

INTERVENING EFFECT OF INTERNATIONAL COMPETITIVENESS ON THE RELATIONSHIP BETWEEN TAX INCENTIVES AND FOREIGN DIRECT INVESTMENT AMONG THE EAST AFRICA COMMUNITY PARTNER STATES

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Abstract

Countries around the world employ different efforts aimed at attracting more FDI, top most being tax incentives. Appropriate fiscal policy framework establishes tax incentive that improves country's investment climate. However, tax incentives may at times not adequately compensate for poor investment climate in developing countries resulting from poor infrastructure, lack of trade openness, weak judicial system, small market size and most importantly political instability. Therefore, this study sought to determine the moderating effect of investment climate on the relationship between tax incentives and FDI among the East Africa Community partner states. The study was carried out using data relating to the five states in the East Africa Community: Tanzania, Rwanda, Kenya, Burundi, and Uganda. Secondary data covering a period of 15 years from 2002 to 2016 was used. The results revealed that tax holiday and the period of losses carried forward had an insignificant and positive relationship with FDI inflows but investment allowances had an insignificant negative relation with FDI inflows. The study revealed that consumer prices and tax holiday had a positive and statistically insignificant relationship with FDI and that investment allowances and the period of losses carried forward had a negative and statistically insignificant relationship. The findings also revealed that tax holiday and export growth had a negative and statistically significant relationship while investment allowances and the period of losses carried forward and export growth had a negative and insignificant relationship. The findings further revealed that consumer prices had a statistically insignificant positive relationship with FDI inflows while export growth had negative and statistically insignificant relationship with FDI. Finally, the study found that tax holiday, consumer prices and export growth had negative and statistically insignificant relationship with FDI while investment allowances and the period of losses carried forward had a positive and statistically insignificant relation with FDI.

Keywords: International competitiveness, Tax Incentives, Foreign Direct Investment, East Africa Community Partner States

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Introduction

Foreign Direct Investment (FDI) is considered a pivotal driving force of global economic integration. It is regarded as one of the factors developing and transitioning economies use to enhance their economic development and a country not attracting FDI is at risk of not accessing the main sources of economic growth (Estrin & Uvalic, 2014; Bhensdadia & Dana, 2004). Foreign investment is associated with skills transfer and creation of employment. Due to the critical role, FDI plays in promotion of economic growth many countries have come up with different tax incentives to attract foreign investors (Fletcher, 2002). According to World Bank (2012) FDI is the flow of investments to a nation state different from the investor's home nation state with the objective of having lasting interest in the host country. Easson (2004) argues that there are two types of investments affected by international fiscal policies, foreign direct investment and portfolio investment.

FDIs takes a number of forms among them Greenfield investments (real investments in factories or production plants), joint ventures (creating global strategic alliances), brown field investments (acquiring existing manufacturing facilities to start a new production line) and cross border mergers and acquisition (Zolt, 2015). Each of the four forms of FDI can take any of the following four major objectives namely: strategic assets acquisition, natural resources exploitation, efficiency seeking and market exploitation (Dunning, 1977). Market seeking firms consider horizontal strategy to penetrate the host country domestic markets. The aim is to serve the surrounding markets with locally produced commodities. Therefore, host countries' economic growth prospect, market size, openness and accessibility to neighboring markets are key considerations in deciding whether

to invest in the host country (Vijayakumar, Sridharan & Rao, 2010).

Efficiency seeking multinationals employs vertical integration strategy to minimize cost of production especially in developing countries. Most of the activities are moved to where the production takes place and seeks to minimize cost by controlling the entire process from production to marketing. A resource seeking Multinational Corporation (MNC) invest in countries with rich natural resources, which they use as raw materials and take advantage of cheap labor force and physical infrastructure (Kinoshita & Campos, 2006). The objective of strategic asset seeking MNC is to take advantage through strategic location, which helps it take advantage of foreign networks, advanced technology, organizational abilities, market intelligence, management expertise innovation as well as access to research and development (Cleeve, 2008).

Tax incentives on the other hand entails are all forms of unique tax dealings targeted to particular sectors or activities only, unlike universal tax treatment applied to all (Klemm, 2010). Tax incentives are also referred to as fiscal incentives. Bolnick (2004) defines tax incentives as fiscal action by governments to attract both domestic and international investment in particular to key sectors of the economy. Tuomi (2011) further defines tax incentives as a facility by government that awards investors' advantageous environment that departs from the normal tax legislation.

UNCTAD (2000) classifies tax incentives into twelve different ways: investment allowances, tax holidays, losses carried forwards, reduced corporate income tax rate, investment tax credits, deductions for qualifying expenses, tax credits for value addition, zero or reduced tariffs, preferential treatment of long capital gains, credits for foreign hard currency earnings,

employment based deductions and reduced taxes on dividends/ interest paid abroad.

Provision of tax holiday is a situation where new foreign investments are exempted either partly or completely from payment of corporate tax income for a specified number of years mostly five years (UNCTAD 2000). In spite of criticism, tax holidays are the most popular form of tax incentive in EAC and in most jurisdictions around the world. Its popularity emanate from the fact that it is easy to implement and does not involve actual cash out flow payment by the host nation. However, it has been opposed because of its several shortcomings. James (2013) identified some drawbacks associated with the tax holiday. Firstly, it is a blanket benefit not related to the amount of capital investment or growth of the investment. Secondly, companies with foreign subsidiaries are able to use tax holiday for transfer pricing practices. That is channeling profits from another jurisdiction to where tax holiday is being enjoyed. Thirdly, firms enjoying tax holidays for a specified number of years have incentives to close and relocate to another country after the expiry of the tax holiday period.

Investment allowances takes the form of special zones investment allowances, accelerated depreciation, Investment tax credit, timing differences (Klemm & Parys, 2012; James, 2013). Investment allowances have various advantages. Firstly, they are only offered when the actual investment has occurred which in actual sense is the real aim of permitting the fiscal incentives and secondly they are not complicated to implement. However, they have been criticized because they cause distortions between old established investment and new investments (Klemm, 2010).

International competitiveness of a country is the extent to which, a country in a free and fair market situation, can be the

preferred investment destination for a firm that seeks to invest internationally (Knoll, 2012). It refers to the ability of a country to spur economic growth by being the preferred investments destination by multinationals, as opposed to its peers without running into balance-of-payments difficulties (Fagerberg, 1988). According to Kharlamova and Vertelieva (2013), international competitiveness is the capacity of nations to build and sustain favorable atmosphere in which enterprises can effectively compete. The study has conceptualized international competitiveness as an intervening variable in the relationship between tax incentives and FDI. Consequently, trade related measures of international competitiveness that are triggered by presences of tax incentives are considered in the study. These trade related indicators comprises of export prices, consumer prices and export growth (Swagel, 2012).

The East African Community (EAC) is an intergovernmental regional bloc formed by six countries namely Tanzania, Rwanda, Kenya, Burundi, South Sudan and Uganda headquartered in Arusha, Tanzania (Penev & Marusic, 2014). EAC is among eight other regional economic communities (RECs) in Africa that are duly recognized by African Union (AU) and the only one with a stated vision in its founding treaty of creating a political federation (Tharani, 2017). According to EAC Secretariat (2016), the population of EAC partner states excluding Southern Sudan was 150 million people by the end of 2015. The bloc was initially founded in 1967 but collapsed in 1977; however, it was resuscitated on seventh, July 2000 by signing of a treaty by the original three partner states Tanzania, Kenya and Uganda with a vision to generate wealth and boost the global competitiveness of the region by improved production, trade and investments. The collapse of initial EAC in 1977 was attributed to several

factors including: inadequate political will, non-involvement of private sector, not engaging civil society, issues around sharing of EAC benefits among the Partner States and lack of proper procedures to solve grievances (Penev & Marusic, 2014).

The community established a custom union in 2004, which encompassed common external tariffs and a free trade area and in July 2010, a common market was ratified by the member states. A common market enables members states to operate a single market for goods, capital, labour, services, free movements of citizens, enacting of common trade and revenue laws. This greatly advantages the member states by allowing them to take advantage of economies of scale through large-scale production (Gastorn & Masinde, 2017). Notwithstanding coming up of EAC's common market there still, exists barriers on free movement of goods capital and services negatively affecting its FDI attractiveness (Penev & Marusic, 2014). Currently, the member states are working on establishing monetary union. The East Africa Assembly in April 2018 passed a bill creating East Africa monetary institute. The institute is charged with preparatory works for establishing East African Monetary Union (EAMU). According to (Union & UNECA, 2016) the EAC is the most integrated and ambitious regional economic community bloc among the eight regional economic communities in Africa. However more work need to be done on integration process as it was noted by Reith and Boltz (2011).

Governments in EAC continue granting tax incentives to attract FDI despite heavy criticism from various stakeholders. Tax incentive in EAC benefits the countries differently and in some extreme cases benefit MNCs to the detriment of local governments. The effectiveness of tax incentives to attract FDI will thus, largely depend on the context. Countries with good investment climate will be more

effective in luring FDI compared to states with poor investment climate (Bolnick, 2004).

In June 2016 budget, Rwanda introduced more incentives to foreign investors by scrapping corporate income tax for foreign companies that invest more than USD 10 million and have their headquarters' in Rwanda. Those investing more than \$ 50 million will enjoy tax holiday for seven years. The Rwanda government has also increased capital allowances relief, from 40 percent to 50 percent, for investments made in the capital, Kigali. A reduced income tax rate of 15 percent has also been introduced for priority sectors such as manufacturing, energy, tourism and information and communication technology (TJN-A, 2016).

Tanzania also continues to provide a variety of incentives. Income tax holiday of up to 10 years is given to companies operating in the export processing zones (TJN - A, 2016). Kenyan government in 2015 introduced more tax incentives through a new special economic zones Act, 2015. Companies registered under this arrangement will enjoy lower corporate tax rate (CIT) at 10% for the first 10 years and 15% for the next 10 years. The Kenya finance Act, 2016 brought in apprenticeship tax incentive. The employers who employ at least 10 university graduates for a period of six months or more will enjoy a tax rebate (Kenya Finance Act, 2016).

FDI inflow in EAC was almost nonexistent in 1990s. However, noticeable inflow begun in 2000s (Penev & Marusic, 2014). Since 2001, the FDI inflow increased resulting to an increased FDI inflow to GDP ratio from an average value of 12.9% recorded in 2001 to 19.4%, which was recorded in 2013. Statistics however show that there is a room for improvement in FDI inflows among the EAC Countries in comparison with other African countries. In the whole of Africa,

the ratio of FDI inflows to GDP was 33.2% in 2013 compared to 19.4% recorded within the East Africa region (Penev & Marusic, 2014). The rest of the paper is organized as follows: Review of theoretical and empirical literature, the methodology used, the results and the study conclusions.

Theoretical and Empirical Literature Review

Dunning (1977) provided theoretical justification as to why firms find it necessary to locate their manufacturing business abroad instead of exporting. Using eclectic theory, he observed that for a company to make a decision to invest in a foreign country it must pose some advantages over and above the local companies. Some of these factors include labour costs, government incentives and raw materials. The advantages will make the products of the company competitive. One of factors, which can help to reduce the cost of production of foreign companies, is tax incentives. Neoclassical investment theory by Jorgenson (1963) argues that reduction in cost of production leads to accumulation of investment. Countries which offers tax incentives reduces cost of production for Multinational Enterprises (MNCs) resulting to more investment by multinational companies in such countries (DeMooij & Ederveen, 2003).

Evidence from empirical studies on the influence of tax incentives on FDI flows is inconclusive and most studies have produced results oscillating from significant to insignificant effect. Studies explored indicating tax incentive have a significant effect on FDI are: Olaleye (2016); Ahmed (2015); Munongo (2015); Lee (2012) while those showing insignificant effects include: Peters and Kiabel (2015); Tuomi (2011); Chai and Goyal (2008).

Olaleye (2016) carried a study on the effect of tax incentives on FDI in Nigeria

for period of 10 years (2005 to 2014). The study used descriptive research design targeting 74 listed manufacturing companies. Stratified purposive sampling technique was used. The study established that FDI in manufacturing sector in Nigeria was greatly influenced by provision of tax incentives.

A study exploring the relationship between taxation and FDI in Bangladesh from 2001-2010 was carried out by Ahmed (2015). The data was analyzed using regression, correlation and descriptive statistic. The dependent variable FDI was measured using FDI net inflow (% of GDP) while corporate taxation which was the independent variable was measured using corporate tax rate (CTR). The study used inflation, GDP and exchange rate as the control variables. There was negative significant relationship between FDI and CTR. There was however negative statistically insignificant relationship between FDI and exchange rate. FDI was positively insignificantly related to GDP whilst FDI had positive significant association with inflation.

A study on the effectiveness of fiscal incentives in luring foreign investments in Southern African Development Community (SADC) was carried out by Munongo (2015) for the period 2004 to 2013. The study used panel data model. The study found that tax incentives were important in attracting FDI in the SADC region. A study by Lee (2012) in the export sector of the People's Republic of China (PRC) found that tax incentive influences location decisions of investors. The study used Resource flow model and comparative advantage analysis and established that by reducing corporate tax and value added tax investors were attracted to invest in Taipei, China and Hong Kong processing trade sector. Conversely, a study by Peters and Kiabel (2015) to established influence of tax incentives in an investor's decision to locate business in Nigeria found that

increase in tax incentives do not lead to corresponding increase in FDI. The study used error correction modelling model. Using micro data and firm interviews to determine drivers of FDI in South Africa Tuomi (2011) found that tax incentives play a negligible role in influencing location of FDI. Chai and Goyal (2008) carried out a study in Eastern Caribbean Currency Union on the relationship of tax concessions and FDI. The study established that the revenue foregone due to the tax concessions was very huge while on the other hand FDI did not seem to depend on the tax incentives.

Methodology

A longitudinal descriptive survey was used in this study. The design was appropriate

since it involved data relating to a period of time. The study was carried out in the five states in the East Africa Community: Tanzania, Rwanda, Kenya, Burundi, and Uganda. South Sudan was excluded because of lack of data. The main source of the data were published Ernst and Young worldwide tax data, UNCTD, EAC secretariat; World/African Development Indicators of the World Bank, World Resource Institute, tax and finance Acts of the individual countries and Partner states tax Authorities and OECD. The unit of analysis was the individual partner states. The data covered a period of 15 years from 2002 to 2016 and the analytical tool use was the multiple linear regression. The model was formulated as follows:

Stepwise regression analysis to test the intervening effect of international competitiveness on relationship between tax incentives and FDI in EAC

$$\text{Step1: } FDI_{ct} = \beta_0 + \beta_1 X_{1ct} + \beta_2 X_{2ct} + \beta_3 X_{3ct} + \varepsilon$$

$$\text{Step2: } Interc_{ct} = f(TI_{ct})$$

$$\text{Step3: } FDI_{ct} = \beta_0 + \beta_1 Interc_{ct} + \varepsilon$$

Step 4:

$$FDI_{ct} = \beta_0 + \beta_1 TI_{ct} + \beta_2 Interc_{ct} + \varepsilon$$

Where; FDI =Foreign Direct Investment in country (c) at time (t)

TI_{ct} = Tax incentives in country (c) at time (t)

$Interc_{ct}$ = International competitiveness in country (c) at time (t)

β_1, β_2 = Regression coefficients

β_0 = intercept

t = time period

ε = Error term

Stepwise regression Analysis

$$\text{Step 1: } FDI_{ct} = \beta_0 + \beta_1 TI_{ct} + \beta_2 Investc_{ct} + \varepsilon$$

Step 2:

$$FDI_{ct} = \beta_0 + \beta_1 TI_{ct} + \beta_2 Investc_{ct} + \beta_3 TI_{ct} * Investc_{ct} + \varepsilon$$

Where; FDI =Foreign direct investment in country (c) at time (t)

TI_{ct} = Tax incentives in country (c) at time (t)

$Investc_{ct}$ = Investment climate in country (c) at time (t)

β_1, β_3 = Regression coefficients

β_0 = intercept

t = time period

ε = Error term

Results and Findings

Descriptive Statistics

Table 1 shows a summary of the results from the five East African partners' states from 2002 to 2016.

Table 1: Summary of Descriptive Statistics for the Study Variables

Variable	Obs	Mean	Std. Dev	Min	Max	Skewness	Kurtosis
FDI inflows (Ratio of FDI to GDP)	75	.0275052	.0403863	0	.3333932	.990	1.206
Tax holiday (No of years)	75	7.973333	3.921436	0	10	-1.505	.349
Investment allowances (Rate in percentage)	75	.3123213	.0819039	.17	.435	.148	-1.156
Losses carried forward (No of years)	75	7.506667	2.601316	4	10	-.110	-1.985
Export Prices (Log of export unit price index)	75	2.240089	.1628207	1.908832	2.508359	-.302	-.901
Consumer prices (Log of CPI)	75	1.957497	.1689259	1.613456	2.220607	-.159	-1.176
Export Growth (Ratio of export growth)	75	.1248365	.1580736	-.285787	.5085437	.046	.411

Source: Researcher (2018)

The descriptive results for the five countries show that FDI inflows had a mean of 0.275 with the minimum and maximum values being 0 and 0.3333932 respectively thus an indication there was a country which had zero FDI inflows. The average number of years for tax holiday was 7.97 hence an indication that most nations offer a tax holiday of more than 8 years. The results also depict that the average rate of investment allowances for the five nations was 0.3123 with minimum and maximum values being 0.17 and 0.435 respectively while the average number of years for carrying losses forward was 7.50 with minimum and maximum values of 4

and 10 years respectively. The results on international competitiveness indicate that the average value of export prices was 2.240, minimum of 1.908 and maximum value of 2.508 and the average value of consumer prices was 1.957 with minimum and maximum values of 1.90883 and 2.508359 respectively. The results show that the average export growth value of 0.1248 with the minimum and maximum values being -0.285787 and 0.5085437 which indicates some country's had negative growth in exports in some of the years within the study period.

Correlation Analysis

Correlation analysis was carried out to determine the strength and the nature of the relationship between the study

variables. The Karl Pearson correlation coefficient was used in this study to determine the correlation among the study variables. Table 2 shows the results

Table 2: Correlation Analysis

	FDI inflows	Tax holiday	Investment allowances	Losses carried forward	Export Prices	Consumer prices	Export Growth
FDI inflows	1						
Tax holiday	.080	1					
Investment allowances	-.095	.636**	1				
Losses carried forward	.315**	.399**	-.242*	1			
Export Prices	.187	-.134	.075	-.216	1		
Consumer prices	.146	.157	.151	-.110	.803***	1	
Export Growth	-.154	-.413**	-.245*	-.169	-.028	-.370**	1

The results on Table 2 show that there is a weak and positive correlation (0.080) between tax holiday and FDI while investment allowance has a weak and negative correlation (-0.095) with FDI. On the other hand, there is a weak and positive correlation between the period of losses

carried forward (0.315) and FDI inflows. There is a weak and negative correlation between tax holiday and export prices (-0.134) and export growth (-0.413) but a weak and positive correlation between tax holiday and consumer prices (0.157) respectively. The results further show that there is a weak and positive correlation between investment allowances and export prices (0.075) and consumer prices (0.151) but a negative and weak correlation between investment allowances and export growth (-0.245). Further, according to the

finding, there is a weak and negative correlation between the period of losses carried forward and export prices (-0.216), consumer prices (-0.110) and export growth (-0.169) respectively.

Regression Analysis

The indicators for international competitiveness were consumer prices measured using the consumer price index and export growth measured using the export growth ratio. To achieve this objective, stepwise panel regression analysis as advocated by Baron and Kenny (1986) involving four steps, was used test the intervening effect of international competitiveness on the relationship between tax incentives and FDI in EAC. The hypothesis of this study :

H1: The intervening effect of international competitiveness in the relationship

between tax incentives and FDI in EAC

partner states is not significant

Table 3: Regression Analysis

Linear regression, heteroskedastic panels corrected standard errors						
Group variable:	Countryid		Number of obs	=	75	
Time variable:	Year		Number of groups	=	5	
Panels:	heteroskedastic (balanced)		Obs per group: min	=	15	
Autocorrelation:	no autocorrelation		avg	=	15	
			max	=	15	
Estimated covariances =		5	R-squared	=	0.0331	
Estimated autocorrelations =		0	Wald chi2(5)	=	2.48	
Estimated coefficients =		3	Prob> chi2	=	0.2887	
FDI inflows	Coef.	Het-corrected Std. Err.	z	P> z	[95% Conf. Interval]	
Consumer prices	.0249629	.0270819	0.92	0.357	-.0281166	.0780425
Export growth	-.0294028	.0294905	-1.00	0.319	-.087203	.0283974
_cons	-.0176891	.0541954	-0.33	0.744	-.1239101	.0885319

The results on the relationship between international competitiveness and FDI on Table 5.12 shows that consumer prices had a positive (B = 0.0249629) and statistically not significant (P value = 0.357>0.05) relationship with FDI inflows. The findings also indicate that export growth had negative growth (B = -0.0294028) and statistically insignificant (P value = 0.319>0.05) relationship with FDI inflows.

In addition, the results revealed that international competitiveness indicators account for 3.31% of FDI inflows among the East African Community partner states as shown by the R square value of 0.0331. These findings indicate that international competitiveness does not significantly influence FDI hence there was no intervening effect of international competitiveness on FDI inflows among the East African community partner states.

Summary and Conclusions

The study revealed that consumer prices and tax holiday had a positive and statistically insignificant relationship with FDI and that investment allowances and the period of losses carried forward had a negative and statistically insignificant relationship. The findings also revealed that tax holiday and export growth had a negative and statistically significant relationship while investment allowances and the period of losses carried forward and export growth had a negative and insignificant relationship. The findings further revealed that consumer prices had a statistically insignificant positive relationship with FDI inflows while export growth had negative and statistically insignificant relationship with FDI. Finally, the study found that tax holiday, consumer prices and export growth had

negative and statistically insignificant relationship with FDI while investment allowances and the period of losses carried forward had a positive and statistically insignificant relation with FDI.

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