

Taxation Policies And Foreign Direct Investments: Evidence From East Africa Community Member Countries

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Abstract

This article examines how taxation policies influence foreign direct investment inflows across East African Community member countries during the period 2014 to 2023. Using a balanced panel of country year observations and a random effects generalized least squares estimator, the study models FDI on four tax instruments namely corporate income tax, capital gains tax, withholding tax, and value added tax while controlling for unobserved country effects. The specification is jointly significant and explains a substantial share of variation in FDI, with explanatory power concentrated in differences across countries. Results show that all four tax variables are negatively and significantly associated with FDI. Higher corporate income tax reduces expected after tax returns for multinational enterprises and lowers the probability of locating capital in the region. Capital gains tax and withholding tax raise transaction and repatriation costs which discourages cross border investment. Value added tax increases the cost of intermediate inputs and weakens supply chain competitiveness, further reducing inflows. The findings suggest that predictable, competitive, and administratively efficient tax regimes are important for attracting and retaining foreign capital. Policy makers should emphasize clarity, simplicity, and credible enforcement to reduce uncertainty, and coordinate reforms that align statutory rates and effective burdens with investment promotion goals. The study motivates future work on how investment incentives and macroeconomic stability interact with taxation to shape FDI outcomes in integrated models.

Keywords: *taxation policies; foreign direct investment; corporate income tax; capital gains tax; withholding tax; value added tax; East African Community*

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I. Introduction

A. Background

Foreign direct investment is a key channel for capital formation and technology transfer, and its responsiveness to host country taxation remains a central policy concern. Prior syntheses indicate that corporate income tax and the broader design of tax systems influence the cost of doing business and expected after tax returns, shaping multinational location choices (Gutola & Milos, 2022; Shafiq et al., 2021). Evidence from developed economies further shows that lower corporate tax rates are associated with higher FDI inflows, underscoring competitive pressures created by international tax differentials, although many studies narrow their focus to a single tax instrument and thus leave gaps on the role of other taxes (Pratomo, 2020). These strands motivate a context specific assessment that moves beyond simple rate comparisons toward the wider fiscal architecture relevant to investors.

Within the East African Community, member countries display heterogeneous fiscal regimes that create varied effective burdens for prospective investors. Understanding how taxation policies shape FDI in this region is important because countries pursue different corporate, capital gains, withholding, and value added tax structures while competing for cross border capital (Celani et al., 2022; Demena & van Bergeijk, 2022). Regional integration has advanced, but differences in tax design and administration persist, suggesting that the level and composition of taxes may help explain divergent FDI outcomes across the bloc.

Operationally, this study treats FDI as annual inflows, consistent with widely used approaches in the literature (Kalotay & Sass, 2021; Topalli et al., 2021). Taxation policies are disaggregated into instrument level

measures to reflect investor relevant channels: corporate income tax, capital gains tax, withholding tax, and value added tax, each captured by its annual statutory rate (Gutola & Milos, 2022). Disaggregation aligns with calls in prior reviews to examine how broader fiscal design, rather than a single headline rate, shapes investor behaviour, and provides a basis for comparable analysis across countries and over time.

B. Problem Statement

Taxation policies remain a decisive factor shaping foreign direct investment decisions, yet the mechanisms through which they influence location choices are not fully understood. Higher tax rates are expected to deter FDI by raising business costs and lowering expected after tax returns, but the literature provides mixed magnitudes and limited consensus on the channels at work across different contexts (Camara, 2023). The need for clarity is pressing because global FDI rebounded after the pandemic shock, yet inflows to many parts of Africa remain uneven, suggesting that the structure and administration of taxes may be central to attracting sustainable capital (UNCTAD, 2022).

The East African Community offers a distinct and underexplored setting in which member states maintain diverse fiscal regimes and administrative capacities that can yield different outcomes than those observed in OECD or Asian economies (Hakelberg & Rixen, 2021). Despite market integration initiatives, countries in the bloc continue to experience uneven FDI inflows, pointing to potential differences in corporate income tax, capital gains tax, withholding tax, and value added tax design and implementation that may influence investor decisions (UNCTAD, 2022). This context underscores the need for region specific evidence on how taxation policies relate to FDI within the EAC.

Methodologically, many prior investigations rely on static or cross sectional designs and short time horizons that do not capture the dynamic, country specific nature of investment decisions, including studies focused on developed economies as well as local analyses that aggregate annual data without isolating tax instrument effects (Gasparénienè et al., 2022; Hakas et al., 2022; Evans, Kariuki, & Wafula, 2022). Theoretical lenses such as the eclectic paradigm, internalization theory, and double taxation theory offer useful foundations but often underplay the evolving fiscal environments characteristic of EAC economies (Mensah & Mensah, 2021). From a policy standpoint, governments require empirical guidance on designing tax structures that balance revenue generation with the attraction and retention of foreign capital, since overly high tax burdens can discourage investment (Sookram et al., 2022). This motivates a focused inquiry into the effect of taxation policies on FDI in the East African Community.

II. Literature Review

A. Theoretical Review

The eclectic paradigm, or OLI framework, anchors the study by arguing that foreign direct investment occurs when firms possess transferable ownership advantages, identify conducive location advantages, and find it efficient to internalize transactions rather than rely on markets (Dunning, 1973; Aberu, 2023; Tsang & Mishra, 2023). As applied here, taxation policies shape location advantages through their effect on expected profitability and perceived operating conditions. Critics caution that the OLI triad may oversimplify complex strategies and understate the evolving roles of technology and institutions in multinational decisions (Ashiru & Oni, 2022; Jiang, 2021).

Neoclassical investment theory contends that firms invest when expected returns exceed costs, with decisions guided by net present value under rational expectations and the time value of money (Keynes, 1936; Calcagnini, Giombini, & Travaglini, 2019; Emmanuel & Kehinde, 2018). Taxation policies directly enter the cost of capital and expected after tax cash flows, making corporate, capital gains, withholding, and value added taxes salient to cross border project appraisal. Critics note that real world choices often depart from perfect information and purely rational behavior, and that uncertainty and risk aversion can distort NPV based rules (Osiobe, 2019; Gao & Yu, 2020; Daugaard, 2020).

Internalization theory explains multinational expansion as a response to market imperfections, where firms bring activities in house to exploit firm specific advantages when the benefits exceed the marginal costs of operating abroad (Buckley & Casson, 1976; Hennart, 1982; Casson, 1983; Hymer, 1960). Host country rules, including tax provisions and ownership restrictions, condition these costs and benefits, influencing whether firms internalize through FDI or rely on external contracts. Critics argue that the theory leans on strong assumptions about rationality and frictionless adjustment, and may underappreciate technology and information constraints (Dragoi, 2019).

Double taxation theory highlights how taxing the same income in multiple jurisdictions can deter cross border activity by raising overall tax burdens, and how treaties allocate taxing rights or provide credits to mitigate that burden (Wickersham, 1926; Harris, 2020; Inim, Samuel, & Prince, 2020). For FDI, domestic tax design and treaty networks jointly shape effective liabilities on profits and repatriations, thereby affecting location choices.

Critiques warn that treaty outcomes can favor powerful economies, pose complexity for smaller firms, and sometimes create openings for avoidance strategies (Dafnomilis, 2022; Pignatari, 2021).

B. Empirical Review

Taxation policies exert a complex and context-dependent influence on foreign direct investment, shaping the cost of doing business and the after-tax return that foreign firms can expect. Evidence from multiple reviews confirms that corporate income tax rates and the structure of tax incentives are consistently among the most salient determinants of FDI flows, yet their effects vary by industry, host-country characteristics, and the presence of tax treaties. This underscores the need to move beyond simple rate comparisons and examine how broader fiscal design shapes investor behaviour (Gutola & Milos, 2022). Because that study relied on a systematic literature review rather than primary data, it highlights but does not empirically resolve the mechanisms at work, leaving a methodological gap that this study addresses through panel-data analysis.

Meta-analytic findings further reinforce the significance of taxation policies while illustrating its heterogeneity across economic settings. Synthesizing results from a wide range of countries and time periods, Shafiq et al. (2021) demonstrate that tax policy does influence FDI decisions, but the magnitude and direction of effects depend on factors such as a country's development stage and sectoral composition. Their work, while comprehensive, remains constrained by its secondary-data design and thus cannot provide context-specific guidance for regions such as East Africa, revealing both methodological and contextual gaps that motivate the present inquiry.

Empirical evidence from developed economies illustrates more specific tax–FDI linkages. Using panel data from OECD countries, Pratomo (2020) shows that lower corporate tax rates are associated with significantly higher FDI inflows, highlighting the competitive pressures created by international tax differentials. However, the study focuses narrowly on corporate income tax and omits other forms of taxation such as capital gains or indirect taxes that can also affect investment decisions, leaving a conceptual gap regarding the breadth of taxation variables.

Kenya-based research provides additional insight into how tax reforms influence FDI but similarly reveals limitations. Kungu (2019) found that reforms such as integrated tax management systems and mobile-money tax payments positively affected FDI inflows between 2014 and 2018. While valuable for understanding administrative improvements, this work does not examine how specific tax types: corporate, capital gains, withholding, or value-added shape FDI, leaving a conceptual gap that this study directly tackles.

Overall, existing scholarship establishes that taxation policies matters for FDI yet stops short of offering a comprehensive, empirically grounded understanding of how different tax instruments and incentive structures jointly affect investment decisions, especially in emerging regional blocs like the East African Community. By employing longitudinal panel data and disaggregating taxation policies into corporate income, capital gains, withholding, and value-added taxes, the present study addresses these conceptual, contextual, and methodological gaps.

III. Methodology

The study adopted a positivist philosophy to examine observable relationships among economic variables using objective, quantifiable evidence. Positivism suits hypothesis testing with secondary macro data and supports the use of econometric techniques to uncover generalizable patterns while minimizing researcher bias (Cooper & Schindler, 2021). In line with this stance, a descriptive research design was used to measure and analyze conditions as they exist across countries and over time, enabling systematic testing of relationships with structured statistical methods (Creswell & Creswell, 2023; Saunders et al., 2023).

The population comprised all eight East African Community member countries, and the study conducted a census covering the full set of countries. Secondary data spanning January 2014 to December 2023 were assembled from revenue authorities, central banks, national statistical bureaus, the World Bank, and UNCTAD. Foreign direct investment inflows were the dependent variable, while taxation policies were operationalized through annual statutory rates for corporate income tax, capital gains tax, withholding tax, and value added tax. This design allowed consistent cross-country comparisons and alignment with prior empirical work.

Data analysis combined descriptive statistics with panel regression to estimate the effect of taxation policies on FDI. Assumption checks addressed normality, autocorrelation, homoscedasticity, multicollinearity, stationarity, and model specification using tests such as Shapiro–Wilk, Wooldridge, Breusch–Pagan, variance inflation factors, augmented Dickey–Fuller, and the Hausman test. Where needed, transformations were applied to meet assumptions. Hypotheses were evaluated using coefficient estimates, p values, the coefficient of determination, and joint significance tests, ensuring valid inference from the panel structure and robust interpretation of results.

IV. Results And Discussion

A. Descriptive Results

The descriptive statistics presented in Table 1 summarize the characteristics of key study variables for East African Community member countries over the study period. FDI inflows across the eight EAC member countries between 2014 and 2023 display considerable variability, with values ranging from a net outflow of – USD 1,467,350 to a peak inflow of about USD 17.2 million. The mean inflow of USD 2,124,890 and a high standard deviation of USD 4,530,478 indicate substantial disparities in investment attractiveness and capital movement across countries and years. The median inflow of USD 416,044 is far below the mean, revealing a positively skewed distribution in which a few countries and years attracted exceptionally high FDI, while many recorded modest inflows or even net disinvestments. This pattern reflects the reality of the EAC, where relatively larger economies such as Kenya and Tanzania often draw disproportionately more foreign capital than smaller or politically volatile members.

Corporate income tax rates show moderate dispersion, ranging from 20 percent to 35 percent across the countries and years. The mean rate stands at 29.2 percent with a small standard deviation of 0.038, and the median is 30 percent, which indicates that most EAC countries maintain corporate tax rates close to the regional average. The small standard error suggests a consistent corporate tax regime during the period under study with only minor reforms or country specific deviations. From an investor perspective, the relatively narrow range of corporate tax rates implies limited opportunities for tax driven arbitrage within the EAC. Therefore, the predictability of tax administration, clarity of legislation, and ease of compliance may be more critical for investors than minor differences in the statutory tax rate.

Capital gains tax rates exhibit significant variation, spanning from a low of 2 percent to a high of 30 percent, with a mean of 21.2 percent and a relatively large standard deviation of 0.126. The median of 30 percent indicates that several countries levy capital gains tax at the upper bound while others apply very low rates, creating an uneven landscape across the region. Such heterogeneity can strongly influence foreign direct investment decisions, particularly for investors whose returns rely heavily on the appreciation of assets such as real estate or equity investments. Countries with lower capital gains tax rates may be more attractive to investors seeking capital appreciation, whereas higher rates can discourage reinvestment and limit cross border portfolio flows.

Withholding tax on dividends, interest, or royalties ranges from 5 percent to 20 percent, with an average of 11.3 percent and a moderate standard deviation of 0.049. The median rate of 10 percent suggests that most EAC members cluster around a standard international norm, although some countries impose significantly higher rates. A higher withholding tax can discourage the repatriation of profits by foreign investors and may affect the decision to reinvest earnings locally. Conversely, a predictable and moderate withholding tax regime enhances the attractiveness of the investment climate by reducing the effective tax burden on cross border income flows.

The value added tax rate across the EAC ranges from 10 percent to 18 percent, with a mean of 16.5 percent and a standard deviation of 0.026, reflecting low dispersion across member states. The median of 18 percent shows that many countries operate close to the upper end of the range. Although VAT is an indirect tax primarily affecting consumption, high rates can influence foreign direct investment by increasing the cost of doing business, especially for investment projects with substantial local procurement. The narrow spread suggests that member states have moved toward harmonizing their VAT regimes in line with regional integration objectives. However, the efficiency of VAT administration, timeliness of refunds, and transparency of the system remain crucial factors for investors

Table 1: Summary of Descriptive Statistics

stats	N	Min	Max	Mean	SD	Median	se(mean)
FDI inflows (USD)	80	-1467350	17.2M	2124890	4530478	416044.4	506522.8
Corporate tax rate	80	0.20	0.35	0.291875	0.0376894	0.30	0.004214
Capital gains tax rate	80	0.02	0.30	0.211667	0.1262788	0.30	0.016303
Withholding tax rate	80	0.05	0.20	0.1125	0.0487177	0.10	0.005447
VAT	80	0.10	0.18	0.165	0.0261447	0.18	0.002923

B. Hypothesis Testing

Table 2 presents the results of the random-effects generalized least squares (GLS) regression model used to test the first objective of the study, which was to determine the effect of taxation policies on FDI in East Africa Member countries.

The Wald chi-square statistic is 90.32 with a p value of 0.000, showing that the model as a whole is highly significant and that the set of taxation policies variables jointly explain a meaningful portion of the variation in FDI inflows. The between-groups R-squared of 0.7227 indicates that about seventy two percent of the variation in FDI inflows across countries is explained by differences in corporate tax rate, capital gains tax

rate, withholding tax rate, and value added tax. The overall R-squared of 0.6215 further confirms a good fit when both within- and between-country variation are considered. The within-groups R-squared is low at 0.0064, which is expected in a panel data context where changes within each country over time are smaller than differences across countries.

The coefficient for corporate tax rate is -5.496 with a standard error of 0.412 , yielding a z statistic of -13.33 and a p value of 0.000 . This is a strong and statistically significant negative relationship, indicating that a one unit increase in the corporate tax rate (interpreted as a one percentage point increase when rates are expressed as fractions) leads to a 5.50 unit decrease in FDI inflows, holding other variables constant. The confidence interval of -8.36 to -2.37 confirms the robustness of this effect. This finding means that higher corporate taxes substantially discourage foreign investors by reducing after-tax profits and lowering the overall attractiveness of the host country. The result provides empirical support to reject the null hypothesis H_{01a} , showing that corporate income tax has a significant negative effect on FDI inflows.

The capital gains tax rate has a coefficient of -1.175 with a standard error of 0.135 , giving a z statistic of -8.69 and a p value of 0.000 . This indicates a strong and statistically significant negative impact on FDI inflows. A one percentage point increase in the capital gains tax rate is associated with about a 1.18 unit decrease in FDI inflows. The 95 percent confidence interval ranges from -2.09 to -0.44 , showing that the effect is both economically and statistically significant. This result suggests that higher capital gains taxes reduce the incentive for foreign investors to realize capital appreciation, making EAC countries with high rates less attractive to investors seeking equity stakes or long-term capital growth. Therefore, the null hypothesis H_{01b} is rejected, and capital gains tax is confirmed as a significant deterrent to foreign investment.

The coefficient for the withholding tax rate is -1.073 with a standard error of 0.327 , resulting in a z statistic of -3.28 and a p value of 0.001 . This demonstrates a statistically significant negative relationship, meaning that a one percentage point increase in the withholding tax rate is associated with an approximate 1.07 unit decline in FDI inflows. The confidence interval of -1.71 to -0.43 reinforces the strength of this finding. Withholding taxes directly affect the repatriation of profits, dividends, and interest, so higher rates reduce net returns to foreign investors and discourage inflows. Consequently, the null hypothesis H_{01c} is rejected, confirming that withholding tax is an important factor influencing foreign investment decisions in the EAC region.

The value added tax rate shows a coefficient of -3.515 with a standard error of 0.358 , producing a z statistic of -9.82 and a p value of 0.000 . This indicates a strong and statistically significant negative effect on FDI inflows. A one percentage point increase in VAT corresponds to a 3.52 unit decrease in FDI inflows, with the 95 percent confidence interval ranging from -5.51 to -1.52 . While VAT is an indirect tax on consumption rather than profits, higher rates can increase the cost of production and reduce domestic demand, thereby lowering the profitability of investments that depend on local markets. These results lead to the rejection of the null hypothesis H_{01d} and show that VAT levels are a key component of the tax environment influencing foreign investors.

The results of the random effects GLS regression clearly demonstrate that taxation policies significantly influences foreign direct investment inflows in East Africa Community member countries, leading to the rejection of the overall null hypothesis H_{01} . Each component of taxation policies: corporate income tax, capital gains tax, withholding tax, and value added tax shows a negative and statistically significant relationship with FDI inflows, with p values well below the 0.05 threshold. Specifically, the strong negative coefficients for corporate income tax ($p = 0.000$), capital gains tax ($p = 0.000$), withholding tax ($p = 0.001$), and VAT ($p = 0.000$) confirm that increases in these taxes reduce the volume of foreign investment. Consequently, the sub-hypotheses H_{01a} , H_{01b} , H_{01c} , and H_{01d} are all rejected, affirming that each tax element exerts a distinct and significant negative effect on foreign direct investment across the EAC region

Table 2: Taxation Policies and Foreign Direct Investments

Random-effects GLS regression		Number of obs		=	80	
Group variable: CountryID		Number of groups		=	8	
R-sq:		Obs per group:				
within = 0.0064		min		=	10	
between = 0.7227		avg		=	10	
overall = 0.6215		max		=	10	
		Wald chi2(4)		=	90.32	
corr(u _i , X) = 0 (assumed)		Prob > chi2		=	0.000	
FDI inflows	Coef.	Std. Err.	z	P>z	[95% Conf.	Interval]
Corporate tax rate	-5.495949	0.412327	-13.33	0.000	-8.35997	-2.36807
Capital gains tax rate	-1.175182	0.135205	-8.69	0.000	-2.08981	-0.44018
Withholding tax rate	-1.072892	0.326891	-3.28	0.001	-1.71359	-0.4322
VAT	-3.51528	0.358059	-9.82	0.000	-5.50897	-1.5216
cons	-3.40006	0.659517	-5.16	0.000	-5.3724	-1.42772

V. Conclusion

The study concludes that taxation policies play a decisive role in shaping foreign direct investment across East African Community member countries. Each of the four instruments examined: corporate income tax, capital gains tax, withholding tax, and value added tax shows a clear negative association with investment inflows. In practical terms, higher statutory burdens reduce expected after tax returns and dampen the likelihood that multinational firms will commit capital to the region. Corporate income tax and value added tax emerge as especially influential because they affect both profit margins and the cost of operating within local supply chains.

A second conclusion is that durable differences in how countries design and administer their tax systems are a major source of divergence in investment outcomes. Investors respond not only to headline rates but also to the clarity of rules, the predictability of enforcement, and the ease of recovering legitimate claims such as value added tax refunds. The evidence therefore points to the importance of competitive and transparent tax design, consistent administration, and credible policy signalling to strengthen the region's investment appeal.

VI. Recommendations

EAC governments should focus on predictable and investment friendly tax design and administration. Prioritize clarity in corporate income tax rules, reduce uncertainty through medium term tax policy statements, and limit frequent discretionary changes. Streamline VAT systems by accelerating refunds, improving input credit verification, and publishing service standards. Rationalize withholding taxes on dividends, interest, and royalties to lower frictions on cross border payments, and clarify capital gains tax treatment for equity and asset disposals to reduce disputes. Strengthen digital tax administration and advance ruling programs so that investors can obtain binding guidance before committing capital.

Regional coordination can amplify these gains. Work toward gradual convergence of tax bases and definitions across the bloc, develop common guidance on transfer pricing and treaty application, and establish fast track mechanisms for resolving tax disputes that involve cross border transactions. Improve transparency by publishing consolidated tax guides, administrative circulars, and timelines for compliance processes. Pair reforms with regular impact reviews that assess investment outcomes and revenue performance, allowing adjustments that preserve the tax base while improving the region's attractiveness to long term foreign investment.

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