

Institutional, Governance and Economic Factors Influencing Foreign Direct Investment Inflows in East Africa

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Abstract

East Africa exhibited the lowest in-flow of FDI when compared to other African Regions, despite the substantial policy and structural changes as well as economic integration that had been taking place in the East Africa during the study period. The main objective of this study was to examine the institutional, governance and economic factors influencing FDI Inflows in Eastern African Countries. Non-experimental panel data analysis was conducted for eight Eastern African Countries during the period 1996-2010. A one-way fixed effects least squares dummy variable model was estimated. The study found that control of corruption, political stability, rule of law, and infrastructure among others significantly influenced FDI inflows to East Africa. The findings suggested that East African governments needed to strengthen their institutional base and governance as well as improve their macroeconomic environment in order to attract more FDI

Key words: Foreign direct investment inflows, institutional, governance and economic factors

1.0. Introduction

It is widely recognized that Foreign Direct Investment (FDI) produces economic benefits to the recipient countries by providing capital, foreign exchange, technology, competition and by enhancing access to foreign markets (UNCTAD, 1991; Romer, 1993; Caves, 1996; World Bank, 1999; Crespo and Fontura, 2007).

FDI inflows to East Africa had stagnated at around 2% of the total inflows in Africa from 1970 to 1990, after which it rose to 8% in 2000 and then dropped to 4% in 2003 (UNCTAD, 2005). According to UNCTAD's Annual Report (2011), East African Countries continued to exhibit the lowest in-flow of FDI when compared to other African recipients, despite the substantial policy and structural changes as well as economic integration that have been taking place in East Africa in the last one decade. While FDI inflows to Africa reached a record high of US \$ 88 billion in 2008, the inflow into East Africa represented a mere 5% (\$4 billion) of the total, almost the same as the previous year.

East African Countries suffer from institutional weaknesses such as corruption, poor application of the rule of law, political instability, among others, that raise the cost of doing business and thus constrain FDI inflows. In the KIPRA/World Bank (2004) study, investors rated institutional weaknesses such as corruption, crime, theft and disorder as major issues of concern in promoting private sector activities in Kenya. Rogoff and Reinhart (2002) argued that an obvious and powerful deterrent to FDI was political instability mainly due to wars. There is great need to assess the extent to which the Institutional FDI Fitness model may apply in the case of East African Countries. This raises the need to examine the relationship between institutional factors and FDI inflows in some of these developing countries.

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Therefore, the purpose of this study is to examine the relationship between institutional factors and FDI inflows in the Eastern Africa in order to draw implications for the three East African Countries and determine the factors influencing FDI inflows.

Moreover, there was a continuing unequal distribution of FDI flows in East African Countries. It was not clear what would explain this pattern of FDI flows into the East African countries. In 1970s and 1980s, cumulative FDI in the East African (EA) region was predominantly in Kenya, which had 87% of foreign ownership of the companies in the EA region (UNCTAD, 2005). In recent period, however, Uganda and Tanzania have taken up an increasing share of FDI as shown in Figure 1.1.

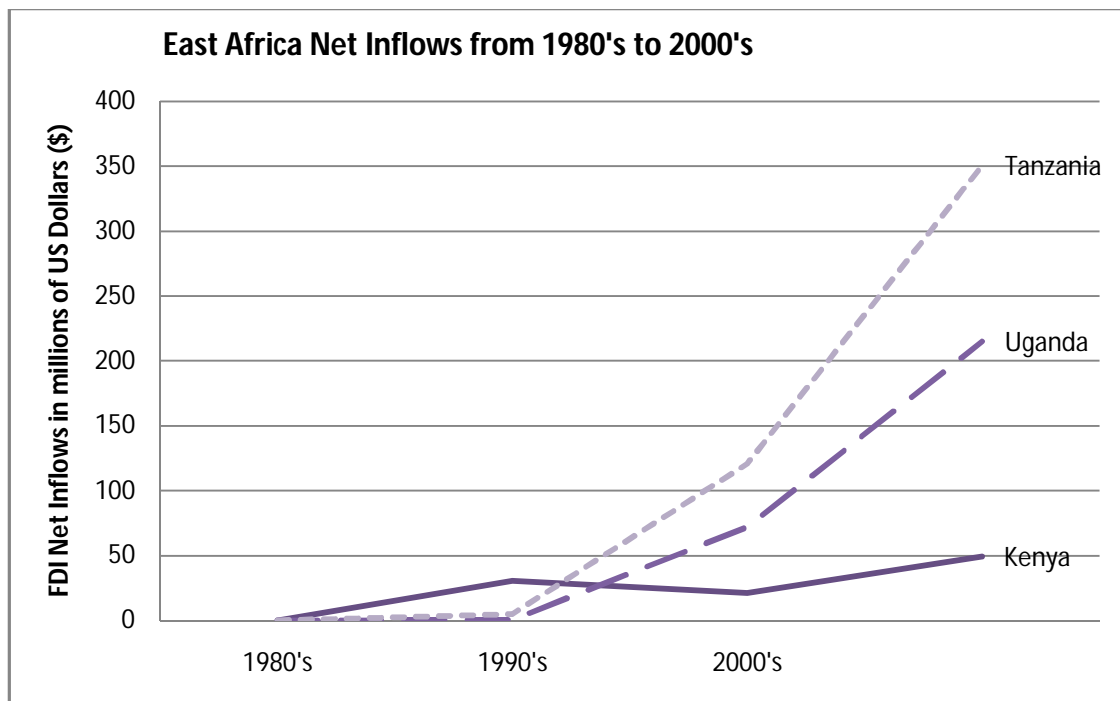


Figure 1.1 East Africa FDI Net Inflows from 1980's to 2006 in Millions of US \$

Source: UNCTAD FDI database and World Investment Directory (2008)

2.0 Literature Review

2.1 The Theory of Institutional FDI Fitness

The Institutional FDI Fitness theory postulates that it is institutions, their policies and implementation, rather than generic inflexible variables that give a country a competitive advantage in the global FDI market (Wilhelms, 1998). Generic variables control for broad underlying conditions that are intransigent or predetermined and thus seem inherent to a country. According to these theory countries with high Institutional Fitness experience higher inflows of foreign direct investment than countries with low Institutional Fitness. High Institutional Fitness means that a country's institutions are transparent, well-functioning, reliable and predictable. The term FDI Fitness refers to a country's ability to attract, absorb and retain FDI by reacting swiftly to dangers and opportunities, creativity and flexibility in carving out a niche in which a country can survive against competitors.

This theory draws analogy with the Darwinian concept of the survival of the fittest by suggesting that it is not necessarily the largest and strongest countries that attract FDI but rather those which adapt most cleverly and fittingly to existing conditions. The Institutional FDI Fitness theory explains why FDI flows are distributed so unevenly and often out of proportion to natural resources. Some seemingly disadvantaged countries have been able to attract relatively large FDI inflows better than others that are more richly endowed with natural resources by developing favourable institutional framework, policies and laws. According to this theory there are four main FDI Fitness Institutions, namely government, markets, education and socio culture as represented by the Figure 2.3.

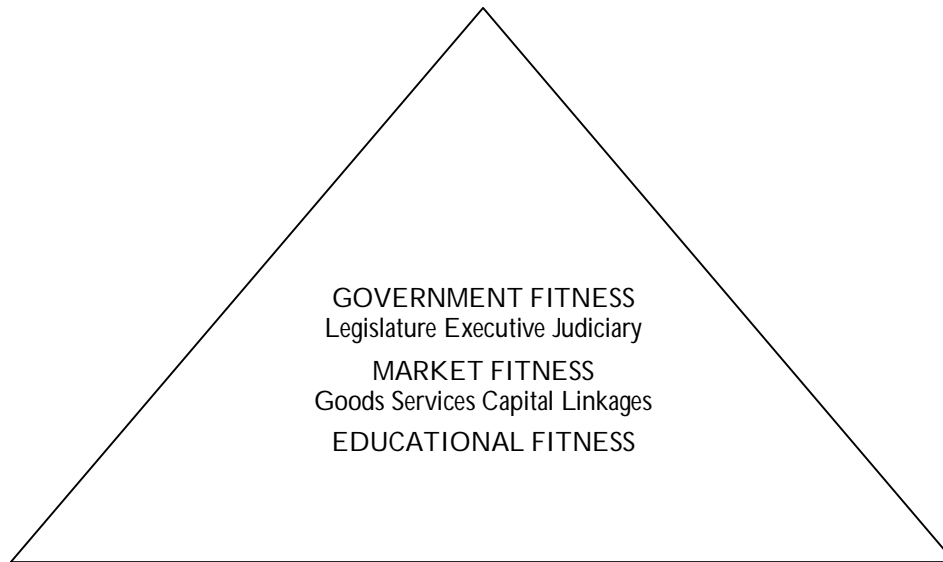


Figure 2.3 Pyramid of FDI Institutional Fitness

According to Wilhelms (1998), the higher the degree of receptiveness and integration of a country's socio culture, the greater the capacity for attraction of FDI due to the perceived cultural proximity by foreign investors. For instance, East African region may be perceived as a suitable FDI location by investors from the region due to cultural proximity. Educational fitness creates favourable environment for FDI through information, research, development and technology. Open competitive markets with protective regulation attract more FDI than markets subjected to directive regulation. At the top of the pyramid is the government fitness, which is responsible for regulation and coordination of the other three institutions through policies and their implementation that in turn determine FDI inflows. FDI Fitness Institutions interact in varying forms to influence one another but the net effect of this interaction affects FDI inflows.

2.2 Selected Empirical Studies

Wilhelms and Witter (1998) tested the Institutional FDI Fitness theory by conducting ordinary least squares (OLS) analysis for 67 developing countries between 1978 and 1995. The functional form of the model was specified as follows:

$$FDI = b_0 + b_1G + b_2M + b_3E + b_4S$$

Where G, M, E and S represented government, markets, education and socio culture variables. The study found that governmental and market fitness played the central role in attracting FDI. More generic variables such as location, socio culture, and total population were not or only lowly correlated with FDI inflows.

Economic policies such as high degree of openness and their implementation were found to be instrumental in attracting FDI. Favourable economic, legal and infrastructure framework had positive and significant effect on FDI. The study concluded that adjustable policy variables carried more weight than intransigent variables in line with the Institutional FDI Fitness theory. Asiedu (2002) studied the determinants of Foreign Direct Investment (FDI) in developing countries and examined why Sub-Saharan Africa (SSA) had been relatively unsuccessful in attracting FDI despite policy reform. The dependent variable was FDI/ GDP, while the independent variables included the return on investment, openness and infrastructure development for SSA and non-SSA countries, and an African dummy. The results indicated that the factors that drove FDI to developing countries had a different impact on FDI to SSA. Specifically, infrastructure development and a higher return on capital promoted FDI to non-SSA countries. In contrast, these factors had no effect on FDI to SSA. Openness to trade promoted FDI to both SSA and non-SSA countries. However, the marginal benefit from increased openness was less for SSA – suggesting that trade liberalization would generate more FDI to non-SSA countries than SSA countries. Another important finding was that, all else being equal, FDI was uniformly lower in SSA. This indicated that there was an “adverse regional effect” for SSA: a country in SSA would receive less FDI by virtue of its geographical location, implying that Africa was different.

Levy-Yeyati *et al.* (2002a and 2003) used the OECD database containing bilateral FDI stocks between developed and some selected developing countries. Their results suggested that regional integration, on average, contributed to attracting FDI, but the benefits were unlikely to be distributed evenly. They made a simulation and found out that the Free Trade Area of the Americas (FTAA) would clearly increase FDI from US and Canada and from the rest of the world to Latin America. However, the specific impacts could differ according to the characteristics of the different host countries.

They found that common membership in a RIA with a source country increased FDI from that source by around 27 per cent. Countries that were more open and whose factor proportions differed more from those in the source country were likely to benefit more, as they tended to receive FDI of the vertical variety. They also found that the increase in the size of the market associated with regional integration contributed to attracting more FDI to the RIA as a whole. However, only member countries that offered a more attractive overall environment for FDI were likely to be winners in this game. The study findings also indicated evidence of a small FDI diversion effect that affected on average non-member countries. This study was limited by omission of other important factors that influenced FDI flows.

In a study to compare the intra and extra regional impact on FDI of two European Union (EU) enlargements (Spain and Portugal in 1986, and Austria, Finland and Sweden in 1995), De Sousa and Lochard (2004) showed that Spain and Portugal did not benefit from more FDI, whereas the 1995 enlargement generated additional foreign investment in the new member countries. In turn, the European Single Market increased FDI inflows into EU countries from other EU member states, but it did not significantly affect FDI inflows from non-EU member states. Regarding intra-regional FDI inflows, regional integration had a strong positive impact in small EU countries, while its impact was more subdued in large EU countries where country specific structural factors played an important role in attracting FDI. When it came to extra-regional FDI, whereas no effect was found for the EU as a whole, the authors state that the Single Market had significantly increased FDI inflows from non-EU countries into some EU members. Again, this effect was stronger in small countries.

Ngugi and Nyangoro (2005) studied the relationship between FDI and various institutional factors for developing countries and drew implications for Kenya using panel data for the period 1990 and 2000. The results of the study showed that both traditional and non-traditional determinants such as investment return, market size, macroeconomic variables, infrastructure, labour factors and institutional factors were important in attracting FDI. The study recommended that the Kenya government puts a lot of resources to curb crime and restore law and order, embrace positive democratic practices, maintain its stability and embrace zero-tolerance on corruption more emphatically to gain substantially in investment growth and more so in FDI flows.

3.0 Methodology

3.1 Theoretical Framework of Gravity Model

According to Görg and Greenaway (2002), the gravity models predicts that FDI becomes more dominant relative to domestic production and trade as countries become more similar in terms of relative size and endowments. The model also predicts that relatively similar factor endowments between countries encourage horizontal FDI and vice versa (Carr *et al.*, 2001).

The study estimated an empirical model that was defined as follows:

$$Y_{it} = \alpha_i + \beta X_{it} + \mu_{it} \quad \mu_{it} \sim N(0, \sigma^2_{it}) \quad i = 1, \dots, N \quad t = 1, \dots, T \quad (3.1)$$

Where X_{it} was a vector of all the identified independent variables; Y was dependent variable; α and β were coefficients; i was the observation (country) while t was the time period.

$\mu_{it} = \omega_t + v_{it}$; μ_{it} was unobservable individual country specific effects, ω_t were the unobservable time effects, and v_{it} was a stochastic disturbance term.

Assumptions about the error term determined whether we examined fixed effects or random effects models. In a fixed effects model, μ_{it} was assumed to vary non-stochastically over i or t , making the fixed effects model analogous to a dummy variable model in one dimension. In a random effects model, μ_{it} was assumed to vary stochastically over i or t requiring special treatment of the error variance matrix.

3.2 The Model Specification for FDI inflows

The model for FDI inflows was specified as follows:

$$FDI_{it} = \alpha_i + \beta_1 GDP_{it} + \beta_2 EXD_{it} + \beta_3 INF_{it} + \beta_4 LIR_{it} + \beta_5 OPEN_{it} + \beta_6 CORR_{it} + \beta_7 GOVEFP_{it} + \beta_8 STABP_{it} + \beta_9 REGQUP_{it} + \beta_{10} LAW_{it} + \beta_{11} NET_{it} + \mu_{it} \quad (3.2)$$

where FDI_{it} was the ratio of foreign direct investments to nominal GDP in country i at time t , with GDP_{it} , EXD_{it} , INF_{it} , LIR_{it} , and $OPEN_{it}$ being the corresponding GDP growth, debt service on the external debt, Inflation rate, lending interest rate and degree of openness. The corresponding institutional and governance variables included: $CORR_{it}$, $GOVEFP_{it}$, $STABP_{it}$, $REGQUP_{it}$ and LAW_{it} , representing percentile ranks of Control of Corruption, Government Effectiveness, Political Stability and Absence of Violence/Terrorism, Regulatory Quality and Rule of Law. NET_{it} represents internet users per 100 people

3.3 Diagnostic Tests

To examine whether fixed and/or random effects existed in the panel data, joint validity of fixed and period effects and Hausman's test were conducted. Panel unit root test was conducted to investigate whether there were any variables in the model that were non-stationary.

3.4 Definitions and Measurement of the Variables

FDI inflows were the annual foreign direct investment inflows from countries in the world to each of the Eastern African Country. It was measured as FDI net inflows as % of GDP

GDP growth rate was the average annual growth rate of real GDP. It was measured as annual % change in GDP at constant prices

Inflation (INF) was the persistent rise in general price level of goods and services in an economy over a period of time. It was measured by annual % changes in consumer prices.

Rate of return on investment (LIR) was the rate of return on capital for each country. It was measured by the domestic lending interest rate (%) of each country.

Openness to trade (OPEN) was the degree to which countries or economies permit or have trade with each other. It was measured by summation of exports and imports as percentage of GDP of a country.

Debt service on external debt (EXDS) was the annual proportion of GDP used to refinance external debt. It was measured by the external debt refinance as a proportion of GDP.

INTERNET (NET) was the rate of use of internet used as a proxy for the quality of infrastructure. It was captured by internet users per 100 people

Control of corruption (CORR) referred to perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. It was captured by the percentile rank of control of corruption.

Government effectiveness (GOVEFP) referred to perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. It was captured by the Percentile Rank of Government Effectiveness.

Political stability (STABP) referred to the perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism. It was captured by the percentile rank of Political Stability and Absence of Violence/Terrorism.

Regulatory Quality (REGQUP) referred to Perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. It was captured by the percentile rank of regulatory quality.

Rule of Law (LAWP) referred to the perceptions of the extent to which agents have confidence in and abide by the rules of society, and the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. It was captured by the percentile rank of rule of law

4.0 Study Findings

4.1 Descriptive Statistics

Descriptive statistics were used to describe the basic features of the data in this study. Table 4.1 presents summary statistics for the variables of the eight countries between 1996 and 2010.

Table 4.1 Overall Summaries of Descriptive Statistics of Eastern Africa Countries

	Mean	Median	Maximum	Minimum	Std. Dev.	Skewness	Kurtosis
FDI	3.30	2.10	17.37	-0.61	3.68	1.65	5.35
GDP	5.43	5.77	13.85	-12.68	4.07	-0.96	5.75
EXDS	2.99	2.01	27.20	0.34	3.38	3.93	25.15
INFL	7.87	6.87	44.39	-8.24	7.15	2.01	10.41
LIR	18.41	16.91	49.00	7.00	8.03	1.37	5.82
CORR	40.81	34.02	82.44	8.78	21.34	0.27	1.55
GOVEFP	40.50	37.31	77.18	6.34	17.30	0.45	2.42
STABP	35.21	23.56	88.94	2.89	27.21	0.63	1.87
REGQUP	37.87	36.89	76.56	7.35	17.45	0.22	2.24
LAWP	40.66	38.15	82.30	4.31	20.76	0.56	2.47
OPEN	37.19	27.05	122.68	12.77	25.63	1.52	4.52
NET	5.62	0.66	41.00	0.001	9.37	2.27	7.85

Source: Constructed from the Study Data

Key: FDI is the ratio of foreign direct investments to nominal GDP; GDP is the GDP growth, EXD is the debt service on the external debt as per cent of GDP; INF is the inflation rate; LIR is the lending interest rate; CORR is the percentile rank of control of corruption; GOVEFP is the government effectiveness; STABP is the political stability and absence of violence/terrorism; REGQUP is the regulatory quality; LAWP is the rule of law; OPEN is the degree of openness and NET is the internet users per 100 people. The results presented in Table 4.1 show that the average FDI inflows as a per cent of GDP for all the countries over the study period was 3.3%, while the average economic growth rate for the region was 5.4% over the study period. The ranking of the five institutional and governance variables was generally poor, as it was less than 50, with the highest average being 40.8 for corruption. There was a wide variation in the mean rate of use of internet, with the highest being 40 and the lowest being 0.001. This implies that some countries in the region were lagging behind in ICT. Generally, many countries in the region had low degree of economic openness as evidenced by the low average of openness.

4.2 Empirical Results

Fixed Effects Model Estimation Results

The least squares dummy variable model (LSDV) was estimated. Some of the institutional variables were dropped owing to their high degree of correlation as indicated earlier. One of the eight country dummies, i.e. for Uganda, was excluded from the regression equation in order to avoid perfect multicollinearity. The specific LSDV model estimated was expressed as follows:

$$FDI_{it} = \alpha_i + \beta_1 GDP_{it} + \beta_2 EXDS_{it} + \beta_3 INF_{it} + \beta_4 LIR_{it} + \beta_5 CORR_{it} + \beta_6 STABP_{it} + \beta_7 LAWP_{it} + \beta_8 NET_{it} + \mu_1 ethi + \mu_2 ken + \mu_3 mad + \mu_4 mau + \mu_5 rwa + \mu_6 sey + \mu_7 tza + \varepsilon_{it} \quad 4.1$$

Where μ_i were the respective parameter estimates for the country dummies? The regression results of the model are provided in the Table 4.2.

Table 4.2 Least Squares Fixed Effects Model Estimation Results

Dependent variable : Foreign Direct Investment Inflows (FDI)			
Independent Variable	Coefficient	Standard Error	Probability
Constant	-4.055947***	1.436058	0.006
GDP	0.0876793*	0.0469841	0.065
EXDS	-0.0082692	0.0768998	0.915
INF	-0.0549313**	0.02568	0.035
LIR	0.2296301***	0.0378704	0.000
CORR	0.043289*	0.0262273	0.100
STABP	-0.1250073***	0.0280776	0.000
LAWP	0.0767509**	0.0346724	0.029
NET	0.2137485***	0.0290904	0.000
ETHI	2.454844***	0.9100842	0.008
KEN	-0.7252009	0.89411	0.419
MAD	0.9806411	1.3556	0.471
MAU	-0.789619	1.64957	0.633
RWA	-1.069693	1.099579	0.333
SEY	9.138714***	1.719781	0.000
TZA	1.431108*	0.7856891	0.071
Adjusted R-squared	0.7625		
F-statistic	26.47***		
Prob(F-statistic)	0.000		
*/**/** indicate significance of the coefficient or rejection of the null hypothesis at 10%/5%/1% level of significance. Country specific fixed effects are reported in Appendix			

Source: Constructed from the Study Data

The results showed that all except the estimated coefficients of political stability had expected theoretical or hypothesized signs. The model fitted well and explained 76% of variations in the FDI inflows. All the four coefficients of macroeconomic variables except GDP growth rate and the external debt service were statistically significant at 1% or 5%.

4.3 Discussion of the Results

a) Institutional and Governance Factors

Four institutional and governance variables, namely, infrastructure (NET), rule of law (LAWP), corruption (CORR) and stability (STABP) were included in the model for estimation. The coefficients of political stability and internet use were statistically significant at 1% while rule of law was significant at 5%. Consistent with the Institutional FDI Fitness model, all the institutional and governance variables were found to significantly influence the FDI inflows in the region except control of corruption which was only significant at 10%. The Institutional FDI Fitness model postulates that it is not the intransigent generic conditions, but rather the institutions, and their policies and implementation that are pivotal to increasing foreign direct investment (Wilhelms, 1998).

The Institutional FDI Fitness model predicts that, all else equal, countries with high Institutional Fitness experience higher inflows of foreign direct investment than countries with low Institutional Fitness. High Institutional Fitness means that a country's institutions are transparent, well-functioning, reliable and predictable. Countries with high quality institutions provide an environment for both investment attraction and expansion of existing firms, since it attracts a favourable environment for operation for foreign investors. Institutional reforms that change laws, rules and regulations, create a better investment climate in an economy by reducing transaction costs, hence, creating opportunities that attract FDI.

According to this theory, one of the institutional or FDI Fitness variables with the highest correlation with FDI includes the rule of law. The coefficient of the rule of law was found in this study to be statistically significant at 5%. An increase in the percentile rank in the rule of law by 1 unit increased FDI inflows as a per cent of GDP by about 0.07 units. A strong rule of law implied a particularly low likelihood of government contract repudiation or expropriation as well as strong protection of investors' rights by the legal system (Morgan, 1998). Ngugi and Nyangoro (2005) noted that where law and order was observed, growth in FDI inflow was higher, since a risky environment discouraged investments by either reducing the investment return or scaring away potential investors.

Moody (1992) also showed that "well developed infrastructure" was a determinant of capital investment by multinationals. In line with these findings, the study showed that infrastructure, proxied by internet use, had a positive effect on FDI, and was statistically significant at 1%. An increase of one unit of internet user per 100 people was likely to increase FDI inflows as a per cent of GDP by 0.21 units. Mottaleb (2007) found that countries with abundant modern infrastructural facilities, such as internet could successfully attract FDI. Infrastructure facilities increased the productivity of the investments, and therefore, stimulated FDI inflows into the country.

The ranking of control of corruption had the expected positive sign and its coefficient was statistically significant at 10%. An increase in the percentile rank in control of corruption by 1 unit was likely to increase FDI inflows as a per cent of GDP by about 0.04 units. According to World Bank (2004), corruption was regarded as a threat to foreign investment for several reasons: it distorted the economic and financial environment; it reduced the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability; and last but not least, it introduced an inherent instability into the political process. Foreign lenders and investors would find it difficult to conduct business effectively in countries where there is widespread financial corruption in the form of demands for special payments and bribes connected with import and export licenses, exchange controls, tax assessments, police protection, or loans. Due to persistent corruption, some East African countries like Kenya had suffered from suspension of foreign aid, which impacted negatively on the FDI inflows.

Interestingly, the study showed that political stability, though statistically significant at 1%, had unexpected negative coefficient. This is contrary to several studies (Aharoni, 1966; Jensen, 2003), which underscored the importance of political stability for FDI inflow. For instance, Schneider and Frey (1985) conducted a research on 80 developing countries and found that political instability in a country led to a sharp decline in the inflow of foreign capital. The unexpected negative coefficient was most likely due to the problem of multicollinearity since political stability was highly correlated to corruption. However, as Wilhelms (1998) found out, there were exceptions to the rule that Institutional Fitness determines FDI. Some countries had such strong preconditions in their favor that investors came anyway, even in the face of hostile policies and instability. The positive coefficients of country dummies implied that there were other factors enhancing FDI inflows into these countries compared to the reference country. These factors may be unobservable or even unknown to the analyst but they were there. For instance, with their unique locational advantages some East African Countries could still attract FDI despite their political instability. Moreover there was tendency for FDI to flow to developing countries that were emerging from political instability. Basemera and Mutenyo (2012) noted that although institutional indexes for East African states were at one time worsening, FDI inflows were rising. Nonetheless, many investors might in the long run pull out after enduring continued losses if political instability persists.

b) Economic Factors

Four economic variables, namely, economic growth rate (GDP), external debt service as a per cent of GDP (EXDS), inflation (INF) and lending interest rate (LIR) were included in the model for estimation. The coefficients of all the four macroeconomic variables except the one of external debt service as a per cent of GDP were statistically significant.

GDP growth was positively correlated with FDI inflows and its coefficient was statistically significant at 5%. This implies that a 1 unit increase in economic growth led to 0.09 units increase in FDI inflows as a per cent of GDP in East Africa. This implied that economic growth attracted FDI, especially the market-seeking FDI. Moreover a country with a large market as indicated by high GDP had a greater ability to consume the production capacity established by the inflows of FDI (Calhoun *et al.*, 2002). This explains why Kenya has been losing to the neighbouring countries that have been growing more rapidly as indicated by their higher GDP growth rates.

Inflation as expected had a negative effect on FDI. The coefficient was statistically significant at 5%. The model shows that a 1 unit increase in inflation would lead to a 0.05 units decrease in FDI inflows as a per cent of GDP. This implies that macroeconomic stability was crucial in enhancing FDI. Inflation not only reduces the level of business investment, but also the efficiency with which productive factors are put to use. It is thus necessary for a country to maintain price stability to attract FDI. The higher the level of macroeconomic-instability, the higher the risk premium on investment, and the lower would be the level of investment as indicated in a study by Ngugi and Nyangoro (2005). East Africa countries had been experiencing rising inflation rate during the study period, which partly contributed to low FDI inflows.

The coefficient of the return on investment was found to be positive as expected and statistically significant at 1 per cent level of significance. This implies that 1 unit increase in lending interest rate resulted to 0.23 units increase in FDI inflows as a per cent of GDP. These findings agree with a study by Asiedu (2002), which showed that a higher return on capital promoted FDI. High returns on capital enhanced FDI, since investors prefer countries where they realize return on their investments.

c) Dummy Variables

As earlier noted, the cross-section effects and period effects represented differences in political, institutional and economic policy systems that were not explicitly included in the specification, but which was accounted for when estimation was done, ultimately leading to more representative estimates.

Each country was represented by a dummy except Uganda, which was assumed to be the base and thus her dummy, DUGA, was excluded from the regression equation in order to avoid perfect multicollinearity.

The dummy coefficients ($\mu_1 - \mu_7$) were parameter estimates of country dummy variables. The parameter estimate of Uganda dummy (dropped dummy) was presented in the LSDV intercept (-4.056), which was the baseline intercept (reference point). Each of $\mu_1 - \mu_7$, represented the deviation of its country specific intercept from the baseline intercept which was -4.056 (intercept of Uganda). For instance, $\mu_1 = 2.455$ meant that the intercept of Ethiopia was 2.455 larger than the reference point, -4.056, and was statistically significant at 1%. The coefficient for Kenyan dummy (μ_2) was -0.725 which implied that her intercept was 0.725 less than that of the base country or the reference point though not statistically significant. This implied that there were other unique factors not included in the model that hindered FDI inflows to Kenya as compared to Uganda.

In general, for countries with positive coefficients, it implied that there were other factors enhancing FDI inflows into these countries (Ethiopia, Madagascar, Tanzania and Seychelles) compared to Uganda. These factors may be unobservable or even unknown to the analyst but they were there. For countries with negative signs, it implied that there were other factors constraining FDI inflows in these countries (Kenya, Rwanda and Mauritius) compared to Uganda. However these factors were only statistically significant for Tanzania at 10% as well as Ethiopia and Seychelles at 1%

5.0 Summary and Conclusions

The study found out that the following institutional and governance variables significantly influenced the FDI inflows in East Africa: rule of law, corruption, political stability and infrastructure (proxied by internet use). Overall the study found out that the perception people had on the rule of law and control of corruption had positive effect on the FDI inflows. Internet use was also found to have positive effects on the FDI inflows. This finding emphasized the need for improvement in infrastructure, especially in the development of ICT. Contrary to the expectations, the study found out that political instability seemed to attract FDI inflows.

Economic growth and the return on investment were found to be positively correlated with FDI inflows. Inflation had a negative effect on FDI. The study thus underscored the importance of stable macroeconomic environment for enhancing FDI inflows. The empirical findings showed that the significance of dummy estimates implied that some countries had unique factors that were not captured in the model that enhanced or hindered FDI inflows. These were cross-section effects and period effects that represented differences in political, institutional and economic policy systems that were not explicitly included in the specification, but which were accounted for in the estimation. This might explain why some countries would still attract FDI despite political instability.

This study findings yield several insights into the analysis of FDI inflows in East Africa. The study has underscored the importance of both the traditional and non-traditional factors in determining FDI inflows. Though the non-traditional factors such as institutional and governance factors are not directly measurable and hence tend to be ignored in many studies, they have significant impact on FDI. The empirical findings have demonstrated the importance of individual institutional, governance and economic factors that are unique to each country, yet they influence the FDI inflows. This implies that though countries may share the same region they have crucial dissimilarities that may significantly affect FDI.

The study findings confirm the Institutional FDI Fitness theory which postulates that it is institutions, their policies and implementation, rather than generic inflexible variables that give a country a competitive advantage in the global FDI market. The institutional and governmental factors such as rule of law, a corruption free environment and well developed infrastructure play a key role in attracting FDI. In other words, the fewer obstacles foreign direct investors encounter, the more they will invest.

The findings also strongly suggest that economic factors such as macroeconomic stability, economic growth and high returns to investment influence positively the FDI inflows. Macroeconomic stability is crucial in enhancing FDI. The negative relationship between inflation and FDI inflows indicates that price instability hinders FDI inflows. A case in point is Kenya which was experiencing a rising inflation rate in the study period which was accompanied by declining FDI inflows. The study also showed that each of the East African countries had different unique features that might attract or discourage FDI. This calls for differential implementation of some policies to take into account this uniqueness. For instance, Uganda is a land locked country unlike Kenya and Tanzania which in itself discourages FDI.

5.1 Policy Implications

The empirical results of this study provide invaluable information for policy formulation and implementation. These results indicate the great need for East African (EA) Countries to understand and appreciate the role of institutions and governance as well as economic factors in enhancing FDI inflows. There is also a need to continuously reform institutions in order to improve their efficiency and productivity to attract more FDI inflows. Given that infrastructure positively and significantly influences FDI, there is need for the EA governments to develop the infrastructure to encourage FDI inflows. Internet greatly improves means of communication within and outside the country and thus promotes FDI. Well-developed infrastructure is a determinant of capital investment by multinationals. Multinational Corporations thrive in countries with a reliable infrastructure because that would result in more efficient business operations. Infrastructure facilities increase the productivity of the investments, and therefore, stimulate FDI inflows into the country. However, as the study has shown each East African country might have some unique features that might attract or hinder FDI and thus policies that have been successful in one country should not be blindly replicated in another, since these policies might have differential impact.

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