researchers such as Zheng et. al. (2004) and Zhang (2015). However, when separated, the effect of the same variable on export performance was positive but insignificant for OECD and negative and insignificant for non-OECD group. It could be argued that Kenya's absorptive capability seems to be essential for acquiring potential benefits of full sample, but the insignificant results for OECD would be due to the wide gap of technological capacity. This could be attributed to the fact that the motive of FDI from non-OECD group is to access the Kenyan market rather than efficiency-seeking.

The quantity of labour measured by total labour force had a negative effect on export performance across all the three groups of the full sample, OECD and non-OECD. This may be attributed to the nature of FDI in Kenya and the related exports that do not need high labour intensity such as service industry.

The impact of exchange rates on export performance in Kenya was measured by the ratio of home to host country's official exchange rates. The variable had a positive sign with significant effect in the context of OECD sample but was insignificant though with the correct sign for the full sample and non-OECD FDI. This empirical evidence is consistent with Sharma's (2003) and Zheng et. al.'s (2004) observations, that a fall in domestic prices due to exchange rates' depreciation made exports cheaper in the international markets resulting into their increased demand. The findings are also in line with the extant literature pointing to depreciation making exports more profitable. One of such studies was Melitz's (2003).

### ***Social-Cultural Factors' Impact on Export Performance in the Host Country.***

One social-cultural factor namely, domestic investment had a significant and positive impact on export in relation to both full sample and non-OECD. It however had a negative and significant impact of export performance for OECD countries. This indicates that domestic

investment as the primary determinant of domestic production acted as an important driving force for Kenya's export growth. This is consistent with findings of similar research such as Sun's (2001). The result also implied that Kenyan domestic investments had not been 'crowded out' by full sample and non-OECD investments which supports Zheng et. al.'s (2004) similar results.

**34Table 7.7. Summary of Findings for Kenya**

Factors impacting on Export Performance	Expected Sign	Observed Sign		
		Full Sample of Home Countries	OECD	Non-OECD
<b>Economic Factors</b>				
FDI <sub>(t-1)</sub>	Positive	Positive/Significant	Positive/Significant	Negative/Significant
GDP	Positive	Negative/Significant	Positive/Insignificant	Positive/Insignificant
Human Capital	Positive	Positive /Significant	Positive/Insignificant	Negative/Insignificant
Labour Force	Positive	Negative/Insignificant	Negative/Insignificant	Negative/Insignificant
Exchange Rates	Positive	Positive/Insignificant	Positive/Significant	Positive/Insignificant
Domestic Investments	Positive	Positive/Significant	Negative/Significant	Positive/Significant

### 7.5.1.2. Main Findings on Impact of FDI on Export Performance in Tanzania

The results in columns 1, 2 and 3 obtained from FEs support over a half of all the variables, as the following explanatory variables out of six are positive and have the right signs; three in model1, four in model 2 and three in model 3.

**35Table 7.8. Results for Tanzania.**

		Res 1996-2016		
		The Top 22 Home Countries	12 OECD Countries	10 Non-OECD Countries
Variable	Variable Name	1	2	3
Constant		0.005640***	1.875315*	0.597477***
St. Error		(0.161426)	(0.343441)	(0.156690)
LRFDI(t-1) (Predictor) H1,2,3	Lagged FDI	-0.001929	0.373043***	-0.051902
		(0.035899)	(0.060877)	(0.062546)
LRGDP (Control)	GDP	0.057414***	0.062847***	0.169621***
		(0.012188)	(0.016501)	(0.059531)
LRHCAP (Control)	Human Capital	0.287488***	0.645224***	0.263500***
		(0.040729)	(0.151394)	(0.095727)
LRTLFORC (Control)	Labour Force	-0.228905	-0.845509	-0.190920
		(0.014091)	(0.198111)	(0.020324)
LROEXR (Control)	Exchange Rates	-0.011622	0.118912***	0.053537
		(0.008595)	(0.012441)	(0.015652)
LRDI (Control)	Domestic Investments (DI)	0.620880***	-0.471318**	0.627870***
		(0.081458)	(0.230984)	(0.135643)
Number of Observations		483	273	210
R2		0.564	0.407	0.536
Adj R2		0.539	0.347	0.471

Notes: Standard errors are reported in (). \*, \*\*, \*\*\* indicate significance at 10%, 5% and 1% level respectively.

### **FDI (full sample) flows' impact on export performance in Tanzania.**

FDI is negative and insignificant in Hypothesis 1. This could be due to inward-oriented policy that Tanzania pursued for a long time which may have discouraged export-oriented foreign investment. This is consistent with Sharma's (2003) similar findings in India.

This result may further mean that MNEs in Tanzania tend to focus largely on simple and low-value added tasks in order to exploit cheap labour costs and a liberal regulatory regime. Therefore, contributions of FDI alone are largely limited to raising volume of exports, particularly in labour-intensive products and low value-added activities in medium-and high-tech production, and its benefits to export upgrading are relatively small. FDI seem to cater for domestic demand not export. This result is consistent with similar results by Sharma's (2003) and Zhang's (2015).

Conversely, the nature of FDI flows into Tanzania is not compatible with absorptive capability of related exports. This view is shared by Zhang (2005) who argued that foreign investments failed to adjust to local capabilities and needs by providing too few or the wrong kind of resource and assets for a particular economy. Also, FDI to Tanzania seems motivated by market-seeking motive, producing not for export but local consumption. Consequently, H1 is rejected for the case of Tanzania.

### **FDI flows from OECD countries' impact on export performance in Tanzania.**

The variable in hypothesis 2 was positive and significant at 1% level. This empirical result suggests that FDI from OECD is one of the key drivers of export performance in Tanzania. A 1% rise in OECD FDI would increase export performance in Tanzania by 37.3%. Specifically, the effect of FDI is clearly larger in OECD than in the full sample. This is consistent with Harding and Javorcik's (2012) evidence that FDI inflows offered potential for raising the quality of exports in developing countries. However, the effective happening of such spillovers was nonetheless, influenced by the nature of the investment determined by a range of factors such as the motivation (Crespo and Fontoura, 2007 and Narula and Driffield, 2012). Therefore, the empirical findings could be attributed to the nature of foreign investments from OECD and exports as well as the destination of Tanzanian exports. Over 30% of Tanzania's exports are shipped to Europe and North America. Mineral exports alone accounted for 55.1% in 2016 of Tanzania's total value of merchandise exports. This signifies the rising importance of minerals in the country's export equation and it draws its base in the massive foreign investments in the sector (WDI, 2018) hence the positive and significant impact. Consequently, H2 is accepted.

### **FDI flows from non-OECD countries' impact on export performance in Tanzania.**

The impact of FDI flows from non-OECD countries on export performance in the host country was tested in Hypothesis 3. Positive but insignificant results were generated negating the hypothesis and it implies that a percentage increase in non-OECD FDI leads to an insignificant proportionate rise in overall export earnings. This finding may reflect the market-seeking motive for investors from non-OECD countries.

This is consistent with a section of Amighini and Sanfilippo's (2014) results that did not find a widespread evidence of export performance enhancing for non-OECD FDI in African economies. Similarly, Domician (2008) also argued that attracting FDI was not necessarily an automatic export sector development move. In Africa, for this case Tanzania, FDI seems to have benefited external integration at the expense of internal integration as reflected in the establishment of enclave economies, especially in mining and oil sectors that Tanzania is hugely endowed with. Consequently, H3 is rejected.

### **Other Control Factors' Impact on Export Performance in Tanzania.**

#### ***Economic Factors' Impact on Export Performance in the Host Country.***

GDP's impact on export performance in Tanzania has a positive and significant result for all the three groups of home countries. This is consistent with similar findings such as Rodrik's (1999) that reported significant effect of GDP on export growth in Sub-Saharan Africa and Amighini and Sanfilippo (2014) on export upgrading of African economies. The result could be attributed to Tanzania's economy that is dominated by extraction industry for export purposes.

Human capital had a positively and significant effect on export performance in Tanzania for all the three groups of home countries. This result is consistent with similar studies such as Aitken, Hanson and Harrison's (1997) and Zhang's (2015) which emphasized that the magnitude and extent of technological benefits from MNEs were conditional on host-country's human capital that are needed to acquire and work with the foreign technology. Therefore, it can be argued that Tanzania's absorptive capacity is essential for acquiring potential benefits from both OECD and non-OECD countries which is also consistent with Abou-Stait (2005), Domician (2008) and Prasanna (2010) studies that had similar results.

The quantity of labour measured by total labour force had a negative effect on export performance across all the three groups (the full sample, OECD and non-OECD). This, like in

Kenya, may be attributed to the nature of investments in Tanzania and the related exports that would not need high labour intensity such as service industry.

The exchange rate had the right sign with significant effect for the OECD countries only. This empirical evidence is consistent with the extant literature (Melitz, 2003) pointing to depreciation making exports more profitable. However, when regressed separately, estimations for full sample and non-OECD groups showed that changes in Tanzania’s currency did not have a significant effect on export performance. This might be due to exchange rates that are almost similar between home and host countries in this group and therefore less sensitive.

***Social-Cultural Factors’ Impact on Export Performance in the Host Country.***

Domestic Investment (DI) had a significant and positive effect on export performance in Tanzania for both full sample and non-OECD groups. It however had a negative and significant impact of export performance for OECD countries. This indicated that DI as the primary determinant of domestic production acted as an important driving force for Tanzania’s export growth. This is consistent with findings of similar research such as Sun’s (2001). In contrast, DI had a negative effect on export performance in Tanzania for OECD group; perhaps due to inefficient policies in relation to investors from OECD. This is consistent with Zhang’s (2005) similar findings.

**36Table 7.9. Summary of Findings for Tanzania**

Factors impacting on Export Performance	Expected Sign	Observed Sign		
		Full Sample of Home Countries	OECD	Non-OECD
<b>Economic Factors</b>				
FDI <sub>(t-1)</sub>	Positive	Negative/Insignificant	Positive/Significant	Positive/Insignificant
GDP	Positive	Positive/Significant	Positive/Significant	Positive/Significant
Human Capital	Positive	Positive /Significant	Positive/Significant	Positive/Significant
Labour Force	Positive	Negative /Insignificant	Negative/Insignificant	Negative/Insignificant
Exchange Rates	Positive	Negative/Insignificant	Positive/Significant	Positive/Insignificant
Domestic Investments	Positive	Positive/Significant	Negative/Significant	Positive/Significant

**7.5.1.3. Comparison of Kenya and Tanzania**

The comparison of impact of FDI on export performance in Kenya and Tanzania displays some similarities and differences as summarised in Table 7.10 below.

**37Table 7.10. Summary of Combined Findings for Kenya and Tanzania**

Factors impacting on	Expected Sign	Observed Sign	
		Kenya	Tanzania

<b>Export Performance</b>							
		<b>Full Sample of Home Countries</b>	<b>OECD</b>	<b>Non-OECD</b>	<b>Full Sample of Home Countries</b>	<b>OECD</b>	<b>Non-OECD</b>
<b>Economic Factors</b>							
FDI <sub>(t-1)</sub>	Positive	Positive/Significant	Positive/Significant	Negative/Significant	Negative/Insignificant	Positive/Significant	Positive/Insignificant
GDP	Positive	Negative/Significant	Positive/Insignificant	Positive/Insignificant	Positive/Significant	Positive/Significant	Positive/Significant
Human Capital	Positive	Positive/Significant	Positive/Insignificant	Negative/Insignificant	Positive/Significant	Positive/Significant	Positive/Significant
Labour Force	Positive	Negative/Insignificant	Negative/Insignificant	Negative/Insignificant	Negative/Insignificant	Negative/Insignificant	Negative/Insignificant
Exchange Rates	Negative	Positive/Insignificant	Positive/Significant	Positive/Insignificant	Negative/Insignificant	Positive/Significant	Positive/Insignificant
Domestic Investments	Positive	Positive/Significant	Negative/Significant	Positive/Significant	Positive/Significant	Negative/Significant	Positive/Significant

The purpose of this chapter has been to examine the impact of FDI on export performance in Kenya and Tanzania. Like in the previous chapter, it has been noted that there are other control factors that affect export performance. The emphasis here is on FDI which is the main variable.

The empirical results shown in Tables 7.6 and 7.8 can now be compared between the two countries to those of similar empirical studies investigating the impact of FDI on export performance. The study confirms that FDI performed much better in Kenya than Tanzania with regard to exports. This implies that Kenya has a stronger absorptive capacity for FDI than Tanzania. In fact, the coefficient is insignificant at the full sample and non-OECD levels in Tanzania. This could be due to an inward-oriented policy that Tanzania pursued for a long time which may have discouraged export-oriented foreign investments or type of FDI which is directed towards home consumption goods. This is consistent with results of similar studies such as Sharma's (2003) and Zhang's (2005). Therefore, Kenya's absorptive capacity is essential in acquiring potential benefits from FDI from both OECD and non-OECD countries whereas Tanzania's is for FDI from OECD countries only. The similarities between the two countries could be attributed to their absorptive capabilities of the FDI from OECD countries. While the difference held between them is the effect of FDI from full sample and non-OECD on their export performance.

It could also be down to the nature of FDI from OECD group which is consistent with evidence in Dominican's (2008) similar study in Tanzania. Mining and tourism were found to attract higher export earnings from developed compared with developing countries. This signifies the rising importance of minerals in Tanzania's export equation; and it draws its huge FDI

investments from OECD countries in the sector which seem to be export oriented. Meanwhile, Kenya seems to have attracted FDI that is beneficial to its export performance boosted by several factors such as natural resources and export potentials.

Consequently, the similarities and differences compared above for Kenya and Tanzania support literature works such as Sun's (2001) and Zhang's (2015) which concluded that the impact of FDI on export performance was expected to be different between countries due to not only geographical features but also by social and economic characteristics such as the level of economic openness, industrial structure, factor endowments and economic policies.

#### **7.6.0. Summary and Policy Implications of Impact of FDI on Export Performance.**

This chapter was developed to investigate the comparative impact of FDI on export performance in Kenya and Tanzania. The empirical tests were based on three sample estimates of the full sample, OECD and non-OECD home countries. Similarly, it assessed other factors' impact on export performance in the two host countries. The empirical findings confirmed that while FDI from the full sample, OECD and non-OECD countries contribute positively and significantly to export performance in Kenya, only FDI from OECD countries make a positive and significant contribution to the export performance in Tanzania. The main results suggest that not only does FDI matter for export performance in Kenya and Tanzania but the origin of FDI also matters. The findings provide in fact empirical evidence in support of a stream of research (Gelb, 2005 and Amighini & Sanfillipo, 2014) pointing to a great potential of a non-OECD to non-OECD FDI flows due to a smaller technology gap and a similar level of production capacity. It is also shown in the study that FDI from non-OECD countries (42.32%) positively impacted on Kenya's export performance than FDI from OECD countries (23.9%).

FDI flows from all the three categories of home countries (full sample, OECD and non-OECD) impacted positively and significantly on export performance in Kenya. Similar results were generated by FDI from OECD countries only, into Tanzania. The result is consistent with philosophy drawn from macroeconomic of international trade and investment. Thus, when FDI flows into a country at macro level, it can alter the factor endowment of the country and hence the structure and direction of its trade (Kojima, 1973 and Kojima and Ozawa, 1984). The empirical evidence also resonates with recent findings such as Zhang's (2015) studies that supported a widely held view that FDI positively impacted on the ability of African economies to increase their export performance.

The study also revealed that the relationship between FDI from both full sample and non-OECD countries and export performance in Tanzania is not significant and thereby a less important factor in export performance. As a result, and in support of Zhang's (2005) and Ayanwale's (2007) similar views, the nature of FDI flows from non-OECD countries into Tanzania is not export-oriented but is mainly market-oriented because as mentioned earlier, an inward-oriented policy that Tanzania pursued may have discouraged export-oriented firms.

The empirical evidence further found that the contributions to Kenya's export performance came mainly from FDI, human capital and domestic investments whereas human capital, GDP and DI were the main contributors of export performance in Tanzania.

Tanzania's export performance is driven by human capital, GDP, and exchange rates in relation to the OECD while only exchange rates does the same for OECD group in Kenya. Export performance in both Kenya and Tanzania is promoted by GDP and domestic investments for non-OECD countries. Following the microeconomic literature, this result suggests that the direct effect of FDI on exports is stronger than the indirect effects in Kenya than in Tanzania. This could be attributed to the assumption that only weak linkages exist between foreign and domestic firms in mainly Kenya.

Factors that are responsible for export performance in Tanzania include human capital and GDP. These factors returned positive and significant results in all the three estimates of full sample, OECD and non-OECD home countries. This outcome is consistent with Zhang's (2015) view that developing host country's absorptive capacity reinforced the effect of FDI through learning efforts, which is necessary to capture potential gains from FDI. The evidence also points to Zheng et. al.'s (2004) view that host countries with more skilled workforce, as measured by education levels would be expected to compete more favourably in terms of competitiveness of exports.

Similarly, human capital and domestic investments were found to be important drivers of export performance in Kenya at the full sample level. Tanzania had GDP in addition to these two for the same group of home countries. These findings are consistent with previous works such as Rodrik (1999) in SSA. Kenya's GDP was not important to export performance due to may be most of East African countries' agricultural and unprocessed products were consumed locally and not sold on international market.

Meanwhile, exchange rates were found to be one of the most important drivers of export performance in both Kenya and Tanzania within the OECD context. These findings are

consistent with results of works such as Anyanwu's (2012) which argued that an increase in rate of exchange reflected an appreciation of the host country's currency against other currencies which made exports expensive.

Based on empirical results of this research, Kenyan government need to direct its efforts mainly towards sustaining the country's attractiveness to FDI flows from both OECD and non-OECD countries. This is because the study revealed that FDI flows from both groups of countries, generally played a positive and significant role in export performance in Kenya. The finding implied that linkages between the foreign and domestic sectors in Kenya needed to be improved for FDI from OECD to boost competitiveness of domestic enterprises. Conversely, the Tanzanian government should sustain its efforts on encouraging more FDI flows from OECD countries. This is because the study established that FDI from OECD group of economies had a positive and significant impact on export performance in Tanzania unlike that from non-OECD countries.

Therefore, both Kenya and Tanzania should put in place appropriate policies and institutions that will guide and restrict FDI in areas where the host countries can draw maximum benefits now and in future. Equally, the two governments should tackle underlying reasons for why some FDI does not affect export performance. Consequently, Kenya and Tanzania's success in promoting exports through FDI is needed and can be achieved in bargaining with MNEs. This is required mainly by Tanzania whose FDI from non-OECD has been found to be market oriented. Therefore, national policies and host governments' bargaining power in relation to MNEs are important for attracting export oriented FDI.

Taken together, these findings support the argument that FDI flows from OECD and non-OECD countries have mixed effects on export performance of a host developing country. This study confirms that the relationship between the nature of FDI from OECD and non-OECD with export performance in Kenya and Tanzania warrants further research. While this study was primarily interested in impact of FDI flows from OECD and non-OECD on export performance of a non-OECD host country, there is a possibility of the direction of causality or that the relationship might be bi-directional in the two countries. These possibilities need to be investigated further as well. Further to this, while the approach taken in the analysis generated mixed effects of FDI on export performance in Kenya and Tanzania, a break-down by sector would also be useful. As such, these topics beyond the export-performance effects of FDI merit additional research.

## **CHAPTER 8: CONCLUSIONS AND POLICY IMPLICATIONS.**

### **8.1.0. Introduction.**

The study has investigated the determinants and impacts of FDI on economic growth and export performance in Kenya and Tanzania from an OECD and non-OECD perspective. The structure of the chapter is as follows: Firstly; the main findings of the research will be summarised. Secondly; the contributions of the research to the literature will be discussed. Thirdly; the policy implications deduced from the research will be discussed. Fourthly; some weaknesses of the study will be outlined. Finally, weaknesses of the research are examined, and the potential future studies' direction is identified.

### **8.2.0. Summary of The Main Findings of Research**

The findings summarised herein are based on the tests quantitatively conducted on all hypotheses which were presented in each of the three empirical chapters of determinants of FDI, the impact of FDI on economic growth and the impact of FDI on export performance in Kenya and Tanzania. In relation to the introduction chapter, these findings show that there are important differences between and within Kenya and Tanzania in terms of FDI determinants and impacts on economic growth and export performance. There are also further differences between OECD and non-OECD FDI in the two countries which explains why Kenya lags behind Tanzania in terms of amounts of FDI inflows into the two countries.

In terms of the determinants of FDI, the empirical findings show that for both Kenya and Tanzania, there are key similarities in these determinants that imports, infrastructure development and political and institutional factors are common variables for both Kenya and Tanzania at the full sample level. There are, however, important differences between the two countries such as natural resources and cultural distance which are important determinants of FDI for the Kenyan full sample while human capital, labour force and exchange rates are important for the Tanzanian full sample. FDI is also driven by different determinants at the host country level of development with exchange rates and infrastructure found common determinants for FDI flows from OECD into both countries. Cultural distance and political and institutional factors are determinants of FDI from OECD countries into Kenya whilst imports, human capital and natural resources determine FDI from OECD countries into Tanzania. Another important similarity between Kenya and Tanzania is that exchange rates attract FDI

from non-OECD countries into the two countries. However, the differences are also reflected in the finding that non-OECD FDI in Kenya is determined by political and institutional factors while imports and inflation rates determine FDI flows from non-OECD countries into Tanzania.

On the investigations of the impact of FDI on economic growth, empirical findings found further important differences between the two countries. While FDI from full sample, OECD and non-OECD countries contributed positively and significantly to economic growth in Kenya, only FDI from non-OECD countries made a positive and significant contribution to economic growth in Tanzania. It is further suggested by the empirical evidence that the contributions to Kenya's economic growth came mainly from FDI, openness to trade and total labour force. On the other hand, mineral resources were main contributors to the economic growth in Tanzania at the full sample level. Meanwhile, degree of openness to trade, human capital, total labour force, availability of mineral resources are important drivers of economic growth in Kenya for OECD countries. Similarly, Tanzania's economic growth is driven by openness to trade, total labour force, mineral resource endowment and political and institutional factors when OECD group is considered. Openness to trade, total labour force, infrastructure and domestic savings contribute to economic growth in Kenya for non-OECD countries. Infrastructure, mineral resource endowment, domestic savings and political and institutional factors drive economic growth in Tanzania in the context of non-OECD group.

Considering the impact of FDI on export performance, findings indicated further differences between the two countries. While FDI from the full sample, OECD and non-OECD countries contributed positively and significantly to export performance in Kenya, only FDI from OECD countries made a significant contribution to export performance in Tanzania. The empirical evidence further suggested that the contributions to Kenya's export performance came mainly from FDI, human capital and domestic investments whereas human capital, GDP and Domestic Investments were the main contributors of export performance in Tanzania at the full sample level. Tanzania's export performance is driven by human capital, GDP, and exchange rates in relation to the OECD while only exchange rates do the same for OECD group in Kenya. However, further similarities between Kenya and Tanzania were revealed when GDP and domestic investments promoted export performance for non-OECD economies in both countries.

In terms of findings of comparative analysis of FDI flows and impacts in the two countries, the study shows that although Kenya lags behind Tanzania by a huge margin in terms of amounts of FDI received, Kenya benefits more from its FDI than Tanzania. This is because FDI from all the three groups of home countries (full sample, OECD and non-OECD) had a positive and significant impact on both economic growth and export performance in Kenya. On the other hand, Tanzania's economic growth only benefits from FDI from non-OECD countries while only FDI from OECD countries impacted positively and significantly on export performance in Tanzania.

### **8.3.0. Research Contributions**

#### *Contribution to Knowledge*

Until now, it seems no study in Kenya and Tanzania has investigated FDI, economic growth and export performance in a coherent way. The research therefore enables an understanding of the nexus between the core themes of FDI, economic development and export performance. Also, in general there is a dearth of knowledge on country-specific assessment of determinants of FDI flows and their impact on countries in Africa and in particular to Kenya and Tanzania. Available studies do not link FDI flows and their impact to countries of origin. Investigations conducted in this context have been mainly regional and largely under researched partly due to data availability and the difficulty in the general acceptance of some of the results. Infact, this study is immensely important not just for Kenya and Tanzania but also for other developing countries. The two countries' experience can provide a guideline for other developing countries in formulating specific policies and therefore benefit from attracting FDI from specific group of home countries. Moreover, Kenya and Tanzania are developing countries, hence any knowledge contributed to the literature through this study can be extended to other developing countries.

Regarding the determinants of FDI, a number of contributions were made. Firstly, previous studies on FDI in Kenya and Tanzania have not extensively investigated how the different hypotheses under the theories of FDI explain FDI activities in Kenya and Tanzania and other developing countries. Secondly, inter-country comparisons in Africa such as Kenya and Tanzania are far less common. This could be because they are relatively small economies and therefore considered relatively unimportant. Indeed, findings from the few studies conducted within the Africa diaspora have not proved conclusive or have generally been based on data of multiple countries aggregated together without an effort to compare one country with another

and within itself. This study has compared determinants of FDI between and within Kenya and Tanzania. Thirdly, although few of studies have analysed FDI determinants in Kenya and Tanzania, they did not distinguish the FDI determinants between the home economies. Through this study, a greater understanding of the determinants of FDI in the context of the two countries has been developed by considering both home and host countries' characteristics based on OECD and non-OECD economic groups. Fourthly, the study provided empirical evidence that shows seemingly similar and yet different determinants (economic, social-cultural and institutional) of FDI between and within Kenya and Tanzania. Having used this study to fill some of the gaps in the literature, it is imperative to recognise the following: 1) although countries may share the same political, environmental, geographical boundary, colonial history and institutional characteristics, they behaviourally differ in their FDI determinants. 2) if all things remain constant, Kenya has received and is likely to continue to receive less FDI flows compared to Tanzania in both absolute amounts of FDI and FDI as a proportion of GDP. 3) investigating determinants of FDI in Kenya and Tanzania from home country perspective has added interesting and important dimension as to what specific factors attract FDI from OECD and non-OECD economic groups into Kenya and Tanzania.

Regarding the impact of FDI on economic growth, a number of contributions to the literature were made: Firstly, very few studies exist on the impact of FDI on economic growth in Kenya and Tanzania, the majority of these studies used mixed country data (many African countries) rather than comparing two countries within a region. This research has employed country-specific data set of the two African economies in a comparative setting to explain the impact of FDI in Kenya and Tanzania. Secondly, unlike most studies in this context, the study distinguishes flows originating from OECD countries and other non-OECD countries with the aim of testing the assumption that they might impact differently on the ability of the two recipient countries to absorb the positive spillovers embedded in inward FDI. The result provides empirical support to a strand of research pointing to a high potential of Non-OECD to Non-OECD integration due to a smaller technology gap for both Kenya and Tanzania. Thirdly, understanding the impact of FDI from either OECD or non-OECD economic groups to host economies can lead to efficient targeting of FDI from specific home economies for enhanced economic growth in Kenya and Tanzania. It is also important to note that if factors remain constant, FDI from both OECD and non-OECD countries will positively impact on Kenyan than Tanzanian economy.

The contribution to the literature on export performance analyses lies in exploring the effect of FDI on export performance in Kenya and Tanzania. This is an area that has least been explored, its importance to these countries notwithstanding. Firstly, this research takes this argument further and shows that the origin of FDI flows also matters for export performance of the host countries. Although only FDI from OECD countries make a positive and significant contribution to the export performance in Tanzania, the result provides empirical support to a strand of research pointing to a high potential of Non-OECD to Non-OECD integration due to a smaller technology gap for the case of Kenya. Thirdly, there being a possibility of no study that has tried to compare FDI's impact on export performance within and between Kenya and Tanzania; the contributions have enhanced an understanding of impact of FDI on export performance in the two countries. That is by addressing the impact of FDI, some of the other factors that influence export performance are also addressed and vice versa. Also, the export sector of an economy has an important role to play as an engine of economic growth. Thus, understanding sources of FDI and its impact of export performance in each host country can lead to the efficient allocation of resources to target FDI from specific sources as well as improvement of trade and in particular export performance.

In terms of strength of impact of FDI on economic growth and export performance, it does appear that FDI from OECD countries has a greater impact than non-OECD countries and very little work has been done in this area. As a result, this is another contribution to the literature.

The differences between amounts of FDI inflows and their impact on economic growth and export performance in the two countries reveal that huge volumes of FDI inflows do not necessarily translate into huge benefits to the host country. Consequently, this is another contribution to the literature.

This research's contributions to literature, suggest significant and interesting implications to policy makers, entrepreneurs, investors and academicians.

### ***Contribution To Policy***

The findings of this research reveal important factors that robustly influence inward FDI and its impact on economic growth and export performance in Kenya and Tanzania. Having used three broad pillars (economic, social cultural and institutional factors) to support the different theories and also to capture some of the variables used in the empirical analyses, it is important to conclude that these factors can effectively determine FDI inflows from both OECD and non-OECD home countries and FDI impact on economic growth and export performance in Kenya

and Tanzania. However, economic factors have been robust in determining FDI flows to both countries and economic growth and export performance from both OECD and non-OECD perspectives. This is a significant factor in progression terms, along the investment development path. Therefore, the challenge for the Tanzanian government is how to sustain their comparable better performance in attracting FDI, while for the Kenyan government, it is how to increase FDI inflows and catch-up. As a result, based on the findings and conclusions of the research, a number of policy implications have been derived. Owing to the nature of the study, some of the policy implications can overlap.

Firstly, this research is showing selective targeting of FDI sources (Enderwick, 2005 and Zheng, 2013) which could be important to Kenya and Tanzania. Therefore, FDI policies would best be tailored to home countries' characteristics and attributes for attracting more FDI in general and particularly from targeted countries. Specific policies can be formulated to achieve particular purposes in attracting desirable FDI from specific OECD and non-OECD countries to maximise potential economic growth.

Secondly, FDI brings with it superior experience and high managerial skills, better marketing techniques and technological knowhow. Having these things also improves flows of FDI. Hence, it is important for Kenya and Tanzania to improve their business environment because the presence of foreign enterprises or their interaction with domestic counterparts will spur possible spillovers, enhance productivity, profitability and economic value of firms as well as their export performance. It will also bring in more FDI.

Thirdly, efforts to upgrade infrastructure should be pursued by both countries. This is because it is the only FDI determinant that was consistently positive and significant for both Kenya and Tanzania in two groups of full sample and OECD home countries.

Fourthly, it is important that good governance is continuously monitored and improved in both Kenya and Tanzania as it is a huge incentive to FDI flows. This can be supported by international organisations and partners with an objective of attracting more FDI flows mainly from OECD countries considering their greater impact than non-OECD FDI on economic growth and export performance of the two countries.

Fifthly, both Kenya and Tanzania are endowed with natural resources and pursuing policies targeted at opening up their natural resource sector to foreign investors from all home countries for Kenya and OECD countries for Tanzania. This will better utilise their abundance of their natural resources and thereby attract FDI from the selective sources. Since mineral reserves

factor has the highest potential of contributing to economic growth in Tanzania, it needs to be properly channelled and integrated more in the mainstream economy. Similarly, the conflicts and instability being generated by oil in Kenya, needs to be addressed in order to maximise oil production and encourage fair distribution of wealth generated by natural resource and thereby economic growth.

Sixthly, it is important for policy makers in Kenya and Tanzania to formulate policies that can develop an educated workforce with a view of positioning them to absorb the technology spillover and technical knowhow that accompanies investments. Countries with high levels of low-skilled labour are less likely to be attractive to FDI that is associated with high value-added industries or efficiency and productive seeking FDI and therefore lag behind in economic growth. This is supported by the fact that the spillovers flowing to host country firms from FDI to high skilled sectors contribute more value added than that from low-skilled sectors. This is the case for Kenya and Tanzania presently, since findings show that the pool of human capital in the two countries has not reached the threshold to attract or benefit fully from FDI spillovers.

Seventhly, Kenyan government can direct its efforts mainly towards sustaining the country's attractive investment environment to FDI flows from both OECD and non-OECD countries. This is because the study revealed that FDI flows from the two group of home countries generally played a positive and significant role in economic growth in Kenya. However, Tanzanian government can direct its efforts more on encouraging FDI flows from non-OECD countries. This is because the study established that FDI from these economies generally had a consistently positive and significant influence on economic development than flows from OECD countries into Tanzania.

Finally, Kenyan government can direct its efforts mainly towards sustaining the country's attractiveness to FDI flows from both OECD and non-OECD countries. This is because the study revealed that FDI flows from both groups of countries, generally played a positive and significant role in export performance in Kenya. Meanwhile, Tanzanian government can sustain its efforts on encouraging more FDI flows from OECD countries. This is because the study established that FDI from OECD group of economies had a fairly consistent positive and significant impact on export performance in Tanzania than FDI from non-OECD countries. On the other hand, the two governments needs to tackle why some FDI does not impact on their country's growth and export performance.

#### **8.4.0. Weaknesses of the study**

While this research has contributed to knowledge and arrived at important findings, there were however some weaknesses to the study. Firstly, the sample size did not include all the major FDI home countries from both OECD and non-OECD economic groups due to data availability. There was also a reduction in sample size attributed to complications with round tripping and tax havens. However, the sample used for the three analyses seemed representative. As a result, different sample sizes were used to answer the research questions and achieve the research objectives. This was more pronounced in the analyses involving FDI determinants as only 22 and 23 home countries were used for Kenya and Tanzania respectively. Not only does the availability of data limit the number of variables that can be used, it can also reduce the quality of data, considering the two host countries in this study, may have doubtful results. Expanding database would have been better and allowed for the analysis involving FDI determinants to be conducted on a huge panel estimation. Secondly, most current studies in the field of international business have taken the direction of firm level analysis to explain FDI determinants. This study did not fully embrace the current wave of analysis due to data availability. It instead employed only country level data to explain FDI activities. Thirdly, the study did not consider the type, nature, industry, quality and the mode of entry of FDI when examining determinants and impacts of FDI in Kenya and Tanzania. Inclusion of these FDI attributes in the research would have made this study richer, since such findings would have aided better decision making by policy makers and potential investors. Fourthly, some important variables were not used in the research. For instance, data on labour wages, kilometres of paved roads, kilometres of rail lines and literacy rates were not obtainable. Fifthly, most data on explanatory variables are not available for many countries particularly for the two host countries before 2006 and beyond 2016. There are significant delays in obtaining data from developing countries in spite of some of these explanatory variables being collected by World Bank Development Indicators (WDI). Quality of data in developing countries can also be questionable. Sixthly, Kenya and Tanzania are huge countries and there are regions that get more FDI than others and therefore a possible regional spillover. Mapping the two countries probably by capital city against non-capital cities in terms of FDI, would have possibly generated better results for policy makers and foreign investors.

### **8.5.0. Future Research**

Possible direction for the future research has been identified based on the weaknesses of this study. Firstly, the study has established that the net effect of FDI on economic growth is greatly dependant on the features of home and host countries and the investment itself. It therefore recommends future research into the type, nature, industry, quality and the mode of entry of FDI to establish whether different attributes of FDI flows from either OECD or non-OECD countries are motivated by similar or different factors. This could provide more information on the real impact of FDI on economic growth in Kenya and Tanzania. Secondly, future research in foreign direct investment in Kenya and Tanzania should consider using firm level data. This will help compliment what is already known of the determinants of country level FDI in the two host countries. Thirdly, future studies can explore the further impact of inward FDI spillovers on the host countries such as productivity from the two home country groups' perspective. Fourthly, future research should map regions of Kenya and Tanzania for examination of a more possible regional spillover. Fifthly, expanding database in the future studies can better the results and also raise the quality of the research. Furthermore, future research can also incorporate some of the important variables and variable measures of the determinant and impact of FDI on economic growth and export performance that were omitted by this research.

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## List of Appendices

### 38 Appendix 1. Sample of Top Home Countries for Kenyan and Tanzanian FDI

For Kenya			For Tanzania		
Australia	India	South Africa	Australia	India	South Africa
Belgium	Japan	Switzerland	Belgium	Iran	Spain
Canada	Korea Rep.	Tanzania	Botswana	Ireland	Sweden
China	Netherlands	Uganda	Canada	Italy	Switzerland
Egypt	Nigeria	United Kingdom	China	Kenya	Uganda
France	Norway	United States	Denmark	Malaysia	United Kingdom
Germany	Pakistan		Egypt	Norway	United States
Hong Kong	Saudi Arabia		France	Pakistan	

Source: Kenya Investment Authority (KenInvest, 2018), Tanzania Investment Council (T.I.C,2018) and W.D.I. Database (2018).

### 39 Appendix 2. FDI and Exports for Kenya and Tanzania 1996-2016.

YEAR	FDI NET FLOWS (% of GDP)		EXPORTS AS % of GDP (ANNUAL %)	
	KENYA	TANZANIA	KENYA	TANZANIA
1996	0.90	2.31	25.20	19.94
1997	0.47	2.05	22.69	16.22
1998	0.18	1.84	20.17	12.40
1999	0.40	5.32	20.83	12.53
2000	0.87	4.54	21.59	13.36
2001	0.04	5.29	22.93	17.01
2002	0.21	3.66	24.90	17.58
2003	0.54	2.73	24.09	18.56
2004	0.28	3.45	26.61	19.65
2005	0.11	5.52	28.51	16.91
2006	0.19	2.16	22.98	17.10
2007	2.28	2.70	21.92	18.92
2008	0.26	5.05	22.67	18.65
2009	0.31	3.33	20.03	17.37
2010	0.44	5.77	20.66	18.75
2011	3.45	3.62	21.63	20.76
2012	2.73	4.60	19.82	21.29
2013	2.03	4.70	18.15	17.65
2014	1.33	3.46	16.92	19.41
2015	0.96	3.51	15.77	21.62
2016	0.55	2.88	13.9	19.59

Source: Column (1) and (2) are from World Bank Database (2018), data in column (3) has been computed by the author.