

Determinants of Foreign Direct Investment in Kenya: a Theoretical review

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Abstract: Manufacturing in Kenya has been on the decline for a considerable period of time with its contribution to GDP stagnating at 10% from 1960's. The performance of manufacturing sector is affected by low capital injection, limited access to finance and poor institutional framework which has resulted in limited FDI into the country. The challenge facing Kenya is how to attract more FDI in dynamic products and sectors with high income elasticities of demand away from the primary sector. There is a lot of literature written on determinants of foreign direct investment (FDI) in Africa. The present paper has focused on the extent to which a combination of institutional policy and other determinants of FDI determine growth of FDI in the manufacturing sector of the Kenyan economy. The main argument of this review is that ownership, location and internalization determinants together with institutional determinants influences flow of FDI in a country. This paper using data on FDI inflows in the Kenyan manufacturing sector and selected determinants performed a cross-sectional analysis for the period 2008-2013. This review posits that there is significant positive relationships between market size of the economy, trade openness, governance and FDI growth which implies that these variables determines growth of FDI in the Kenyan manufacturing sector. It is expected that a combination of ownership, location and internalization (OLI) together with institutional determinants influences flow of Foreign Direct Investment (FDI) in a country.

Keywords: Foreign Direct Investment; Corporate Governance; Political Risk; Manufacturing Sector; Multinational Enterprises.

INTRODUCTION

The main argument of this paper is that ownership, location and internalization (OLI) as put forward by Dunning [1], together with institutional determinants influences flow of Foreign Direct Investment (FDI) in a country. In the last two decades, FDI has been a major source of investment capital in developing countries and an important issue in international finance since the globalization of capital markets. FDI is defined as the net inflows of investment to acquire a lasting management interest taken as 10% or more of voting shares in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, long-term and short-term capital as shown in the balance of payments according to International Monetary Fund [2].

There is a lot of literature written on determinants of FDI in Africa; however the present paper has focused on the extent to which a combination of institutional policy and traditional determinants of FDI together

determine flow of FDI in the manufacturing sector of the Kenyan economy. The studies done have not given enough emphasis to institutional determinants; the literature on FDI in Kenya is also fairly recent and limited posits Kinuthia [3]. Through review of earlier literature the current research has identified and examined the extent to which trade openness, market size of the economy and governance determine FDI inflows in the Kenyan manufacturing industry.

The literature on determinants of FDI does not say much about how institutional determinants like corporate governance might affect the FDI decision posits Jackson & Strange [4]. Recent studies are recognizing the importance of non-traditional factors such as globalization and governance according to Dikova et al. [5] mainly because FDI in developing countries is shifting from market-seeking and resource-seeking which are horizontal to more vertical efficiency-seeking FDI argues Campino [6]. Previous studies on determinants of FDI in developing countries

including Kenya have largely tested Dunning's eclectic paradigm of ownership, location and internalization (OLI) advantages (Kinutha [3]; Mutenyo [7]; Ndungu et. al [8]; Obwona [9]; Onyeiwu [10]). The studies have concentrated on analyzing the effects of ownership of firm specific advantages (both tangible and intangible) of multinational firms over the local firms on FDI inflows to a country. Studies like Kinuthia [3]; Mutenyo [7]; Ndungu *et al* [8]; Obwona [9]; Onyeiwu [10] emphasize how locational advantages of a host country such as market size, availability of natural resources, and macroeconomic stability, affect FDI inflow. Although the importance of institutional determinants in FDI inflows cannot be underestimated, the studies done have not exhaustively investigated their contribution. The findings elsewhere in the African countries show that institutional quality, trade openness, and infrastructure development encourages FDI inflows as argued by Asiedu [11].

Studies in other African countries show that trade openness play a positive role in attracting FDI posit Busse & Hefeker [12]. Jensen [13] shows support for political stability and democratic governance as determinants of FDI. Campos & Kinoshita [14] agree on the importance of quality of institutions in determining FDI. Studies show these institutional factors include political, legal, regulatory factors and global market interactions Busse [15]; Makola [16]; United Nations Conference on Trade and Development-UNCTAD [17]). The motivation of this paper was to examine how FDI inflow is determined by among other variables the institutional determinants like governance as supported by mentioned studies elsewhere. Better institutional functions (low corruption, political stability, and legal system reliability) influence on the different types of capital flows where examined was found to encourage FDI. Other studies also found that the strength and impartiality of the legal system, popular observance of law, strength and quality of bureaucracy, and government stability have a direct effect on FDI [18]; Mishra [19]. Onyeiwu *et al.* [20] finds that trade openness and privatization increase FDI flows, while corruption and bureaucratic red tape reduce flows. Mina's [21] study of Gulf Cooperation Council Countries (GCC) found that the estimates show that while institutional quality, trade openness, and infrastructure development have encouraged FDI flows, human capital has significantly discouraged them.

THEORETICAL FRAMEWORK

Theoretically, the linkage between FDI, trade openness, capital formation and economic growth tends to be positive. This is supported by the neoclassical theories and endogenous growth theories that underline that FDI promotes economic growth in a capital scarce economy by increasing volume and efficiency of

physical investment [22]; Romer [23]. There is a variety of theoretical models explaining FDI and a wide range of factors that has been experimented within empirical studies in order to find the determinants of FDI. Casson [24] has suggested that the theory of FDI is a logical intersection of three distinct theories: the theory of international capital markets, which explains the financing and risk-sharing arrangements; the theory of the firm, which describes the location of headquarters and trade theory, which describes location of production and destination of sales.

Dunning and Rugman [25] offer an elaborate account of how early economic theory failed to deal with FDI; the explanation of international capital movements relied exclusively upon the neoclassical financial theory of portfolio flows, capital was assumed to be transacted between independent buyers and sellers, there was no role for the Multinational corporations (MNCs) and no separate theory of FDI. However the work of Hymer [26] came in as a landmark and is influential in FDI studies. The theoretical models reviewed below show an attempt to explain FDI location determinants and will provide information on the range of determinants that are likely to induce the flow and growth of FDI.

Industrial Organization Theory

The reasons given by Hymer [26] for the internalization of companies is of two kinds: variables related to the company's dimension and ownership of specific assets (scale economies, diversification and knowledge accumulation) and variables derived from the existence of market failures. From this classification of variables, two groups of theories can be distinguished in the literature: those formed within industrial organization Caves [27]; Kindleberger [28] and those focusing on the internalization process Buckley & Casson [29]; Hennart [30]; Rugman [31].

The authors within the industrial organization school hypothesize that multinational enterprises (MNEs) undertake FDI to benefit from the specific capabilities that they own, which give them certain monopolistic power [28]. Such power can become apparent in the form of innovative technological processes, patents, trademarks, financial resources, management abilities or exclusive distribution channels. According to Ohlin [32], FDI is motivated by the possibility of high profitability in growing markets, along with the possibility of financing these investments at relatively low rates of interest in the host country, the necessity to overcome trade barriers and to secure raw materials. Caves [27], considers the diversification of products as the main influencing factor.

Market Imperfections Theory

Hymer [26], argues that if MNEs are able to compete with local firms that have a much better knowledge of the local market and environment, it is because the MNEs present advantages ranging from imperfect competition due to a product differentiation, in the factor markets, access to capital and economies of scale. Hymer [26] in his seminal paper moved economics and finance toward an analysis of the MNEs from the perspective of industrial organization theory and made it possible to understand why MNEs transfer intermediate products across borders while retaining control over production. Fundamentally, Hymer claimed that to explain FDI, one must explain control.

Hymer [26] explained that among the reasons why a firm controls foreign operations are the removal of conflict and the exploitation of a particular country's advantage. With regard to the former, if markets are structurally imperfect, it is more profitable to have one centralized decision-making entity in one country, controlling all enterprises in different countries, rather than have separate structures in every country. With regard to the latter, structurally imperfect markets prevent owners of a particular advantage from wholly appropriating its returns, unless they retain control over its use through FDI [26]. Other researchers have observed that, although Hymer's [26] work was right to point out that MNEs will exist at least in part due to structural market failures, he neglected to observe that MNEs must resort to FDI because of transaction-costs [25].

International Trade Theory

Internalization theory was conceptualized by Buckley et.al [29] by extending Coase [33] explanation as to why multinationals internalize intermediate markets; they argued that internalizing intermediate production processes reduces uncertainty by circumventing market imperfections. According to [34,35] the internalization theory is founded on transaction cost economies. Thus the company would incline towards internalization forms which involve a high degree of control, that is, it would prefer internalizing international activities through FDI rather than exporting or licensing [36]. According to Rugman [31] internalization as an efficiency-based approach adopted by firms can help to offset the hidden economic costs of protection and discriminatory regulations.

The new internalization theory explained by Rugman [35] makes explicit the need to model the MNE's internal organization, and its network capabilities, in addition to focusing on stand-alone firm specific advantages such as strengths in research and development, manufacturing and branding. A great strength of internalization theory is that it provides clear

conditions for the choice of entry mode. Foreign direct investment determinants are based on the transaction cost internalization according to Buckley *et al.*; [29], due to imperfection of intermediate product markets with high transaction costs, integrating these markets by MNEs minimizes costs; this argument is in line with the study on the determinants of FDI that leads MNEs to set or invest in manufacturing firms in the target economies rather than portfolio investments or even exporting from their home countries. Internationalization includes factors affecting availability of inputs like natural resources, the size of the market, geographical location, and the position of the economy, the cultural and political environment [31].

Dunning's Eclectic (OLI) Paradigm

Dunning [1] by bringing together the structural market imperfections, transaction-cost market imperfections, and location theory, developed the eclectic paradigm of international production. Dunning [1] established that a firm engaged in FDI must satisfy three conditions: First, it must possess some ownership specific advantage. Second, it must be more advantageous to use rather than to sell or lease this advantage. Third it must be profitable to combine this advantage with some factors located abroad [1].

Dunning [1] argues that the reasons for investing abroad are search for resources, for markets, for efficiency and for new strategic assets; these reasons therefore determine where FDI will flow. FDI will take place when the three kinds of advantages come together posits Dunning [1]. All the advantages are interconnected and affect indistinctly the likewise interconnected decisions of 'why', 'how', and 'where' to internationalize argues Buckley [29]. José and Javier [37] argues that ownership advantages mostly determine the 'why' decision, internalization advantages mostly determine the 'how' decision and location advantages mostly determine the 'where' decision.

Dunning's eclectic paradigm [1] suggests that, when ownership, location and internalization advantages are high, firms will prefer an integrated entry mode e.g. FDI or joint ventures, versus export or licensing. Dunning [1] opines that, in the former case strategic asset-seeking investments take place, in which FDI is used in mergers and acquisitions, seeking horizontal efficiency. In the second case, investments are characterized by the search for markets, and resources, thus being of vertical efficiency (Dunning [1]; Dunning et.al [38]). Despite the criticism, the OLI paradigm is dynamic in understanding the determinants of FDI and their level of influence and therefore useful and relevant opines Erramilli and Rao [39].

Agency Theory

Agency theory, developed by Jensen and Meckling [40], has been fruitfully applied in examining the nature of the relationship in a firm that exists between the principal and the agent as explained by Barry et al. [41]. In an agency relationship, the principal hires and retains the agent because of the agent's specific talents, knowledge and capabilities to increase the value of an asset. This encourages efficient allocation of resources. However, the agent enjoys only part of the outcomes of his efforts posits Denis and McConnell [42]. When shareholders are risk-averse, they should favor a less risky FDI portfolio of the firms they have ownership stakes in explains Jensen and Meckling [40].

Agency theory is concerned with designing governance mechanisms that address the agency problem that stems from the goal conflict between the principal and the agent. Because it is empirically oriented, the positive agency theory is fruitful in analysis of corporate governance as determinant of FDI. From a liberalist perspective, corporate finance and corporate governance are closely connected opines Claessens et al. [43]. The function of effective corporate governance is to improve a firm's ability to access finance at a lower cost and generally improve its performance by enhancing the efficiency with which resources are allocated within the firm according to OECD [44]. The ability of a firm and country to attract investments depends on the effectiveness of its corporate governance since this encourages investors to be confident that their investments will be protected and rewarded appropriately. Motivated by agency theory, the ownership structure of a company should play a non-negligible role for the risk involved in a firm's foreign expansion policy via FDI.

Proposition

Foreign Direct Investment inflows in a country is determined by ownership, location and internalization (OLI) advantages

In the long term, a strong and stable GDP should secure FDI and attract new investors to a country according Thanyakhan [45]. Studies show possible correlation between the market size and the volume of inward investment argues Dunning [1] and Zhao *et al.*; [46]). Moreover, market size and the national income level are important to consider for the host country, especially for market-seeking FDI according to Guerin [47]. The developing countries' FDI is widely seen as market-seeking rather than resource-seeking opines Dunning [1]. Recep and Ersoy [48] argues that the trade effects of FDI depend on whether it is undertaken to gain access to natural resources, to consumer markets or whether the FDI is aimed at exploiting locational

comparative advantage or other strategic assets such as research and development capabilities. Opolot et al. [49] posits that openness to trade positively affect FDI inflows to Sub-Saharan Africa. Obwona [9] however notes that openness is not FDI inducing.

Proposition

Foreign Direct Investment inflows in a country is determined by ownership, location and internalization (OLI) together with institutional determinants

In examining the impact of governance on FDI inflows, Khamfula [50] shows that corruption is more harmful in an import substitution economy like Kenya than in an export promotion one. Mwega and Ngugi [51], posits that FDI is determined by growth rates and quality of institutions. Mkenda and Mkenda [52] find that governance though not significant is positively related to FDI inflows in Africa. Addison & Heshmati [53] argues that democracy increases FDI flows in developing countries. Athukorala [54] finds that lack of improved investment climate such as good governance, accountability and political instability hinders FDI and growth. Countries and firms can attract international investors and effectively compete by improving their governance Wheller and Mody [55] argues and quality of taxation infrastructures posits Wei [56]. Political instability reduces a country's attractiveness as a location of FDI opines Dupasquier and Osakwe [57] this they argue is because political stability is inversely related to FDI inflows. Political events can disrupt the economic order, eliminate markets or even put past investment at risk, as in the case of nationalization and expropriation of foreign owned assets.

Proposition

There is a significant relationship between ownership, location and internalization (OLI) and institutional determinants and foreign direct investment

Conclusion

In conclusion this discussion is in line with the need to consider both traditional determinants of foreign direct investment together with institutional determinants in explaining the flow of foreign direct investment (FDI) in a country. This paper has paid attention to the theories of FDI including industrial organization theory, market imperfections theory, international trade theory, Dunning's eclectic (OLI) paradigm and agency theory. The paper has also set propositions which can be transformed into hypothesis for testing towards conducting deductive quantitative study among development finance scholars. It is expected that the extraction of such empirical evidence will confirm the place of this theories in understanding

FDI inflows dynamics and expand finance and international business bodies of knowledge.

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