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Taxation Policies, Interest Rates and Foreign Direct Investments: Evidence from East Africa Community Member Countries

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Abstract

This article examines how interest rates shape the relationship between taxation policies and foreign direct investment in East African Community member countries from 2014 to 2023. Using a random effects generalized least squares panel framework, the analysis proceeds in the standard three step sequence. First, corporate income tax, capital gains tax, withholding tax, and value added tax each show clear negative associations with foreign direct investment when considered together, establishing a strong baseline. Second, introducing the interest rate alongside the four tax instruments improves model fit and reveals a distinct negative association between higher borrowing costs and investment inflows, indicating that monetary conditions add meaningful explanatory power beyond tax variables alone. Third, interaction terms between the interest rate and each tax instrument are negative and significant, demonstrating that interest rates systematically amplify the adverse association between taxes and foreign direct investment. In practical terms, tighter credit conditions deepen the penalty investors perceive from higher profit, exit, remittance, and consumption related taxes by compressing after tax returns and heightening working capital pressures. The findings show that investment outcomes reflect a combined fiscal and monetary environment, and they underscore that tax reforms aimed at competitiveness will be most effective when coordinated with policies that stabilize financing costs.

Keywords: *Foreign direct investment, taxation policies, corporate income tax, capital gains tax, withholding tax, value added tax and interest rate*

1. Introduction

Taxation policies shape after-tax returns and are therefore central to foreign direct investment decisions. Corporate income tax, capital gains tax, withholding tax, and value added tax directly affect profitability, cash flows, and the repatriation of earnings; high statutory burdens or uncertain administration lower expected returns and elevate risk, discouraging long-term commitments (Shafiq et al., 2021; Scheuer & Slemrod, 2020; Farhi & Gabaix, 2020). Prior work emphasizes measuring these policies through statutory rates commonly used in empirical studies and shows their salience for business location choices, including in developing-country contexts (Gutola & Milos, 2022; Nwakeze et al., 2023; Allayarov & Rakhimov, 2022).

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Interest rates influence FDI through financing costs and the valuation of future cash flows. Higher borrowing costs raise hurdle rates and compress working capital, reducing the present value of after-tax profits even when tax rules are unchanged (Dao et al., 2021). In practice, average lending rates are standard proxies for financing conditions and move with broader monetary settings; when they rise, firms face tighter credit and greater discounting of expected returns, which dampens investment appetite (Mbowe et al., 2020; Kotha & Bhawna, 2016; Hussain et al., 2023).

The East African Community is a pertinent setting because member countries differ in profit, exit, remittance, and consumption tax structures and experience varied domestic financing conditions that affect local interest rates. These differences shape how investors perceive after-tax, after-finance returns and help explain divergent FDI outcomes across the bloc's growing markets (World Bank, 2023; Demena & van Bergeijk, 2022). Region-specific evidence on the combined roles of taxation and interest rates is therefore essential for policy in a region pursuing integration while managing evolving fiscal and monetary environments (Arnold, 2022; Murungi et al., 2023).

1.1 Research Problem

Taxation policies and interest rates are decisive for foreign direct investment, yet the channels through which they jointly influence location decisions remain insufficiently understood. Higher tax burdens raise business costs and lower expected after-tax returns, discouraging inflows (Camara, 2023). At the same time, the cost of finance shapes project viability: when interest rates rise, discount rates increase and the present value of future cash flows falls, dampening investment appetite even if tax rules are unchanged (Dao et al., 2021; Mbowe et al., 2020; Kotha & Bhawna, 2016). Despite their centrality, few studies isolate and assess the combined influence of taxation and interest rates on FDI.

The East African Community offers a pertinent yet underexplored setting for this question. Although global FDI rebounded after 2020, inflows across EAC member countries remain uneven, reflecting differences in fiscal regimes and domestic financing conditions (UNCTAD, 2022; Hakelberg & Rixen, 2021). These conditions differ from those typically examined in OECD or Asian contexts, reinforcing the need for region-specific evidence on how profit, exit, remittance,

and consumption taxes interact with borrowing costs to shape investor decisions in East Africa (World Bank, 2023).

Methodologically, much of the literature relies on static or cross-sectional designs, short time horizons, or single-country analyses that cannot capture joint effects or time variation (Gasparėnienė et al., 2022; Hakas et al., 2022; Evans et al., 2022). Classic theories emphasize ownership and location advantages but often underplay evolving fiscal and financial conditions in emerging regions, leaving gaps in explanation for the EAC context (Mensah & Mensah, 2021). Addressing these limitations calls for longitudinal, multi-country panel analysis explicitly linking taxation and interest rates to foreign direct investment outcomes in the region.

1.2 Research Objectives

The main objective of this study was to examine the influence of taxation policies and interest rates on foreign direct investments among East Africa Community member Countries.

2. Literature Review

2.1 Theoretical Review

The eclectic paradigm (OLI) anchors the study by linking foreign direct investment to ownership, location, and internalization advantages; firms invest abroad when they hold transferable assets, find locations with favorable conditions, and benefit from organizing activities within the firm (Dunning, 1973; Aberu, 2023). In this lens, taxation policies shape location advantages by altering expected profitability, while financial conditions such as interest rates influence the feasibility of internalizing activities through their effect on discount rates and cash flow risk. Critics caution that OLI can oversimplify complex strategies and understate the roles of technology and institutions in shaping FDI, which is salient in rapidly changing environments (Ashiru & Oni, 2022; Jiang, 2021). Neoclassical investment theory posits that firms commit capital when expected returns exceed costs, evaluated through net present value with explicit attention to the time value of money (Keynes, 1936; Calcagnini, Giombini, & Travaglini, 2019). Taxes reduce after tax cash flows, while interest rates raise hurdle rates and lower the present value of future earnings, together shaping project viability and location choice (Emmanuel & Kehinde, 2018). Critiques argue that assumptions of perfect information and purely rational behavior overlook uncertainty and

behavioral biases that can move firms away from strict NPV rules, especially in volatile settings (Osiobe, 2019; Gao & Yu, 2020; Daugaard, 2020).

Internalization theory explains multinational expansion as a response to market imperfections: firms internalize when control over knowledge and coordination yields net benefits relative to using external markets (Buckley & Casson, 1976; Hennart, 1982; Casson, 1983; Hymer, 1960). Host country rules, including the level and administration of corporate, capital gains, withholding, and value added taxes, shift those costs and benefits, while prevailing interest rates affect financing costs and working capital pressures that condition internalization choices. A key limitation is the theory's reliance on strong rationality and frictionless markets, with insufficient attention to technology dynamics and information constraints (Dragoi, 2019).

Double taxation theory highlights how taxing the same income in multiple jurisdictions can depress cross border activity by raising effective burdens on profits and repatriations, while treaties and credits allocate taxing rights and mitigate duplication (Wickersham, 1926; Harris, 2020; Inim, Samuel, & Prince, 2020). Critics note that treaty outcomes may favor powerful economies, add complexity for smaller firms, and sometimes open avenues for avoidance, issues that matter for capital scarce hosts (Dafnomilis, 2022; Pignatari, 2021). For this study, the interaction of domestic tax design and treaty practice, alongside financing conditions captured by interest rates, is central to the effective liabilities and valuation discounts that shape FDI decisions.

2.2 Empirical Review

The interaction between taxation policies and interest rates plays a pivotal role in shaping foreign direct investment (FDI) decisions. Even when statutory tax burdens are competitive, elevated borrowing costs raise hurdle rates, compress working capital, and reduce the present value of after-tax cash flows—dampening investors' willingness to commit capital. Conversely, when financing conditions are predictable and lending rates are moderate, the same tax regime can appear materially more attractive. Despite their centrality, the precise moderating influence of interest rates on the tax–FDI relationship remains insufficiently explored, underscoring the need for empirical models that integrate fiscal variables with explicit measures of financing conditions (Mbowe et al., 2020; Kotha & Bhawna, 2016).

Dimitrova et al. (2020) provide a broad synthesis of studies linking taxation and FDI that also reference financial indicators. Their review suggests that lower corporate tax rates support stronger FDI inflows, but it treats financial conditions largely as background context rather than as moderators. Because the study is a literature review without original estimation, it cannot identify how changes in lending rates alter the slope of the tax–FDI relationship—leaving a methodological gap on the interaction between profit taxation and the cost of capital.

Kenya-focused evidence offers regional nuance but similarly leaves interest-rate interactions underexplored. Nasibu (2021) examined FDI and tax revenue dynamics using macro controls such as GDP per capita and trade openness; however, the analysis did not test how lending rates condition the effect of taxation on FDI itself. This gap is important in East Africa, where lending rates vary with monetary conditions and banking-sector factors, directly affecting investor discount rates and project viability (Mbowe et al., 2020).

Evidence from cross-country panels reinforces the importance of modeling financing conditions alongside taxes. Sujarwati and Qibthiyyah (2020) found that lower corporate tax rates are associated with higher FDI in OECD settings, but financial variables were handled as controls rather than as moderators, leaving unanswered whether tight credit amplifies the deterrent effect of higher taxes. More generally, financial-market studies show that shifts in interest rates change valuation and risk premia, implying that the sensitivity of investment to taxation is likely state-dependent (Kotha & Bhawna, 2016).

Taken together, prior work indicates that both taxation policies and interest rates matter for FDI, yet empirical designs rarely capture their interactive effects. The present study addresses these conceptual and methodological gaps by employing panel data to test whether lending rates moderate the impact of corporate income tax, capital gains tax, withholding tax, and value added tax on FDI across East African Community member states—thereby providing region-specific evidence on how the cost of finance conditions the effectiveness of tax policy (Mbowe et al., 2020; Dimitrova et al., 2020; Sujarwati & Qibthiyyah, 2020).

3. Research Methodology

The study adopted a positivist philosophy and a descriptive panel design to analyze observable relationships between taxation policies, interest rates, and foreign direct investment across all eight East African Community countries. A census approach covered Burundi, Democratic Republic of Congo, Kenya, Rwanda, South Sudan, Tanzania, Uganda, and Somalia. Secondary country-year data spanned January 2014 to December 2023, compiled from revenue authorities, central banks, national statistical bureaus, and international databases to ensure comparability over time and across countries.

Foreign direct investment inflows formed the dependent variable. Taxation policies were operationalized through statutory annual rates for corporate income tax, capital gains tax, withholding tax, and value added tax. Interest rate conditions were captured using average lending rates, reflecting the cost of credit faced by investors. This specification aligned the measurement of policy levers with the financing environment that shapes project appraisal and after-tax, after-finance returns.

Analysis combined descriptive statistics with panel econometrics. Random effects generalized least squares models estimated: the baseline relationship between the four tax instruments and FDI, an expanded model adding the interest rate, and an interaction model testing whether interest rates moderate each tax–FDI slope, following the three-step sequence of Baron and Kenny. Standard diagnostics assessed normality, autocorrelation, homoscedasticity, multicollinearity, stationarity, and model specification, with transformations applied where needed. Inference relied on coefficient signs and magnitudes, confidence intervals, and joint significance tests to determine the baseline effects, the added contribution of interest rates, and the presence and direction of moderation.

4. Findings and Discussion

This section evaluates whether interest rates condition the link between taxation policies and foreign direct investment (FDI) in EAC member countries using a three-step Baron–Kenny approach estimated via random-effects GLS on 2014–2023 country-year data. We first establish a baseline relationship between the four tax instruments and FDI (Table 1), then add the interest rate

as an additional predictor to test its independent association (Table 2) and finally introduce tax–interest-rate interaction terms to assess moderation (Table 3).

Table 1 shows that taxation policies alone are jointly and individually significant drivers of FDI. The model fits well (e.g., strong Wald test; solid overall and between R^2), and each tax instrument is negatively associated with inflows—corporate income tax, capital gains tax, withholding tax, and VAT all exhibit precise, adverse coefficients.

Table 1: Taxation Policies and FDI Inflows

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

Table 2 adds the interest rate and improves explanatory power. The interest rate itself is negative and significant, indicating that tighter credit conditions are associated with lower FDI. Conditioning on interest rates also shifts several tax coefficients in economically coherent ways (e.g., corporate income tax and VAT become more negative), consistent with the notion that financing costs and tax burdens combine to shape investment viability.

Table 2: Taxation Policies, Interest Rate and FDI Inflows

Random-effects GLS regression		Number of obs			=	80
Group variable: CountryID		Number of groups			=	8
R-sq:		Obs per group:				
within = 0.0011		min			=	10
between = 0.8174		avg			=	10
overall = 0.6767		max			=	10
		Wald chi2(5)			=	119.66
corr(u_i, X) = 0 (assumed)		Prob > chi2			=	0.000
FDI inflows	**Coef.**	**Std. Err.**	**z**	**P>z**	**[95% Conf.**	**Interval]**
Corporate tax rate	-6.50371	0.886604	-7.33	0.000	-8.7093	1.701884
Capital gains tax rate	-1.13036	0.145068	-7.79	0.000	-3.15397	-0.414689
Withholding tax rate	-1.12781	0.333722	-3.38	0.001	-3.78189	-0.47372
VAT	-3.97092	1.109913	-3.57	0.000	-5.0662	-1.8756
Interest rate	-0.65818	0.303049	-2.17	0.038	-0.83199	-0.148349
_cons	-4.46784	9.869686	-4.10	0.000	-9.8121	-1.1236

Table 3 incorporates interaction terms between the interest rate and each tax instrument and further strengthens model fit. At the mean interest rate, all four taxes remain negatively and significantly related to FDI; crucially, every interaction term (corporate×rate, capital-gains×rate, withholding×rate, VAT×rate) is negative and statistically significant. This pattern demonstrates clear moderation: higher lending rates systematically amplify the adverse association between each tax instrument and FDI. Accordingly, we reject H01 (that interest rates do not moderate the taxation–FDI relationship) and, by component, reject H01a–H01d for corporate income tax, capital gains tax, withholding tax, and VAT, respectively.

Table 3: Interaction Term for Taxation Policies and Interest Rate

Random-effects GLS regression		Number of obs	=			80
Group variable: CountryID		Number of groups	=			8
R-sq:		Obs per group:				
within = 0.1860		min	=			10
between = 0.8546		avg	=			10
overall = 0.7144		max	=			10
		Wald chi2(9)	=			125.05
corr(u_i, X) = 0 (assumed)		Prob > chi2	=			0.000
FDI inflows	**Coef.**	**Std. Err.**	**z**	**P>z**	**[95% Conf.**	**Interval]**
Corporate tax rate	-7.88745	0.82882	-9.52	0.000	-9.8313	-4.0564
Capital gains tax rate	-1.80306	0.421184	-4.28	0.000	-2.53761	-.96852
Withholding tax rate	-1.7815	0.588117	-3.03	0.002	-2.7587	-1.59762
VAT	-3.62414	0.43131	-8.40	0.000	-6.887854	-1.36043
Interest rate	-1.84506	0.47597	-3.88	0.000	-3.7266	-0.74167
CTRate*Interest rate	-8.76932	0.43565	-20.13	0.000	-12.9226	-6.4612
CGRate*Interest rate	-1.91324	0.69802	-2.74	0.006	-3.28134	-0.54515
WTRate*Interest rate	-3.70617	0.787351	-4.71	0.000	-7.203026	-1.209314
VATRate*Interest rate	-5.2801	0.43137	-12.24	0.000	-7.724	-3.8358
_cons	-2.5897	1.3295	-1.94	0.055	-3.352	0.17265

5. Conclusions

The study concludes that foreign direct investment in the East African Community is shaped jointly by the profit-, exit-, remittance-, and consumption-tax environment and by prevailing financing conditions. Even where tax regimes are predictable, higher borrowing costs erode project net present value, tighten working capital, and heighten risk perceptions, making locations less appealing to long-term investors. Conversely, when credit conditions are supportive, the same tax structures are perceived as more manageable within multinational investment screens.

A second conclusion is that interest rates systematically condition how strongly each tax instrument relates to investment outcomes. Corporate income tax, capital gains tax, withholding tax, and value added tax all align with lower inflows on their own, but their adverse associations become more pronounced when lending rates rise. This state-dependent pattern underscores that

taxation and financing are not separable levers: investor responses to tax burdens depend materially on the cost of capital at the time decisions are made.

Finally, durable cross-country differences remain important, but meaningful shifts within countries are achievable when fiscal and monetary settings move coherently. Policy packages that pair clear, administrable taxes with credible efforts to contain financing costs are more likely to attract and retain foreign capital than isolated actions on either front. For EAC governments, the practical implication is to treat FDI attraction as a coordinated agenda linking tax design and administration with a predictable monetary environment.

6. Recommendations

First, align tax design with investor certainty and cash-flow needs. Publish medium-term tax policy plans and avoid ad-hoc changes; simplify the corporate income tax base, clarify capital gains realization rules, and calibrate withholding on cross-border payments to treaty benchmarks. Tighten VAT administration around fast, rules-based input crediting and refunds, with service-level targets and risk-based audits. Expand certainty tools—advance rulings and advance pricing agreements—and digitize filing, e-invoicing, and refund workflows to cut compliance time. The aim is a transparent, predictable liability profile so investors can price projects on after-tax cash flows with minimal policy risk.

Second, pair fiscal reforms with measures that lower and stabilize the cost of finance. Strengthen monetary-fiscal coordination on inflation control; deepen local currency bond markets to lengthen tenors and smooth rate volatility; and support credit-risk sharing for productive FDI (e.g., partial guarantees for export-oriented capital goods). Encourage practical hedging access for investors (FX forwards/swaps) and promote competition in banking to narrow lending-deposit spreads. Where feasible, create time-bound VAT refund fast tracks for firms meeting liquidity stress tests during tight-rate periods so working-capital frictions do not magnify the effective tax burden.

Third, coordinate regionally and measure what matters. Within the EAC, develop reference bands for key tax rates, model treaty language with anti-abuse provisions, and mutual recognition of advance rulings to reduce fragmentation. Establish an EAC “tax-and-finance scoreboard” that

tracks lending rates, refund timeliness, dispute resolution times, and FDI pipeline/reinvestment rates by sector. Use these metrics for peer review and course correction, and link any targeted, temporary relief (e.g., accelerated depreciation windows during rate spikes) to clear sunsets and ex-post value-for-money evaluations. This integrated, evidence-led approach ensures tax policy and financing conditions work together to attract and retain high-quality FDI.

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