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Effect of Tax Incentives on Foreign Direct Investments in the East African Community

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Abstract:

The use of tax incentives has tremendously grown since the early 90's due to globalization and creation of common markets through regional integration. The logic behind granting tax incentives is to offer potential enterprises opportunities to invest where taxes are seen as impediments. Tax incentives are meant to foster investments into particular economic sectors or industries that are identified as crucial areas of development including export oriented sectors, mining and industrial parks. On the other hand, Foreign Direct Investment is widely regarded as an integral factor in fostering growth and advancement in both advanced and transitional economies. The study aimed to find how tax incentive affects the foreign direct investment by paying attention to the East African Community bloc. The study used the random effect panel model to carry out this investigation. The study concludes that Tax incentive significantly affects foreign direct investment in the East African Community.

Keywords: Foreign direct investment, tax incentive, east african community

1. Introduction

The interrelation between tax incentives and Foreign Direct Investment has received great attention from the academic front where scholars in the discipline of finance and economics have delved to undertake studies on these concepts. This fundamental association dates back to the early years of 1160 where tax incentives were offered to persuade weavers of wool into relocating to Biella in Northern Italy (Wells, 1999). The growing recognition of the nexus between tax incentives and foreign investments is attributed to new era of globalization characterized by the gradual elimination of prevalent barriers to capital movement (Morisset & Pirnia, 2000). Foreign Direct Investments have in the past been associated with positive spillovers such as technology transfer, increased innovation, international production networks, access to new markets, employee training and higher growth rates (Caves, 1998) and (Görg & Strobl, 2001). This has in turn created the urge to attract and retain international investments by developing countries especially those in regional markets that deem themselves to be in stiff competition as their countries have equally attractive investment climates (Morisset & Pirnia, 2000).

Reuber (1973) was one of the earliest proponents of the principle that export-oriented multinational companies base their investment decisions on taxation policies. In his proposition, tax rates had a momentous effect on the organization's activities and were therefore key to an investors' resolve to develop a niche in the market. Ideally, Reuber postulates that tax incentives like duty remissions and tax holidays are predominant to export related projects such that lack thereof would amount to abandonment of the venture. Similarly, Devereux, Griffith and Klemm, (2002) established that these tax incentives are deemed to appeal and lure international investors as they provide cost advantages by cutting down expenses that would have otherwise been directed towards the payment of taxes.

The East Africa Community (EAC) integration has facilitated the surge of inflows of investments into the region (World Investment Report, 2011). UNCTAD (2010) reported that since the entry into force of the EAC Treaty, foreign investment inflows amounted to US\$ 574 million in 2000. In 2005 after instituting the Customs Union, the region received US\$ 895 million worth of FDI. By 2009, the amount had increased to US\$ 1,585 million. Governments in the EAC Partner States have made concerted efforts to increase tax incentives with the motive of attracting foreign capital for investments (Thuita, 2017). Such efforts made are among the strategies employed by different countries to ensure they gain competitive advantages over other nations. According to Action Aid (2016), the notable fiscal incentives presented for uptake by the EAC partner states are in the form of tax holidays offered at Export Processing Zones (EPZs) and customs duties exemptions on input and materials for production of exports.

1.1. Tax Incentive

Klemm (2000) defined tax incentives as initiatives which facilitate preferential taxation treatment to a particular group of persons or companies in specific sectors compared to what is accorded to the industry as a whole. Further, UNCTAD (2000) expounds on this concept highlighting that tax incentives are offered for the purpose of reducing the tax burden so as to prompt investments to certain projects or economic sections. A study undertaken by Gordon and Hines

(2002) depicts that there is a possibility that tax related policies determine the location of foreign direct investment. Earlier studies support this narrative by confirming that in the case where there are higher tax rates, the after tax return is reduced making the commitment to invest funds negligible.

Developing countries find tax incentives politically easier to offer as there are no upfront funds required making them simpler to provide rather than the costly ventures such as development of infrastructure. In concurrence to this view, UNCTAD (2000) observed that developing nations commonly offered fiscal incentives comprising of tax holidays, exemption on imported duties and investment capital allowances which don't require upfront use of the government finances. Advanced economies on the other hand, take on incentives like subsidized loans, loan guarantee schemes and grants. Other financial incentives include investment tax credits, reduction of tax rates, as well as duty draw backs. These are all offered to lessen the burden of tax to the multinational enterprises.

Corporate income tax (CIT) rate has been the area of focus on which scholars have based their studies while assessing how it impacts investments while few empirical works have investigated the role tax incentives play in attracting FDI. Tax incentives have been measured in many ways by different scholars. In some cases, it is calculated as the total amount of revenue that is lost by a government (Action Aid, 2016). In its report of 2016, Action Aid highlighted that East African countries had presented massive incentives to investors resulting to a total revenue loss of US\$ 2.8 billion annually as at 2012. Other studies have used a number of variables to measure tax incentives such as; tax holiday which is measured in terms of the number of years, investment allowance as a percentage.

When regrouping tax incentives, they may be categorized under two main groupings; Investment Promotion Incentives and Trade Related Incentives. Under Investment Promotion Incentives, these are tax incentives offered with the prime goal being to attract and boost investments into the economy. An example of investment promotion incentives is capital investment allowances which are subtractions from the taxable income tied to the portion of new investment. These include; industrial building allowance, farm works deductions, shipping investment deductions and mining operation allowance. On the other hand, the Trade Related Incentives are used towards the promotion of exports and these include; duty drawbacks facility, manufacturing under bond and tax remission export office. This study will focus on the Investment Promotion Incentives particularly capital allowances that are granted towards promoting the setting up of investments as these are the most common within the EAC.

1.2. Foreign Direct Investment

Buckley (2000) describes foreign direct investment as the purchase overseas of tangible equipment for instance property and other assets whose ownership and ultimate control of their operations are conferred to the founding enterprise based away in its native home land. FDI is an undertaking that reflects a long standing interest by a foreign entity residing in a host country other than that of the foreign investors (UNCTAD, 2016). The concept of longevity assures the investor higher stakes in the management of the enterprise and efficiency in operations. There has been a widespread impression that FDI are considered the stimulants for growth and development due to their long-term nature.

FDI is a component of international capital flows considered least volatile unlike the other forms which include foreign portfolio investment and official development assistance. FDI differs from Foreign Portfolio Investment (FPI) as follows. In foreign direct investment, the managing interest is normally ten percent or more, while in foreign portfolio investment, ownership of the stake is less than ten percent (World Bank, 1996) and (IMF, 2007). The stake in foreign portfolio investment is given to an overseas business with a view of earning income streams from the investment in the form of capital gains and dividends with however no operational control of the enterprise. Investments in international portfolios are short term as they are made for less than one year and the flows tend to be more challenging to calculate as they comprise of varied instruments. Reporting is also equally poor causing varying estimates. As for Official Development Assistance (ODA), funds that were provided in the past have been diminishing in importance with passing years unlike before the 1980s where they were popular (IMF, 2007).

In East Africa, there are two prime clusters of FDI based on the motive behind the decision to set up the enterprise as classified by Dunning (1993). These are the market-seeking FDI and resource-seeking clusters. The market seeking kind of foreign investment seeks to supply to the domestic market and this variety of investments are common in Kenya (Abala, 2014). This category of FDI is involved in the opening up of branches and subsidies that are replicas of the originals to facilitate production in the host markets. The other type of FDI is the resource seeking type whose motivation historically has been the seeking of raw materials, minerals and agricultural products (Dunning, 1993) and (Jones, 1995). The logic behind such relocation is cutting on costs since there are abundant natural resources like oil and gas. It is argued that states endowed with natural resources lacked sufficient capital required for extracting the raw material or lacked the skill and technical know-how needed for the same and in other cases lacked the know-how to sell the extractives to the global economy (Dunning, 1993). Foreign Direct Investment is generally measured as an aggregate of the net inflows of various components such as joint ventures, mergers and acquisitions, green field investments, equity and other forms of FDI investments

1.3. Research Problem

Tax incentives remain a popular policy tool in developing nations. The logic behind granting tax incentives is to offer potential enterprises opportunities to invest where taxes are seen as impediments. According to UNCTAD (2000), tax incentives are meant to foster investments into particular economic sectors or industries that are identified as crucial areas of development including export oriented sectors, mining and industrial parks. Additionally, it is widely understood that the concept of tax incentives is associated with FDI that is efficiency-seeking due to costs savings (Global Investment

Report, 2017). Foreign Direct Investment is widely regarded as an integral factor in fostering growth and advancement in both advanced and transitional economies (Blomstrom and Kokko, 2003).

Empirical studies on tax incentives and FDI have concentrated on developed and OECD countries with little research undertaken in Africa. There are scarce theoretical studies locally which are yet to show how tax incentives influence capital inflows in East Africa Community bloc. The EAC partner states have in the past adopted fiscal policies in removing impediments and trade restrictions that have led to a positive bearing in capital inflows. EAC has reached an advanced level of economic integration and with the Monetary Union expected to come into force by 2023, it is imperative that EAC makes the right steps towards the integration of the financial sector through harmonizing and standardizing its tax policies and currency (Alot and Miller, 2015).

A study undertaken by Devereux and Freeman (1995) established a significant outcome of tax burden on the locational choice of FDI. However, the use of five years in conducting the analysis raises concerns as the period is considered too brief to make a well-founded deduction that takes into account the long-run effects (Greene, 2011). Barlow and Wender (1955) through a survey established that only 10% of firms considered favorable taxes in the host country as an important determinant to invest abroad. Disparity of the interrelation can be attributed to use of qualitative research to measure a complex econometric relationship between FDI and taxes. The study should have employed a quantitative or an eclectic approach (William, 2007). Narrowing down to Africa, a study by Olaleye (2016) established that there is a notable positive influence on international investments due to the usage of tax incentives. This empirical work however focused on listed firms in the manufacturing sector in Nigeria yet FDI is known to be majorly spread across various sectors of the Nigerian economy such as mining, extractives (oil) and may not fully be representative of the market situation (UNCTAD, 2009).

Studies conducted in Kenya have mainly attempted to expound the interrelation between FDI and growth in the economy, not necessarily on tax incentives. Additionally, Otieno et al. (2013) established that regional integration insignificantly affected inflows of foreign investment to EAC region. It is Thuita (2017) who focused her study on taxes incentives offered within the Export Processing Zones in Athi River and how they influence FDI inflows. The study employed interviewing technique for data collection. It established that tax holidays attracted inflows of capital into the manufacturing sector. However, use of questionnaire items to determine the interrelation of taxes and FDI would compromise the findings as accuracy of the data provided depends on the transparency of the company employees who may have held back vital information given the sensitivity of such information in the competitive market. Such an approach is not robust in carrying out this type of research as it may result in problems of validity and reliability (Hofisi et al., 2014).

This study was aimed at finding out the role tax incentives had played as a reform mechanism tool adopted by Governments in EAC member countries to attract and encourage Foreign Direct Investments. It was against this backdrop that the prime goal set was to avail empirical evidence on the state of fiscal incentives and the implication these incentives had in attracting inflows of FDI to the bloc. This study sought to respond to the following question: Do tax incentives have an effect on Foreign Direct Investments in the East African Community?

2. Literature Review

2.1. Global Studies

Devereux and Freeman (1995) conducted a study to investigate taxation effect on international investments. They used FDI flows for seven OECD states to investigate the correlation between taxation and FDI flows. Panel data for the research covered the period of 1985-1989 where they employed a complex measure of capital cost and used linear specification to regress foreign investments. In their findings, they established that tax burden is significant in the choice of FDI location. The study however used only five years to assess the outcome. The problem of conducting a 5-year analysis is that, a 5-year period is considered too brief to make a well-founded deduction on the effects of tax on FDI as it fails to take into account the long-run effects (Greene, 2011).

Santis, Mercuri and Vicarelli (2001) undertook an econometric exercise on European Union (EU) member states using panel data to investigate the effect of taxation in determining investment inflow and geographical location. They adopted the gravitational model for analysis which considers geographical and macroeconomic variables. There was augmentation of the specification to include the traditional environmental variables such as infrastructure, technical innovation as well as fiscal elements like corporate income tax, burden of tax and the labour tax wedge. From the findings, it was confirmed that the total fiscal variables were significant in the elaborating how inward flow of FDI to European countries occurred.

Swenson (2001) distinguishes foreign direct investment into six components as illustrated by Aurebach and Hasset (1993) who established that each component of FDI responds differently to taxes. The disaggregated components adopted in the study were inclusive of mergers and acquisitions, joint ventures, plant extensions, equity and other foreign direct investments. The study involved analysis of investments made by 46 countries into 50 States in the US. It was found that the FDI component that had a significant positive response to US state corporate income taxes was mergers and acquisitions while tax elasticity for plant and plant extensions was significantly negative. In conclusion, the study revealed that real investments declined as a result of increased US taxes. Contrary to Swenson's findings other studies in the US used disaggregated data for FDI and undertook cross-sectional analysis with results indicating that property, plant and equipment were also affected by taxes.

The next series of studies that followed used different techniques to empirically investigate the tax incentive and foreign investment nexus. Mixed and varying results have been recorded by other studies undertaken on the subject.

Barlow and Wender (1955) conducted a survey on 247 US firms to establish which key factors informed their decision to invest abroad. Using interviewing as the data collection method, among the questions asked were what were some of requisite conditions investors looked out for in making their locational decisions. Only 10% listed favorable taxes in the host country as factors considered important to invest abroad. Disparity of the interrelation can be attributed to use qualitative research method to measure a complex econometric relationship between FDI and taxes. The study should have rather employed a quantitative or an eclectic approach (William, 2007).

2.2. Regional Studies

Narrowing down to Africa, Olaleye (2016) evaluated listed Nigerian manufacturing firms that used fiscal incentives ranging from corporate income tax, investment allowances, taxes on capital gained, double tax agreement and value added tax (VAT). The econometric analysis employed descriptive research design using both raw and secondary data. Further, inferential and descriptive regression was undertaken revealing that tax incentives had a significant positive effect on foreign investments in listed Nigerian enterprises. The study however focused on listed firms in the manufacturing sector yet FDI in Nigeria is spread across various sectors of the economy such as mining, extractives (oil) and may not fully be representative of the market situation (UNCTAD, 2009).

Boly, Coulibaly and Kere (2019) carried out a study to find out the interrelation of tax policy, spillover effects and FDI. They investigated 19 African nations and employed panel data ranging from the 1990 to 2012. Using dynamic spatial Durbin model to ascertain how changes in corporate income taxes (CIT) affected investment inflow, they established that in the long and short run indeed a reduction of the CIT rates led to a rise in FDI inflow.

A study by Munongo (2015) sought to investigate the efficacy of tax incentives in stimulating international capital flows. The research involved a case study of Southern Africa Development Community (SADC) nations using data from 2004-2013 and it established that fiscal incentives were effectual in capturing FDI inflows to the countries. His study focused on tax holidays, reduced corporate income taxes and losses carried forward as the incentives. It employed four separate panels depending on the factor endowments found in the South African countries.

Agodo (1978) analyzed a sample of 32 US manufacturing companies operating in 20 African countries and came to a conclusion that tax concessions played an insignificant role in determining foreign investment by the US firms. This study however may be too old as the times have changed and may not effectively reflect the current market status. Brafu-Insaidoo and Biekpe (2014) sought to investigate the key causal factors of foreign investment flows to 37 Sub-Saharan Africa nations. Employing a dynamic longitudinal data analysis, the study established domestic financial liberalization created incentives to attract investment capital particularly in emerging and frontier markets. In conclusion, regional integration played an integral part in stimulating FDI but not the other forms of international capital flows.

2.3. Local Studies

Thuita (2017) while investigating the effect of tax incentives on foreign direct investments located in the Export Processing Zones focused on tax holidays and capital deductions as the main incentives. The study employed interviewing technique for data collection, stratification method in selecting the sample size of senior employees to be interviewed and purposive methods to select firm samples. It was concluded that tax holidays greatly influence attraction but not retention of FDI arguing that the manufacturing sector is greatly favored by tax incentives. Recommendation was that the government should consider extending tax holidays beyond ten years on a long term basis depending on the amount of capital employed. However, use of questionnaire items to determine the interrelation of taxes and FDI would compromise the findings as accuracy of the data provided depends on the transparency of the company employees who may have held back vital information given the sensitivity of such information in the competitive market.

In the same vain, Otieno et al. (2013) undertook a study on regionalism and FDI in EAC. They employed the Generalized Least Squares (GLS) method to evaluate the relationship. It was established that regional corporation did not have a significant outcome on inflows of foreign investment in the EAC region. It was however deduced that other elements such as the concentration of political risk and the degree of financial stability impacted FDI inflows, which ultimately determined the volatility of the exchange rate regime.

Musyoka (2012) endeavored to evaluate the tax incentives and FDI nexus in Kenya. The empirical works entailed adoption of time series data for a ten-year duration. He focused on incentives including those that are trade related, investment related and for import duty exemption. The study used descriptive statistics and relative frequencies as well as regression to analyze the variables. Findings revealed a contemporaneous correlation between the predictor and explained variables as it was argued that tax incentives led to loss of revenue by the government.

3. Methodology

3.1. Research Design

According to Cooper and Schindler (2014), Research design is how data collection and analysis is structured for the purposes of answering the research hypothesis by use of empirical evidence. This research employed the Descriptive Research Design in ascertaining the influence that tax incentives have on foreign direct investments. Khan (2008) elaborates that descriptive research is adopted in situations where the researcher is keen on finding out the state of affairs as they exist. This research design was appropriate because it aids in the disciplined gathering and analysis of data which is presented in a systematic manner giving a clear illustration of the characteristics of the phenomenon under study. Further, the nature of descriptive design helps in the provision of valid and accurate analysis of the variables in the study exploring links between the concepts and saving on time and cost when undertaking the study (Best & Khan, 2007).

3.2. Model Specification

In order to find out the effect of tax incentive on Foreign Direct Investment in the EAC, a functional model was specified with FDI as a function of tax incentive. Additionally, to avoid the problem of misspecification of the model, more variables that were deemed to affect FDI were included in the model, these were GDP growth, exchange rate, and trade openness. The functional form of the model is thus:

$$FDI = f(TI, GDP, ER, OPN) \quad 1$$

Where:

FDI=Foreign Direct Investment

TI=Tax incentive

GDP=Gross Domestic Product

ER=Exchange Rate

OPN= Trade openness

3.3. Analytical Model

The research used panel data since it sought to study different countries in the East African Community. Panel data is a multi-dimensional data frequently involving measurements overtime. It contains observations of multiple phenomena obtained over multiple time periods for same firms or individuals. There are two techniques used to analyse panel data, that is, fixed and random effects. Fixed effect is used when analyzing the impact of variables that vary overtime. It explores the relationship between predictor and outcome variables within entity. Fixed effects assume that something within the individual may impact or bias the predictor or outcome variables and we need to control for this. It also assumes that those time-variant characteristics are unique to the individual and should not be correlated with another individual characteristic. If the error terms are correlated, the fixed effect is not suitable since inferences may not be correct. In Random effects model, unlike FE model, the variation across entities is assumed to be random and uncorrelated with the predictor or independent variables included in the model.

Random effect model was established as the suitable model using the Hausman (1978) specification test. In this regard the Analytical model of the study thus becomes:

$$FDI_{it} = \beta X_{it} + \alpha + u_{it} + \varepsilon_{it} \quad 2$$

Where:

u_{it} = Between Entity Error Term

ε_{it} = Within Entity Error Term

α = the regression slope

βX_{it} = A matrix of the explanatory variables namely, Tax incentive, GDP growth, exchange rate and trade openness

4. Findings

Data for this study was mainly collected from secondary sources, the data was quantitative and spanned from 1999-2017. Data was collected for each of the five EAC countries, these included aggregate net FDI inflows, tax incentives, GDP Growth, exchange rates and trade openness. Data was exclusively collected from secondary sources such as the EAC Countries' Revenue Authorities databases, Income Tax and Incentives Acts of Parliament, National Finance Bills and Annual Country Budgets, UNCTAD database, World Bank World Development Indicators database, National Bureaus of Statistics, Central Banks websites, Public libraries and other Governmental publications. The study applied secondary data justified by the fact that the sources mentioned have credible and vital information for this empirical work. For instance, data for tax incentives from Kenya were collected from the Kenya Revenue Authority, Uganda's tax data was sourced from the Uganda Revenue Authority, Tanzania's was collected from Tanzania Revenue Authority, and Rwanda's was sourced from the Rwanda Revenue Authority while Burundi's tax incentive data was collected from *Burundais Des Recettes*.

4.1. Trend Analysis

This research paper undertook a Comparative Study by carrying out a trend analysis on Foreign Direct Investments of the five East Africa Community countries for the period ranging 1999 to 2017. Pickvance (2005) mentioned that comparison gives the researcher a comprehensive insight into the exercise. Figure 1 displays the trend analysis for FDI in EAC countries from 1999 to 2017.

Figure 1: Trend Analysis on Foreign Direct Investment in the EAC

Kenya had maintained a steady flow of FDI from 1999 to around 2008, after which the inflow started increasing to the year 2010. However, in 2011 there was a decline of the foreign investments and in 2012 a rise sharp. The FDI net inflow again deteriorated between 2013 and 2015 later on rising steadily between 2016 and 2017. In 2017, it is noted that Kenya was the East African country that had received the highest FDI inflow at USD 1.275 billion. Uganda on the other hand has maintained a steady rise in FDI throughout the period from 1999. However, in 2010 Uganda experienced a slight fall getting back on track in 2011. Since 2013, Uganda has been experiencing fluctuations in the FDI inflow with the lowest figure being USD 625.7 million in 2016 and a rise recorded in 2017 at USD 802.6 million. Tanzania has experienced periods of rise and falls in FDI. It has however recorded a downward trend since 2013. Burundi has recorded low and steady FDI inflows between 1999 and 2017. Like Uganda, in 2017 there was a slight increase in inflow of FDI from 864 million in 2016 to USD 937.7 million. Burundi has been the EAC country with the lowest total FDI inflow with fluctuations for the period under study. Similarly, Rwanda has recorded low and steady inflows between 1999 and 2010. This situation however changed in 2011 with the highest value of FDI inflow being in 2014 at USD 458.9 million. Rwanda similarly experienced a downfall of inflow from 2014 like the rest of EAC countries but an improvement recorded in 2017 at USD 356.4 million. It is important to note that both Rwanda and Burundi are yet to attract FDI inflow that surpasses the half a million mark.

4.2. Correlation Analysis

Correlation analysis was conducted to determine the monotonic association between the variables in the study. The study specifically focused on the first column of Table 1 which related the individual independent variables and FDI.

	FDI	Tax incentive	GDP growth	Exchange rate	Trade Openness
FDI	1				
Tax incentive	0.4529 (0.000)	1			
GDP growth	0.1769 (0.0899)	0.0387 (0.7093)	1		
Exchange rate	0.2668 (0.0115)	0.0615 (0.5625)	0.0901 (0.3958)	1	
Trade openness	0.4056 (0.000)	0.3660 (0.001)	0.1741 (0.0933)	-0.0701 (0.5089)	1

Table 1: Correlation Matrix

The coefficient for the relationship between foreign direct investment and tax incentive is 0.4529 and statistically significant meaning that the two have a positive relationship. This relationship is however moderately strong meaning that, a rise in tax incentive is expected to lead to a moderate rise in FDI.

Economic growth and FDI have a correlation coefficient of 0.1769 and statistically significant. This shows that there is a positive but weak correlation between GDP growth and FDI in EAC. The P-value of 0.08 is greater than 0.05 therefore statistically insignificant.

The coefficient for exchange rate and FDI is 0.2668. This shows that there is a positive but weak correlation between exchange rate and FDI in EAC. An increase in exchange rate is likely to result to a slight increase in the value of FDI. On the other hand, the correlation coefficient of trade openness and FDI is 0.4056. This shows that there is a positive but moderate correlation between trade openness and FDI in EAC. An increase in trade openness is likely to result in a moderate increase in the value of FDI.

4.3. Regression Analysis

The Hausman specification test identified Random effect as the appropriate model for the study. The random effects analysis are presented in Table 2.

Variables	Coefficients	Standard Errors	Z-statistic	P-value
Constant	-5.78e+08	2.49e+08	-2.32	0.020
Tax incentive	.5374721	.1571267	3.42	0.001
GDP growth	1.99e+07	1.88e+07	1.06	0.289
Exchange rate	164955.8	56942	2.90	0.004
Trade openness	1.58e+07	5154824	3.07	0.002
R-squared	Within Group=0.1402 Between Group=0.8178 Overall Group=0.3372			
Model significance	Wald chi2(4) = 42.73 Prob > chi2 = 0.0000			

Table 2: Regression Results

Following the findings of regression analysis, when all factors under the study are zero, the y-intercept/ constant coefficient is –USD 578 million. Thus, when all independent variables are absent, FDI within the EAC countries would be –USD 578 million meaning that in the absence of the combination of tax incentives, economic growth, exchange rate and trade openness, there would be an outflow of FDI. In this case, it can be deduced that all the study factors play a crucial role in attracting FDI within the EAC region.

Economic growth depicted by GDP growth had a correlation co-efficient 0.1769. Given that this value is below 0.5, the finding was that GDP growth has a fairly weak positive relationship with FDI. Meaning a rise in GDP growth is expected to lead to a slight rise in FDI. From the regression analysis, the slope coefficient for GDP growth is USD 199 million. However, the P-Value of 0.289 was found to be more than 0.05 significance level. This indicates that GDP growth is statically insignificant. In this regard, GDP growth does not have a significant effect on FDI in EAC. According to the empirical literature review, it was evident from a number of studies that economic growth played a significant role in determining where the investors will invest their capital. This study contradicts findings from the works of Iamsiraroj and Doucouliagos (2015). It is noteworthy from this study that GDP growth is the only variable which does not have a significant influence on foreign direct investment.

Exchange rate has a correlation co-efficient of 0.2668 depicting a positive but fairly weak relationship with FDI like GDP growth. Therefore, a rise in exchange rate is expected to lead to a slight rise in FDI. From the multivariate regression analysis, it was found that the slope coefficient for exchange rate is 164,955. The P-Value for exchange rate is 0.004 which is less than 0.05 significance level, hence exchange rate has a significant effect on FDI. The results are consistent with the works of Madura and Fox (2011) who found that exchange rate and FDI have a positive relationship. An appreciating exchange rate will boost FDI inflows as it makes the cost of investment in the host country cheaper relative to the country of the investor. It can be concluded that Exchange rate has a positive but fairly weak significant effect on FDI.

Trade openness has a correlation coefficient of 0.4056 indicating a positive and moderately strong relationship with FDI. Therefore, a rise in trade openness is expected to lead to a moderate rise in FDI. The partial slope coefficient for trade openness is 158 million from the regression analysis. An indication that a unit increase in trade openness would lead to USD 158 million in FDI in the East Africa Community. The P-Value of trade openness is 0.002 which is less than 0.05 significance level. Therefore, reject null hypothesis. In this regard, trade openness has a significant effect on FDI. The findings are consistent with the works of Asiedu (2002) and Sane (2016). The possible explanation for the results could be that, foreign investors would generally invest in countries that have opened up their economies as opposed to those that are restrictive. Similarly, a study by UNCTAD (2010) reported that since the entry into force of the EAC Treaty, foreign investment inflows amounted to US\$ 574 million in 2000, US\$ 895 million in 2005 after instituting the Customs Union, and US\$ 1,585 by 2009. Therefore, trade openness has a positive and moderately significant effect in attracting FDI into the EAC regional economic bloc.

Tax incentives have a correlation co-efficient of 0.4529 indicating a positive and moderately strong relationship with FDI. Hence, a rise in tax incentives would lead to a moderate rise in FDI. From the multiple regression analysis, the findings indicate that the slope co-efficient of tax incentive would lead to a 0.537 million increase in FDI. In this regard, Investment promotion tax incentives that are offered towards the boosting of investment particularly capital allowances attract USD 0.537 million of FDI within the EAC partner states. The P-Value of 0.001 is less than 0.05 significance level. Therefore, reject null hypothesis. In this regard, tax incentives have a significant effect on FDI. These findings are in line with the findings by Devereux and Freeman (1995) who established that tax burden have a significant effect on the choice of location of FDI. From yet another global study undertaken by Santis, Mercuri and Vicarelli (2001) who undertook an econometric exercise on European Union (EU) member states using panel data to investigate the effect of taxation in determining investment inflow and geographical location, found that total fiscal variables were significant in the elaborating how inward flow of FDI to European countries occurred. Regionally, a study by Olaleye (2016) established a significant positive effect that tax incentives have on international investments. Similarly, Munongo (2015) in his case study on the Southern Africa Development Community found that tax incentives were found to be effective in attracting FDI inflows in SADC nations. The justification for these results could be that, tax incentives are designed to ease the tax burden of MNCs and thus motivating them to invest more. Bruce (2014) opined that investors tend to diversify their investments in countries that have favorable tax terms, because it enables them fetch more returns. Therefore, tax incentives have a positive and moderately significant effect in attracting FDI into the EAC region.

Given the amount of FDI attributed to tax incentives is USD 0.537 million for the whole of the EAC community, the continuing implementation of tax incentives may not necessarily be as efficient in attracting large sums of FDI particularly in a regional economic bloc where the tax policies are not harmonized. Musyoka (2012) in his study to find out the relationship of tax incentives and FDI revealed that tax incentives lead to a loss of revenue for the Government.

5. Conclusion

This study's research objectives and hypothesis formulated have been adequately answered. It is evident that there is a positive linear relationship between the predictor variables including tax incentives and FDI as shown from the inferential statistic. The results indicate that a rise in tax incentives would contribute to a rise in FDI in the EAC. It is only GDP growth that does not have a significant effect on FDI within EAC. From both correlational and multivariate regression analysis, it can therefore be concluded that tax incentives have a positive and moderately strong significant effect on foreign direct investments inflows in the East Africa Community bloc. The justification for these results could be that, tax incentives are designed to ease the tax burden of multinational corporations and thus motivating them to invest more as they save on costs which enables them fetch higher returns.

FDI is crucial to the economies of the EAC member countries as it enables the discovery of new technologies, reinforces export capabilities and advances technical and management skills. However, the amount of FDI inflow attributed to tax incentives within the EAC is a slight figure of USD 0.537 million. This figure reflects that the continued granting of tax incentives may not necessarily be as efficient in attracting large sums of FDI particularly in the regional economic bloc where taxes are not harmonized.

Countries in regional markets that have equally attractive investment climates such as the EAC member states find themselves to be in stiff competition for FDI. In a bid to attract and increase the investment inflows, they diversify and escalate the existent tax incentive offers to foreign investors. This competitive trend that governments engage in is deemed as a “race to the bottom” as they seek to create jobs and increase exports by offering a variety of tax incentives. Nations engaged in such trends end up in “prisoner’s dilemma” that is only beneficial to the transnational corporations at the expense of the citizen’s welfare.

A tax incentives cost-benefit analysis should be undertaken in accessing how much revenue is lost through the granting of tax holidays and other exemptions *vis-a-vis* the benefits actually accrued to the economy by setting up of foreign investment entities. The benefits should surpass any cost that has been incurred to lure these investments. On the other hand, despite the tremendous efforts in providing various forms of tax incentives, regional FDI inflow attributed to such incentives would average to less than a billion within the EAC. As the finding indicate, a unit increase in tax incentive would lead to growth in FDI by USD 0.537 million. This phenomenon goes to prove that the tax competitive tactics may not be as effective in attracting foreign capital because it has a moderate impact on FDI and that other factors are key in determining the location of FDI. Tax incentives cannot counterbalance the presence of poor business climatic conditions such as macroeconomic instability, poor governance, insecurity and small markets. Tax incentives only play a marginal role as they moderately attract FDI. Lack of essential and favorable market conditions are not normally overshadowed by the tax incentives provided.

6. Recommendations

The Governments of the East Africa Community countries should put more emphasis in creating enabling business environments which have been known to naturally attract foreign direct investments. These include; the development of proper infrastructure, the improvement of governance structures, provision of political stability and improved competitive global rankings such as in the World Bank’s Ease of Doing Business and the World Economic Forum’s Global Competitive Index.

The East Africa Community is set to move up to an advanced level of integration. The Monetary Union was signed in 2013 but is expected to come into force by 2023. As such, it is imperative that EAC makes the right steps towards the integration of the financial sector through harmonizing and standardizing its taxes and other charges, interest rates and the central bank. It is crucial to have a functioning harmonized taxation and finance systems set up and running prior to that period. Therefore, the EAC Secretariat should prioritize the agenda of Regional Tax Harmonization in its annual calendar with a bid to market East Africa Community as a Common Market for investors rather than having unhealthy competitive tactics amongst the Partner States.

Member States of the EAC should form Enquiry Commissions that deeply look into the cost-benefit analysis of the tax incentives offered versus the benefits accrued to the FDI on a sectoral basis. This is because there is need to carry out a cost benefit analysis to access the impact these tax incentives have on the economic welfare of the citizens within the bloc. The findings would dictate the policies that would be adopted by the relevant authorities such as the Revenue Collecting Agencies and the National Treasury Departments.

Individual Partner States of the EAC should also commit to eliminate discretionary incentives which are granted without transparency but rather provide tax incentives without discrimination. These should instead be granted in a predictable manner manned under one accountable Institution. The new incentives should be prescribed by the Laws and grounded in a legislative instrument. Therefore, the importance of tax administration and systems should be given the necessary attention it deserves. The success at which these administrative systems will be effected depends on the political will and devising actionable strategies.

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