The Impact of Foreign Direct Investment on Economic Growth in Kenya: A Case Study of Kenya’s Special Economic Zones

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Abstract: The universal benefits of Foreign Direct Investment (FDI) for developing economies are quite renowned. Studies demonstrate that FDI enables human capital formation, improves international trade integration, results in technology spillovers, improves enterprise development and helps create a more competitive business environment. The approach to the establishment of these economic zones is also undergoing major change in both form and function, whereby the conventional Export Processing Zones (EPZs) are seemingly giving way to SEZ. The idea is that through the establishment of integrated infrastructure, provision of incentives for and removal of barriers to business, these localised zones will unlock the economic potential of the select sectors and attract more investment. In September 2015, the incumbent president of Kenya, H.E Uhuru Kenyatta, signed the SEZ Act. This has seen the Government set up SEZ designated areas in Eldoret, Athi River, Naivasha, Kisumu, Mombasa, Nairobi and Lamu, to fast-track manufacturing of various products in these locations. The extent to which FDI in Special Economic Zones has succeeded or will potentially succeed in catalysing economic growth in Kenya is what this paper has sought to explore.

Keywords: Foreign Direct Investment (FDI), Economic Growth, Special Economic Zones.

1. INTRODUCTION

For Kenya and other developing countries, attracting Foreign Direct Investments (FDI) has been a key aspect of its outward-oriented development strategy, as investment is considered a crucial element for output growth and employment generation (Kayonga, 2008). FDI provides a major source of capital which brings with it up-to-date technology contributing to economic growth. It would be difficult to generate this capital through domestic savings, and even if it were not, it would still be difficult to import the necessary technology from abroad, since the transfer of technology to firms with no previous experience of using it is difficult, risky, and expensive (Duce and Maitena, 2003).

Foreign Direct Investment (FDI) is associated with visible benefits on the economies of developing countries. Some of the benefits associated with FDI include advancing the human capital capacity, growth of manufacturing technology, enterprise formation and improving competition. The overall impact of the individual components is an improved economy in most measuring capacities. The model of FDI is the most recommended to alleviate poverty especially in developing countries such as Kenya as affirmed by the government (Ocharo, 2014).

Over a long period of time FDI has created many externalities in the form of benefits available to the whole economy which the host countries cannot appropriate as part of their own income. These include transfers of general knowledge and of specific technologies in production and distribution, industrial upgrading, work experience for the labor force, the introduction of modern management and accounting methods, the establishment of finance-related and trading networks, and the upgrading of telecommunications services (Mohamed, 2016). FDI in services affects the host country's competitiveness by raising the productivity of capital and enabling the host country to attract new capital on favorable terms. It also creates services that can be used as strategic inputs in the traditional export sector to expand the volume of trade and to upgrade production through product and process innovation. By altering a country's comparative advantages and improving its competitiveness through technology transfer and the effects of myriad externalities, foreign as well as domestic investments can alter a country's economic volume and pattern of trade in many income-enhancing directions (Ramirez, 2006).
FDI is a key element in international economic integration. FDI creates direct, stable and long-lasting links between economies. It encourages the transfer of technology and expertise between countries, and allows the host economy to promote its products more widely in international markets. FDI is also an additional source of funding for investment and, under the right policy environment; it can be an important vehicle for development (OECD, 2012). FDI inflows have in general been recognized as beneficial to economic growth in developing countries in the sense of improvement of productivity level (Zhao and Zhang, 2010), lowering the level of unemployment (Chaudhuri et al., 2006), expansion of domestic investment, transfer of advanced technologies from abroad, increasing competition in the host country, and increasing export values and foreign exchange earnings (Ram and Zhang, 2002). Therefore, most developing countries have actively tried to attract FDI especially since the 1980s. The Kenyan government embraced the Economic Processing zones (EPZ) and are now pursuing the creation of Special Economic Zones (SEZ).

According to a study done by Daniel O Abala, Kenya has had inconsistent trends of FDI inflows starting with the 1970-1980 period FDI started at a low of around US$ 10 million a year in the early 1970s before peaking at US$ 60 million by 1979-80. The country received relatively large capital inflows partly driven by rapid expansion in the agricultural sector, expansionary fiscal and monetary policies, sustainable budget deficit and the import substitution industrialization strategy (Mohamed, 2016). This involved overvalued exchange rates, import tariffs, quantitative restrictions and import licensing. FDI inflows in the period 1981-1999 averaged only US$ 22 million per annum. However after 1980s, Kenya’s economy was characterized by deterioration in economic performance, corruption and bad governance. Inconsistencies in the implementation of economic policies and structural reform measures as well as deterioration of public service and infrastructure ensured decades of low level of FDI inflows (Mohamed, 2016). However after 1980s, Kenya’s economy was characterized by deterioration in economic performance, corruption and bad governance. Inconsistencies in the implementation of economic policies and structural reform measures as well as deterioration of public service and infrastructure ensured decades of low level of FDI inflows.

The objective of the study therefore, is to establish the effect of FDI on economic growth in Kenya with a keen intake on the SEZ’s. It is with the interest of the contribution of the sectors to economic development that it becomes necessary to evaluate the specific contribution of this form of FDI to Kenya’s economic growth (Ocharo, 2014). Despite a growing emphasis on development of SEZ, little research has been done to ascertain the relationship between establishment of SEZ and economic development in Kenya. To establish the possible reasons why Kenya has pursued the SEZ model as one of the ways to enhance its economic growth, it is necessary to draw a relationship between FDI and economic growth. The study therefore seeks to determine the relationship between the establishment of Special Economic Zones and economic growth in Kenya. Specifically, the study will attempt to answer the question on whether FDI in SEZ is likely to succeed or fail in boosting Kenya’s economic growth. In the long run the study would help to explain the broader relationship between special economic zones and economic development. The study hopes to contribute to policy development in alleviating poverty within developing countries, and specifically to provide insight into the extent to which FDI in SEZ reflects a useful model for economic growth. The qualitative aspects of the growth would be useful in guiding government officials to choose the best model for improved economic growth.

2. THEORETICAL REVIEW

Scholars and policy makers agree that the relationship between FDI and economic development is of a complex nature, and that the determinants and effects of FDI on economic growth in host countries are multi-faceted. To first understand this relationship, this research has undertaken a discourse analysis of some of the theories that have attempted to shed light on the determinants of FDI flows in host countries. The review aims to aid the purpose of this study in its quest to understand the linkage between FDI flows in developing countries and economic growth, and ergo the likelihood and extent to which FDI-attracting instruments such as the special economic zones in Kenya may impact on the country’s economic growth.

Initially, the theories of capital market and portfolio investments were used to describe the initiation of FDI (Nayak & Choudhury, 2014). In this regard, the fundamental premise for capital flow was the variation in interest rates between the country of origin of the investment and the potential host country – thus establishing the interest rate theory. According to (Kindleberger, 1969), where there were no uncertainties or risks, capital tended to flow to the regions where it gained the highest return (Nayak & Choudhury, 2014).
Later, theories attempting to explain FDI flows were revisited. Some of the main theories compared FDI flows under perfect market conditions, vis a vis imperfect market conditions. For the purpose of this study, these two perspectives are briefly discussed.

With regard to FDI flow based on the assumption of perfect market conditions, (MacDougall, 1958) and (Kemp, 1964) stated that, assuming a two-country model and prices of capital being equal to its marginal productivity, when there was free movement of capital from an investing country to a host country, the marginal productivity of capital tended to be equalised between the two countries (Nayak & Choudhury, 2014). They found that after investment, the output of the investing country fell without any decrease in the national income of the country, because in the long term the investing country gets higher income from its investment abroad. (Nayak & Choudhury, 2014).

On the other hand, proponents of FDI theories based on market imperfections argued that some form of market distortion (imperfection) had to be in existence for direct investment to be realised. (Nayak & Choudhury, 2014). One such proponent was (Hymer, 1976), who developed the FDI theory approach of industrial organisation, which was one of the first works to explain international production in an imperfect market framework (Nayak & Choudhury, 2014).

According to (Nayak & Choudhury, 2014), Hymer’s theory notes that firms operating abroad have to compete with domestic firms that are in an advantageous position in terms of culture, language, legal system and consumer’s preference; these disadvantages must be offset by some form of market power in order to make international investment profitable. Sources of market power may take the form of patent-protected technology, brand names, marketing and management skills, economies of scale, and cheaper sources of finance, amongst others (Nayak & Choudhury, 2014).

These sources of market power enable monopolistic advantages for the investment firms, which in turn allow them to compete and thrive in the host countries. In the case of special economic zones as an FDI-attracting model, these monopolistic advantages can be exploited to the maximum benefit of the firms. This is because the pre-existing conditions of the model are meant to provide a conducive environment for private investment, by minimising constraints to growth such as poor infrastructure and high costs of production.

Another component of the FDI theory approach that considers market imperfections and is useful in establishing the link between FDI and economic growth of the host country is the Investment Development Cycle or Path (IDP) theory. According to (Nayak & Choudhury, 2014), the theory proposes a link between a country’s level of economic development measured in GDP per capita, and its international investment positions – the net outward FDI stock per capita.

The basic hypothesis is that when a country develops, the conditions encountered by foreign and local firms will change and this will affect the flows of inward and outward FDI, which will in turn impact on the economic structure of the country (Nayak & Choudhury, 2014). In this regard, a host country, through its policies, can influence FDI flows into its economy through its policies.

Despite their different approaches, these theories are unanimous in the general view that a firm moves abroad to reap the benefits of inherent advantages, and that government policies on the domestic economy also play a vital role in encouraging international investment by firms (Nayak & Choudhury, 2014).

### 3. EMPIRICAL REVIEW

The study relies on both quantitative and qualitative approaches. The targeted population include individuals working in the EPZ and SEZ reachable through the ministry of industrialization. The sample study includes all Special Economic Zones that contribute to the Economic Growth of the Country through Foreign Direct Investment (FDI). Data collection relies on secondary methods. According to (The Report: Kenya 2017), Kenya is the seventh-most populated country in Africa, with inhabitants approximately 44.2m and an annual growth rate of 2.6%. More than 50% of the population are under 25 years of age, which means demographically, it consists of young population. With the promulgation of the new constitution in 2010, a lot has happened such as devolution - where significant amount of power has gone to the counties, improved public service delivery and political accountability has been strengthened. In spite of all the efforts made, poverty, inequality and lack of jobs is still looming, as well as insecurity and Al-Shabaab threats, which has threatened the tourism industry significantly thus, affecting the foreign currency reserves. In all these, the government is working hard to put systems in place that will restore the economic dignity of the country, hence the Special Economic Zone (SEZ) approach (The Report: Kenya 2017).
Chinese companies such as Haier took lead in the establishment of the SEZ strategy, which saw the establishment of an industrial zone in Camden, South Carolina, USA, in 1999, which was later endorsed by the central government in 2006. Eventually, it announced a policy decision to establish up to fifty special economic and trade cooperation zones outside the country Hence, the Chinese government identified SEZ projects in about 15 countries and under the 2006 policy, a total of 19 zones were approved in 2006 (World Bank, 2010).

Kenya’s SEZ is historically rooted in export processing zones (EPZs) as apparatus of spurring the economic growth (Kusango & Tzannatos, 1998). Kenya adopted the EPZ Programme following the enactment of the Export Processing Zones Act (Cap 517) (No.12 of 1990) in 1990 as part of its efforts to promote investment, spur economic growth and export trade (Mwega & Ngugi, 2013). Further, The Kenyan Special Economic Zones Act No.16 of 2015 (Kenyan SEZ Act) was adopted by the Kenyan Parliament in February 2015 and came into operation on 15 December 2015. Since the President signed the SEZ Act in September 2015, the government has set up SEZ designated areas in Eldoret, Athi River, Naivasha, Kisumu, Mombasa, Nairobi and Lamu (Gakuyu & Kamau, 2017).

Definition of FDI and SEZs

According to (Spero & Hart, 2010), Foreign Direct Investment (FDI) is defined as ‘Financial Transfer by a multinational Corporation from the country of the parent firm to the country of the host firm to finance a portion of its overseas operations.’ Foreign direct investment has grown immensely in the last three decades. For instance, prior to the recent global economic crisis, global FDI had risen to US $ 1.833 billion in 2007 (UNCTAD, 2013).

Different scholars have defined the term SEZ in different variations. In this paper, we shall look at two definitions of SEZ. First things first, we need to understand that the term “SEZ” covers a broad range of zones. This includes: free trade zones, export-processing zones, industrial parks, economic and technological development zones, high-tech zones, science and innovation parks, free ports, enterprise zones, and others.

Therefore, Farole (2011), defines SEZ as:

Demarcated geographic areas contained within a country’s national boundaries where the rules of business are different from those that prevail in the national territory. These differential rules principally deal with investment conditions, international trade and customs, taxation, and the regulatory environment; whereby the zone is given a business environment that is intended to be more liberal from a policy perspective and more effective from an administrative perspective than that of the national territory. (Farole 2011, p.23).

According to section 4 of the Kenyan SEZ Act (2015), it defines SEZ as:

A designated geographical area where business enabling policies, integrated land uses and sector-appropriate on-site and off-site infrastructure and utilities shall be provided, or which has the potential to be developed, whether on a public, private or public-private partnership basis, where any good introduced and specific services provided are regarded, in so far as import duties and taxes are concerned as being outside the customs territory and wherein the benefits provided under this Act apply. (Kenyan SEZ Act No.16, 2015, p. 243).

As opposed to EPZ, SEZ has some peculiar characteristics: (i) it has a separate customs area; which has duty free benefits and restructured procedures (ii) it offers benefits for investors physically within the zone (iii) it has a single administration; and (iv) it is geographically delimited area, usually physically secured; (World Bank 2008; Farole 2011).

Additionally, SEZ normally operates under more liberal economic laws as opposed to the prevailing laws in the country. SEZs has two main types of benefits, (a) “static” - this includes the economic benefits such as employment generation, export growth, government revenues, and foreign exchange earnings; and (b) “dynamic” – which includes economic benefits such as productivity enhancement of local firms, technology transfer and innovation, skills upgrading and economic diversification (Zeng, 2010).

Foreign Direct Investment and Special Economic Zone

In attracting Foreign Direct Investment (FDI) and fast tracking implementation of the economic pillar under the Vision 2030, Government has put emphasis through the overhaul of legislation, which influence the ease of doing business. In this way, the Government is key in promoting the SEZ since the Export Processing Zones did not meet the expectations on the economy. On 11 September 2015, the President assented to the Special Economic Zone Act, 2015 (SEZ Act) which was then published on 15 September 2015. The SEZ system provides incentives on ease of setting up, investment and
There seems to be a boom of Special Economic Zones (SEZs) across the sphere. Countries around the globe are increasingly exploring the possibilities presented by SEZs, by using their potential to take advantage of the structural transformation in addition to economic development. A study by the World Bank in six SEZ (Ghana, Kenya, Lesotho, Nigeria, Senegal and Tanzania) in comparison with four non-African countries (the Dominican Republic, Honduras, Vietnam and Bangladesh) implies that accomplishment in African zones is partial to a few countries with moderate performances, such as Kenya and Ghana (Farole, 2010).

In the reading of the budget in the Fiscal Year 2015/16, the cabinet secretary of the National Treasury, alluded that the government had allocated KSh3bn ($29.3m) for industrial development, including SEZs. As a result, this reflects the implication that FDI will promote economic growth for the country (Gachahi, 2017).

Seemingly, China tops as one of the success stories in attracting investment and promoting exports through SEZs. Unfortunately, Africa is not doing well apart from a few examples like Mauritius, Ethiopia, Kenya, Lesotho, and Madagascar. The Export Processing Zone (EPZs) that precedes the SEZs, were innovatively establishment to deal with the issues that were recounting nationwide. The first EPZ was built in Chittagong in 1983 (Farole & Akinci, 2011; FIAS 2008).

**Economic Growth and Special Economic Zone**

According to 2019 report by Kenya’s Ministry of Industry, Trade and Cooperatives, Kenya's FDI has registered an increase of over 200 Billion Kenya Shillings. In addition, reviews undertaken by the African Development Bank (AfDB) show that the Kenyan FDI has soared over the years, creating hope for continuous economic growth. It is expected that the establishment of SEZs would contribute to the forecasted growth. The Ministry also notes that for this growth to occur, certain factors must exist, such as a suitable economic environment to enable higher return for invested capital.

The African Growth and Opportunity Act (AGOA), which helps create competitive markets for locally produced items in the special economic zones, has been one of the strategies that has contributed to regional economic growth. It has been observed that the establishment of the SEZ particularly has contributed to rise in Gross Domestic Product (GDP) through increased exports to foreign markets. The arrangements also generate income opportunities for locals working at the firms in the special economic zones.

According to the article, Kenya bets on AGOA to grow apparel exports - African Growth and Opportunity Act.”, 2019, Kenya raked in 380 Million US dollars on textile sales, a position that is expected to improve with better trade deals with world textile consumers. FDI in Kenya has encouraged growth in the textile industry, which had previously collapsed and has increased access to new markets, which create more opportunities for the local industry. In the longer-term, the success of the textile industry would mean a drop in the demand for secondhand clothes, which would eventually create a more balanced trade with other countries. This would also lead to an increase in GDP, translating to more employment opportunities and higher revenues.

Adan Mohamed, the Cabinet secretary, Ministry of Industrialization alluded that the applications for the Local and foreign investors seeking licenses to put up the SEZ, will only be given to the companies that will observe the use of locally produced raw materials to process products for export. He added that it is only quality SEZ investments that will be able to generate sustainable jobs, impart employable skills and create wealth for local communities through the purchase of locally produced raw materials will benefit. Naivasha SEZ is the new kid on the block, and it will enable manufacturing facilities enjoy access to cheap geothermal power and cheap Standard Gauge Railway transport to Mombasa Port (Business Daily Africa, 2018).

A good example to look at would be the Kenya’s Standard Gauge Railway (SGR) which is part of FDI from the China Government. Seemingly, this is China’s new “Belt and Road Initiative,” which aims to open East and Central Africa up to Chinese trade and investment. As much as the project was marred with controversy just like other Chinese infrastructure projects in Africa, we choose to look at the glass half full and on the positive side, the project has created development opportunities for locals such as jobs, and skills development (Brautigam D, Farole T & Tang Xiaoyang T, 2010).
4. CONCLUSION AND RECOMMENDATIONS

FDI is important for any emerging economy. They narrow down the gap between domestic in house investment and facilitate technology and knowledge transfers from regions of abundance to regions of insufficiency, majorly, the developing economies. However, studies from the research, dictates that FDI has had a positive impact on Kenya’s Economic Growth. Specifically in the case of the Special Economic Zones, which has played a vital role in advancing industrial development, attracting foreign direct investments (FDIs), creating jobs, strengthening export capabilities and acting as experimental for the application of emerging policies and approaches (World Bank, 2014). This has therefore justified the nation’s determination to shift from EPZs that have restrictions and limited interaction with the domestic market to the wider opportunity, SEZs which enjoys an expanded interaction with the domestic market (Economic Survey, 2016).

It is also clear from several scholars and research which ascertain that foreign firms through SEZ are able to certainly affect the levels of productivity and growth rates in the markets they operate from and promote skill upgrading, increase employment and innovation. This means that FDI is a catalyst of economic growth. The concept of SEZ has been widely applied and its acceptance has gained momentum globally as it has an impact that is more positive on economic growth. Conversely, the mixed outcomes of SEZ development in different countries illustrates that it is not ‘one-size-fits-all’. Therefore, it needs to be implemented with caution and tailored into a country’s specific situation. Given the diverse and complex environs in which zone programs are implemented, a clear framework to guide the operations of SEZs in countries where they are deemed relevant to establish would be vital and prudent.

Under the vision 2030, the new Kenya - China partnership, could be explored to transform Kenya into a newly industrialized 'middle-income country providing a high quality life for its inhabitants by the year 2030. Therefore, the establishment of Special Economic Zones is Strategic to the achievement of this vision.

REFERENCES


