Determining The Impact of Political Instability and National Security on Foreign Direct Investment in Kenya

By: Wilfred Mutubwa*, Ian Mwangi**, Beatrice Kavata***, Michelle Kananu**** & Matthew Mbelenga*****

Background

Kenya was a prime choice for foreign investors seeking to establish a presence in East Africa during the 1960s and 1970s.1 Because of politically driven economic policies, rampant corruption, government malfeasance, poor infrastructure and substandard public services during the 1980s, foreign direct investment (FDI) was discouraged.2 Over the past three decades, Kenya has been an under-performer in attracting foreign direct investment with the middle of the last decade being marginally better in attracting FDI.3

Historically, Kenya has been faced with attacks, some of which include- the US Embassy bombing in Nairobi in 19984 as well as the devastating

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*Wilfred Mutubwa LL. D (Designate) FCIArb Chartered Arbitrator  
**Ian Mwangi LL.B (Riara)  
***Beatrice Kavata LL.B (Riara)  
****Michelle Kananu LL.B (Riara)  
*****Matthew Mbelenga LL.B (Riara)

2 Ibid 1.  
3 Ibid 1.  
attack on Kenya’s Westgate shopping mall on Saturday, September 21, 2013 that left 67 individuals dead. During this period, Kenya’s economy dwindled as Somalia being in the immediate geographical proximity, further posed as a threat to Kenya’s national security. During this time, the studies to the effects of national security on FDI were increasingly gaining popularity. This was propounded by the devastating events in the United States on September 11, 2001 where a series of four coordinated terrorist attacks by the Islamic terrorist group al-Qaeda, resulted to the death of up to 2,996 people with multiple casualties that in turn caused over $10 billion in infrastructure and property damage. Moreover, in a study on the impact of terrorism on Foreign Direct Investment in Pakistan, the results indicated that due to the number of terrorist attacks, foreign investors posed negative interests to invest money in Pakistan.

Khan, writing on the impact of political risk on foreign direct investment, accounting for 94 countries over a span of 24 years from 1986-2009, found that most of the political risk indicators resulted to a negative relationship with FDI. This relationship affects the world entirely and, also, the high-income countries, with it being strongest for the upper middle-income countries. All this negatively affected the 1980s, when the influx of FDI surged primarily due to the drying up of commercial

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5 Ibid 1.
6 Ibid 1.
7 Ibid 1.
11 Ibid 10.
bank lending to the developing economies that forced most countries to ease restrictions and offer tax incentives and subsidies to attract foreign capital.\(^\text{12}\) As this was a period when most African countries had transitioned into independence from their various colonies.\(^\text{13}\) Today-political wrangles shake up the economy of a country as a whole, as this also poses a threat to the national security of a country that results to a decrease in the attraction of FDI as exhibited in Kenya during the 2007-2008 post-election violence.\(^\text{14}\) Not only Kenya but also other African countries like South Africa, Zimbabwe, DR-Congo among others.

**Conceptual Framework**

Foreign direct investment herein referred to as FDI is generally thought as outcome of mutual interest of multinational firms and host countries. It is defined as a form of long-term international capital movement, made for the purpose of productive activity and accompanied by the intention of managerial control or participation in the management of a foreign firm. The essence of FDI is the transmission of a package of capital, managerial, skill and technical knowledge to the host country. As per the International Monetary Fund definition, 'FDF is an investment made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor.'\(^\text{15}\) The investor's purpose being to have an effective voice in the management of the enterprise.

\(^{12}\)Ibid 10, pp 2.

\(^{13}\) Alistair Boddy-Evans, Chronological List of African Independence, \((\text{Thought Co. 25 January 2020}),<\text{https://www.thoughtco.com/chronological-list-of-african-independence-4070467}>\text{accessed 1 October, 2020.}\)


A direct investment typically takes the form of a foreign firm starting a subsidiary or taking over control of an existing firm in the country in question. It is the direct type of investment, which is associated with Multinational Corporation because most of the FDI is transferred through firms and remains outside of the ordinary functioning of markets. It is noteworthy to note that FDI should not be confused with Profitability index herein referred to as PI because PI does not seek management control, but is motivated by profit. FDI occurs when individual investors invest, mostly through stockbrokers, in stock of foreign companies in foreign land in search of profitable opportunities.

FDI can be defined in both qualitative and quantitative bases. 'Qualitatively', it is about ownership and control. FDI is done by companies with the intent of having sufficient ownership to ensure a partial or total say on a lasting basis in the management of a corporate entity located in a foreign country. In other words, a company based in the home country has at least a meaningful long-term voice in shaping output, production and marketing strategies, constructing corporate budgets, selecting senior managers, dealing with labour relations and approving new product development in a company incorporated and doing business in the host country. FDI is about long-term, perhaps permanent relationship that could have a significant financial impact (either good or bad) on the foreign company making the investment. It involves relatively large transfers of capital that cannot easily be reversed. While 'quantitatively' i.e. universally accepted definition of FDI is ownership of at least 10 per cent of common stock of a business

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16 The concept of FDI https://shodhganga.inflibnet.ac.in/bitstream/10603/53001/9/09 Accessed on 9th april,2020

enterprise operating in a country other than the one in which the investing company is headquartered.

In order to understand the concept of FDI in a simple manner, it is imperative here to give an outline about the various Components of FDI. These components are as follows:

1. Equity Capital,
2. Re-invested Earnings,
3. Other Capital (mainly intra-company loans)

FDI has been the most prominent source of international financing which has been instrumental in creating assets in an economy. The advocates of increased volumes of FDI argue that in terms of foreign investment, it is the direct investment that should be actively sought for and doors should be thrown wide open to FDI. FDI brings huge advantages with little or no downside.

FDI is perceived superior to other types of capital inflows because of some specific reasons that are listed below:

i. FDI inflows are less volatile and easier to sustain at times of crisis in comparison to portfolio investors and foreign lenders because foreign direct investor typically have a longer-term perspective when making investment in a country.
ii. FDI is most prominently used for productive purposes while debt inflows may finance consumption rather than investment in the host country.
iii. FDI is expected to have relatively strong positive effects on economic growth of the host country because besides providing capital, it offers access to internationally available technology, capital goods, raw materials, technical know-how etc.
The risk-sharing properties of FDI are undisputed. For example, in India where they depend on external funding from foreign states. This suggests that FDI is the appropriate form of external financing for developing countries. Moreover, the volatility of FDI remained exceptionally low in 1990s, when several emerging economies were hit by financial crises. FDI is widely considered an essential element for achieving sustainable development. Even former critics of Transnational Corporation (e.g. UNCTAD) expect FDI to provide a stronger stimulus to income growth in host countries than other types of capital inflows. Especially, after the recent financial crises in Asia and Latin America, developing countries are strongly advised to rely primarily on FDI, in order to supplement national savings by capital inflows and promote economic development.

Foreign investment, particularly FDI has significant advantages over external loans and other forms of financing the resource gap. Generally, the repayment of FDI is cheaper in comparison to loans and commercial borrowings. For Instance, FDI takes the form of repatriation of a certain percentage of earnings in the form of dividend of an enterprise only when it reaches at the stage of commercial profitability.

Foreign investment in Kenya and other African countries has already been unpacked and its various components like capital, technical know-how, management, marketing skill, etc. have been absorbed. That is why, in certain cases, FDI is considered to be much less expensive and much more productive than commercial borrowings where repayment starts normally from the second year, further which is at very high rate of interest. In addition, the type of technology imported through FDI is

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likely to be up-to-date technology, as the foreigners would have interest in follow up action since their financial stock is involved. In addition to technology, FDI is accompanied by management expertise in manufacturing and quality culture, all in a single package. 19

Therefore, it should be noted that FDI can open up export markets because of the marketing expertise, global contacts and outlets of the parent firms. In the case of FDI, the risk of fluctuations in the value of currency is also borne by the foreign investor. The sequencing and prior generation of resources by a Joint venture can usually reduce the strain of higher inflow of foreign exchange over time. Thus, it can be said that there is a growing global realization that it is much better to rely on foreign equity investment, rather than on external commercial loans and foreign portfolio investment, especially when major structural changes are being introduced in the economy. 20

National Security and Foreign Direct Investment

Foreign Direct Investment is considered as a blessing in most developing countries. The current trends of globalization are encouraging the developing countries to increasingly focus on how more to attract more Foreign Direct Investment to boost up their economies. This is possible only when investors are ready to invest in a particular economy. Foreign investors prefer to invest in countries where they their investment is secure and that which will generate higher returns than other possible countries. Therefore, countries facing


20Publishing OECD and International Monetary Fund, OECD Benchmark Definition of Foreign Direct Investment 2008 (Organization for Economic Co-operation and Development 2009), pp.44
the problem of terrorism are hardly attractive to overseas investors due to the issue of insecurity.  

Terrorism being a worldwide crime makes it a transnational issue, which needs to be tackled in totality. The following are some of the terrorist attacks that happened in Kenya since 1980-2019; Norfolk Hotel Bombing, United States Embassy Bombings, Kikambala Hotel Bombing, Al-Shabaab Attacks, Westgate Mall Shooting, Mpeketoni Attacks, Garissa Attack and finally the Nairobi Dusit d2 Complex Attack. These actions of terrorism not only have severe economic, political, social and psychological implications in the country but also there is the withdrawal of Foreign Direct Investment (FDI) by countries and countries due to the direct destruction of infrastructure and the rise of operational costs as a result of high demand for security.

The economic dimension of terrorism concerns losses in Foreign Direct Investment, damages infrastructure, output losses, security costs, reduced economic growth, reduced tourism and trade losses which in developing countries it is more likely to have more impact on the country’s economy than terrorism in a developed country. On affecting tourism, even if the companies themselves aren’t targeted, the risk of terrorism forces investors to implement more security measures and offer compensation to the personnel, thus reducing their returns. For that reason, the investors would opt to redirect their business to safer countries even if salaries are higher. Insecurity may also direct economic resources for highly productive sectors to less productive

sectors thereby crowding out investment. This will not only reduce the GDP of the country and fuel inflation but also reduce the flow of foreign direct investment.\textsuperscript{23}

Terrorism being costly, not only stagnates the growth of Foreign Direct Investment but also the development of any country. One of the non-economic arguments as to the importance of International Trade is that it brings peace meaning that countries that are at peace, are likely to establish a trade relationship. This goes the same for the vice-versa. This in turn means, on the conflict between countries and its relationship with trade, more war leads to less trade, which will in turn affect the Foreign Direct Investment of a country.\textsuperscript{24}

The Kenyan government has been losing finances on security measures caused by the terrorist attacks. Evidently, this can be seen in 2011 when the country launched an operation in Somalia which was dubbed as operation ‘Linda Inchi’ which turned out to be a very expensive operation that was undertaken without regard for the cost that was going to be incurred. The purpose of the operation was to safeguard the country against attacks by the Al-Shabaab who were taking hostages of the ships carrying the goods through the Indian Ocean to the port of Mombasa. In doing this, the Kenyan government hoped to provide assurances to the West and lucrative tourism industry, which pumped in


a great amount into the country’s economy since the attack, was causing a lot of decrease on the country’s revenue.\textsuperscript{25}

The Westgate Shopping Mall shooting left a significant negative economic crisis. This forced the Government of Kenya to launch an investigation to determine who the perpetrators were and the extension of their attack. The shopping mall always being a constant flow by foreign customers, the attack’s direct effect was that there was a reduction of visits to the country, which in turn led to the decrease of foreign direct investment from the global firms that were donors, or investors of the mall.

In conclusion, Terrorist attacks economically affects a country negatively. In the Kenyan situation, the country has been subjected to terror attacks, which target foreign interests that eventually end up harming the country more than the intended targets, which in turn affects the Smooth flow of Foreign Direct Investment of the country. This means that investors will most of the time be reluctant to inject their money into the country’s economy because of the fear of the terrorist acts, which do not guarantee a safe and peaceful environment in which business can be conducted.\textsuperscript{26} Therefore, we can see that there is a direct relationship between Foreign Direct Investment and terrorism. This is to show that if a country has high levels of security, there will be an increase in the Foreign Direct Investment while the vice-versa would be a higher level of insecurity (terrorism) would lead to the reduction of Foreign Direct Investment of a country. Therefore, measures need to be taken up which will help combat insecurity that


\textsuperscript{26} Ibid 20, pp 38.
will in turn attract investments from foreigners which hence will lead to an increase of Foreign Direct Investment in the country.

**Impact of Political Instability on Foreign Investment**

Political instability is defined as the potential for sudden and significant change in the leadership of a country. The widespread occurrence of political instability in several countries across time and its negative effects on their economic performance has arisen the interest of several economists. Political instability is the tendency of a government collapse. This may either be due to the conflicts or extensive competition between various political parties. The index of Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism. Without a shadow of doubt, this affects the foreign investment in that country.

In general, political instability affects the investment climate negatively which in turn reduces Foreign Direct Investment (FDI) inflows and would result in slow growth of the economy. Many developing countries in the world are not politically stable and mostly they suffer from poor quality of governance. A country’s political risks is a crucial factor which is considered by foreign investors while making an investment decision. Today’s political risks are not the classic risks associated with communist takeovers or post-colonial outbursts of anti-foreign sentiment. They are more subtle, arising from legal and regulatory changes, government transitions, environmental and human capital factors.

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rights issues, currency crises and terrorism. Because these risks are subtle (often occurring at the same time as the government is declaring the country “open for business” they are often hard to manage.  

International law that has arisen over time to protect foreign investors’ rights from exploitation by the host Nations serves to mitigate these factors but only to a certain extent.

Political risk that affects foreign direct investment is linked to several factors;

1. Confiscation or damage to property.
A distinction must be made between expropriation, confiscation and nationalization of property belonging to foreign investors. Confiscation is the capricious taking of property by the ruler or the ruling coterie of the State for personal gain. Mostly common in States ruled by dictators or oligarchies. Much of the law on state responsibility was developed in the context of confiscation of property, which had no benefit to the State but only helped to enrich the ruling elite. The situation in modern times has changed as the investors more often than not are large multinational corporations with backing from even greater home States and international law hence host states would be slow to confiscate or damage goods for their individual gain. In a country with political instability or a shifting political regime however, sometimes government officials do confiscate property belonging to foreign investors for personal gain. Given that at the time the Judiciary of such countries is not as

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29 Alba Kruja, Blerta Dragusha,” The Impact of Political Risk on Foreign Direct Investment” (2014) pp.78
30 M. Sonarajah,”The International Law on Foreign Investment” Cambridge University Press, pp. 364.
independent, then recourse to those investors can never be achieved domestically.

2. Production disruption.
Disruptions are defined as major breakdowns in the production or distribution nodes that comprise a supply chain. These may include events such as a fire, a machine breakdown, an unexpected surge in capacity that creates a bottleneck, quality problems, natural disasters, customs delays, or any other number of different problems. These production disruptions can be caused by political instability by intentionally sabotaging processes for either economic gain or other politically inspired gains. This has a large impact on foreign investment in a country, as investors would be shy to invest in a country with such a reputation. Production disruption causes loss of money to the investors.

3. Threats to personnel including operational restrictions that impede the investors’ ability in undertaking certain actions. Restrictions on foreign ownership are the most obvious barriers to FDI. They typically take the form of limiting the share of companies’ equity capital in a target sector that non-residents are allowed to hold, e.g. to less than 50 percent, or even prohibit any foreign ownership.\footnote{Foreign Direct Investment Restrictions in OECD Countries (2002) pp.2.} A common example of majority domestic ownership include airlines and examples of exclusive domestic ownership often applied to natural resource sectors with the aim of giving citizens access to the associated rents. For example, foreign ownership is banned in the fishing and energy sectors in Iceland. Approval procedures can also be used to limit FDI. Stipulations that foreign investors must show economic benefits can increase the cost of entry and therefore may
discourage the inflow of foreign capital. These are some of the operational restrictions imposed by host nations to foreign investors either to protect the domestic markets or otherwise. In countries suffering from political instability, the State always acts in its discretion and can impose as many restrictions as it pleases to investors. Therefore, foreign investors consider these when choosing to invest in a particular country.

4. Riots and changes in the regulatory environment.
The regulatory environment is the set of taxes, rules and laws or regulations that businesses must adhere to. In a politically unstable State, and sudden shifts in government, come with it new regulations imposed by rulers disregarding the existing ones. These adversely inconvenience investors. Changes in laws, which automatically bind the foreign investors, and sometimes not in favorable terms and increased tax burdens eventually force foreign investors out of the country to a more suitable one. Moreover, as a general rule, riots are bad for business, either domestic or foreign because they lead to vandalism and closure of businesses which affect the conduct of business and profit margins. Given that politically unstable countries attract more riots, they tend to be bad for business and many foreign investors would not invest in such nations.

In conclusion, political stability is important in attracting foreign investors to a country. African countries have become more accommodating toward foreign direct investment (FDI) over the last decade or so evidenced by changes in their regulatory regimes. While it is fair to say that in terms of overall statutory FDI regulation African countries are on average less restrictive than other developing nations,

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32 Ibid 31, p.3.
some of the remaining obstacles are both severe and particular to the continent. One of the major obstacles is political instability in countries. This is because of a messy handover of power, refusal to leave power, forms of dictatorship and resistance groups. As a result, despite having favorable conditions for investors, they would shy from investing in these countries because of the factors mentioned above. Stability yields results for investments.

Hence, for a stable and progressive growth of FDI within a country it is evident on the importance of protecting the National Security and Political Stability of a country.

**Recommendations**

1. Insecurity being a major issue in the country, the government should advance and find strict policies that will help curb terrorism, which happen to be less costly.
2. Conduct other non-military mode of conflict resolutions such as negotiations to avoid using of violence to solve violence.
3. Ratify more treaties concerning combating terrorism in the country.
4. Transparency of regulation – consult all the relevant parties before making key changes in legislation.
5. Consistency of implementation – in countries where regulations are implemented selectively in favour of others to the detriment of others. There should be consistency all through to attract investors.
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