Financing Options for Effects of Political Risk in Mining Industry in Kenya

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Abstract- Political risk is the risk that an investment's returns could suffer as a result of political changes or instability in a country. This paper seeks to explore the political risks that affect the mining industry in Kenya. Kenya has a wide variety of minerals which are known and mapped, but most of its potential lies in the yet undiscovered mineral deposits. In Kenya mining industry, local government plays not only a role of administrator and supervisor, but also a role of special interests subject in some cases. This situation results in uncertainty of policies and brings risks to mining investors. In order to cope with political risks, mining investors may adjust the mining production to accelerate and recover the investment. By applying the Risk Assessment Management method, this paper analyzes the effects of political risks in mining industry in Kenya. Based on core types of political risks such as poor legislation, taxation, war and terrorisms, industrial strikes, corruption, expropriation and resource nationalism, it put forward the utility function of local government and the production function of mining enterprise. Hence, it establishes the challenges and the cost of managing political risks in mining industry in Kenya. This paper illustrates that the Government of Kenya has to regulate the mining laws and put in place proper risk management policies so as to tap more investors. This paper will be helpful in solving problems of poor investment environment in mining industry, safety production, and utilization of mineral resources and will benefit potential and current investors, local and foreign financial institutions, ministry of finance and students undertaking MBA finance Option.

Index Terms- Political Risk, Mining, Corruption, Expropriation

I. Introduction

This paper seeks to explore the political risks that do affect the mining industry in Kenya. Mining in Kenya is partly funded by foreign multinationals (Haftel, 2006). Foreign investors, thus, encounter “a trade-off between investing in a low-cost and low-credibility country” and “a high-cost and high-credibility country” in making investment choices (Janeba, 2002 ;).

According to the survey of the Multilateral Investment Guarantee Agency (MIGA), foreign investors from both industrialized and developing nations chose political risks as one of the biggest challenges they face in developing and emerging markets (MIGA, 2010).Political risk is one of the most important challenges to MNCs, especially when they expand their business into developing nations, since many developing nations with lower factor costs tend to be the markets with higher risks in comparison to other more developed countries (Diamonte, et al., 1996; Haftel, 2006b; Mosley, 2003; Neumayer & Spess, 2005).

Political risk is the risk that an investment's returns could suffer as a result of political changes or instability in a country. Instability affecting investment returns could stem from a change in government, legislative bodies, other foreign policy makers or military control. For investors, political risk can simply be defined as the risk of losing money due to changes that occur in a country’s government or regulatory environment. Acts of war, terrorism and military coups are all extreme examples of political risk. Expropriation of assets by the government or merely the threat can also have a devastating effect on share prices.

Also political risk comes in many other forms. Other examples include: a new president or prime minister, a change in the country’s ruling party or an important piece of new legislation. All of these changes can have a big impact on a country’s economic environment and investor perceptions about a country’s prospects. Political risks are notoriously hard to quantify because there are limited sample sizes or case studies when discussing an individual nation. The outcome of a political risk could drag down investment returns or even go so far as to remove the ability to withdraw capital from an investment. In general, there are two types of political risk; macro risk and micro risk. Macro risk refers to adverse actions that will affect all foreign firms, such as expropriation or insurrection, whereas micro risk refers to adverse actions that will only affect a certain industrial sector or business such as corruption and prejudicial actions against companies from foreign countries.

All in all, regardless of the type of political risk that a multinational corporation faces, companies usually will end up losing a lot of money if they are unprepared for these adverse situations. According to (Prasad et al., 2003) the economic development of emerging markets and developing countries depends to a large extent on the possibility to make profitable investments and accumulate capital.

Having access to foreign capital and investments allows a country to exploit opportunities that otherwise could not be used. Recent experiences with opening capital accounts in emerging and developing economies, however, have proved to be a mixed blessing, as it is becoming increasingly clear that not all types of capital imports are equally desirable. Short-term credits and portfolio investments run the risk of sudden reversal if the economic environment or just the perception of investors change, giving rise to financial and economic crises. It is therefore frequently advised that those countries should primarily try to attract foreign direct investment and be very careful about accepting other sources of finance.

Likewise, Gastanaga et al. (1998) examined the link between various political variables and foreign investment inflows. They found that lower corruption and nationalization risk levels, and better contract enforcement are associated with higher financial direct investments inflows. For multinational companies, political risk refers to the risk that a host country will make political decisions that will prove to have adverse effects on the multinational's profits and/or goals. Adverse political actions can range from very detrimental, such as widespread destruction due to revolution to those of a more financial nature, such as the creation of laws that prevent the movement of capital.

More recently, several studies have analyzed the relationship between fundamental democratic rights Using different econometric techniques and periods, Harms and Ursprung (2002), Jensen (2003), and Busse (2004) found that multinational corporations are more likely to be attracted by countries in which democracy is respected. Li and Resnick (2003), on the other hand, argue that competing causal linkages are at work. They found that democratic rights lead above all, to improved property rights protection which in turn boosts foreign investment.

A number of these political risk components are also linked to the quality of political institutions. Above all, the quality of the bureaucracy is closely associated with the institutional strength of a particular country. Likewise, ensuring law and order and reducing corruption levels are important determinants (and effects) of high-quality institutions. They constitute relevant sub-components of an overall assessment of "good governance" (Kaufmann et al., 1999).

Political Risk

According to (Jaffrey 1984), unlike economic or financial variables, political risk is not only difficult to quantify, it may well also be a rather subjective exercise which relies heavily on the scholarly experience of researchers. Risk scores or the quantified indicators are ultimately based on qualitative judgments. Risk implies that the political and economic management of society is threatened by either weaknesses in or challenges to the state or the prevalence African Journal of Public Affairs of uncivil, contending interests within society encroaching on the jurisdiction of the state (Bremmer 2005).

While the concern is a political risk, it is an accepted maxim that political phenomena and economic trends are too integrated to be assessed independently from each other (Kennedy 1988). In the context of this, it is assumed that social stability precedes the prospects for growth, employment creation and a competitive economy. Economies are successful when they fulfill the aspirations and needs of their societies to the extent that the natural stress between societal expectations and institutional capacities are reduced to manageable levels (Mangcu 2008).

Political stability or the lack thereof, under verifiable conditions however, may not necessarily undermine direct foreign investment, or the extractive capacities of the state, or the legitimate redistributive regime of the government or the prospects for growth in both the formal and the informal economy.

Mining in Kenya

According to Munyiri (2009), the mineral industry is perceived to be small, accounting for an insignificant portion of the GDP in our country, but this is due to lack of proper infrastructure and policies to encourage production. The main minerals which have received economic attention by the Government are soda ash (from Lake Magadi), limestone for the cement industry, and fluorspar. Kenya has a wide variety of minerals which are known and mapped, but most of its potential lies in the yet undiscovered mineral deposits. Witness to this is the recent discovery of the coal deposits in the Mui and Mutito Basins in the Mwingi District located in the eastern parts of the country; and the Kwale Hill heavy mineral sands project that is being developed along the country's southeastern coast and of recent is the extraction of the Oil in Turkana County. Gold is currently produced primarily by artisanal workers in the western parts of the country, in the Lake Victoria Goldfields. Kenya has also in recent times become one of the most important sources of colored gemstone. Among others, iron ore is mined from small localized deposits for use in the domestic manufacture of cement. However, most of Kenya"s mineral resources remain unexploited and the mining industry development has been slower than would have been expected.

The Mining Act has been criticized for lacking in contemporary practices such as fair sharing of revenue and efficient waste management. In 2012 the Ministry of Environment and Mineral Resources published a draft Geology Minerals and Mining Bill, which now awaits cabinet approval. The Bill aims to "revitalize the mining sector by ensuring transparent and efficient management … benefit sharing and disputes resolution". Key features include; increased and variable rates for royalties (variable on the type of mineral and value addition), reclassification of certain mining rights, establishing a dedicated "Mining Disputes Resolution Tribunal" and the sharing of benefits by local communities.

On 12 October 2012 the Mining (Local Equity Participation) Regulations, was promulgated, aimed at increasing Kenyan participation in mining companies. The regulation states "It shall be a condition of every mining license that the mineral right in respect of which the license is issued shall have a component of local equity participation amounting to at least thirty five per cent (35%) of the mineral right." The Regulation has been interpreted to mean that at least 35% of shareholders in mining companies must be Kenyan nationals.

The requirement of local investor participation is not unusual in the natural resource extractive sector. Such laws are fast becoming common place in mining economies, with similar laws being adopted in Botswana, Zimbabwe, Tanzania, Guinea and Indonesia. However, for such laws to reach their intended aim there must be adequate finance and financial infrastructure available to local investors. This is a challenge Kenya will need to address, given the potential for large scale mining operations in the near future.

Waitiki Case of Land in Relation with Political Risk Especially Lands Grabbing

The 16 year old controversy over the 930 acre Waitiki farm in Likoni could soon end as owner Evanson Kamau Waitiki has said he is willing to be compensated for the farm.

Over 120,000 squatters live on the land which stretches from close to the Likoni ferry landing for several kilometers to the left of the main Likoni -Kwale road. To the south, the farm covers large swathes of Timbwani and Shika Adabu wards. Waitiki said he was willing to give up the land if he got compensation from the government. The Waitiki farm was originally invaded by 75,000 people during the 1997 Kaya Bombo clashes. Since then Waitiki has been fighting to evict the squatters so that he can develop the land.

Last November, the Mombasa High Court finally issued an order directing the police to evict the squatters. Police Commissioner Mathew Iteere and provincial police boss Aggrey Adoli served the orders but were reluctant to enforce the eviction citing lack of personnel. The squatters have built homes, churches, mosques, and businesses there. Several police stations have also been put up there. The eviction could have affected at least half the developed properties in the expansive Likoni area. Politicians, including the current Mombasa Governor Hassan Joho, have historically made political mileage out of the dispute.

"I only get to hear about these plans from the media. No politician or government official has ever come to me to negotiate on the land. I believe in dialogue. Even enemies, before starting a fight, engage in dialogue. They can come and talk to me but I think these people are trying to hoodwink the public that they are genuine," he said."These people are not squatters. They are investors. You can tell from the type of structures that they have put up. They should all come together and form a union and buy off my property," he said.

The 67 year old businessman said the dispute could continue to plague his children and grandchildren."I have many sons and daughters just like many African men. If I was to die today, they would come out fighting fiercely to have a piece of their inheritance. This is their right too," said Waitiki. He went ahead and blamed a cartel inside his farm of unscrupulously benefiting from his properties including illegal collection of house rent."When they chased me away, they took over some of my properties including several hundred dairy cattle and a thousand chicken. Some are even collecting rent from the houses I had built," he said. he also said he e was forced to flee his farm during the 1997 ethnic clashes. "They would have killed me. I was only fortunate that I did not sleep at my farm that night. They had come for my head and would have taken over all of my property," he said of the attackers.

In conclusion this shows how the Politics can manipulate the lands owners, affecting their livelihoods and not able to utilized their land for their own investments. Hence, jeopardize them and deny them a chance in order to develop their land.

Key Issues Relating To the Mining Industry in Kenya

According to Rop (2010), the Government of Kenya recognizes that mining can act as an engine for economic development however, like other African countries with similar natural endowments, there are policy challenges. Some of this challenges that have accelerated the undermining and under utilization of these natural resources include;

- Lack of adequate and up to date regulations addressing the bright of key stakeholders such as communities in mineral rich areas. Additionally, the present laws are outdated and full of loop holes that have provided lee ways for fragmented mining activities that are usually dangerous to the inexperienced miners.
- Lack of cohesive policies relating to land reclamation on land that has been exhausted of minerals.
- Poor trade and foreign investment attrition policies into the country in the mineral industry.
- Poor eviction, compensation or resettlement and general land policies concerning land rich in minerals.

The above contemporary issues are some of the very many problem areas that the government is trying to address through its various policies such as the National Mineral Resources and Mining Policy (2007) (Government of Kenya, 2012 and Munyiri, 2009)

The Relationship between Political Risk and Mining Industry

The widespread phenomenon of political (and policy) risks in several countries across time and its negative effects on their economic performance has arisen the interest of several economists. As such, the profession produced an ample literature documenting the negative effects of political risks on a wide range of macroeconomic variables including, among others, GDP growth, private investment, and inflation. Alesina et al. (1996) use data on 113 countries from 1950 to 1982 to show that GDP growth is significantly lower in countries and time periods with a high propensity of government collapse.

In a more recent paper, Jong-a-Pin (2009) also finds that higher degrees of political risks lead to lower economic growth. As regards to private investment, Alesina and Perotti (1996) show that socio-political instability generates an uncertain politico-economic environment, raising risks and reducing investment.

According to Aisen and Veiga (2006).indicated that Political risks also leads to higher inflation, Quite interestingly, the mechanisms at work to explain inflation in their paper resemble those affecting economic growth; namely that political instability shortens the horizons of governments, disrupting long term economic policies conducive to a better economic performance.

Purpose of the Study

This paper seeks to establish the effects of political risks on the Mining industry in Kenya bearing in mind that such risks do influence investment in this sector both locally and internationally. The target group includes both potential and current investors; local and foreign, financial institutions, Ministry of Finance and students undertaking MBA finance option.

II. METHODOLOGY

The study adopted a desk research study whose source of data was secondary. This was derived from books, various websites, Public Service periodicals, journals and newspapers.

III. RELATED LITERATURE

Types of Political Risk

1. Poor Legislation

The Mining Act Cap 306 of 1940 is outdated and does not apply to standard mining regulation procedures. The industry wants to see a new law that aims to remedy the problems by stating the timeframes and procedures to be followed when access to land is unreasonably denied. The current Mining Act, which dates back to the 1940s, has been termed as a major block in the development of the mining industry.

Therefore, the disjoint of this policy stems from the aspect of current technologies, complexities in the global mining industry. The mining legislation does not offer a conducive investment environment to potential and existing investors. Although Kenya has proven its mineral potential, the country is losing greatly on investments to our neighbors in Tanzania and Uganda due to lack of proper policies to guide the industry. Despite the fact that minerals are vested in the Government, it is a fact that, today, exploration and mining companies must obtain licenses or consents not only from the Commissioner of Mines and Geology but also from local authorities, through the County Councils, and from land right holders.

As the two later are not coordinated in any way with the office of the Commissioner of Mines and Geology, and are not regulated by the Mining Act, what results is that the process of obtaining exploration or mining rights is considerably complicated and there is no certainty for investors that the rules under which they operate are going to remain the same. It is a fact, for example, that County Councils have been changing their taxation rates in totally chaotic and unpredictable manner. For instance, investor confidence in Kenya's mining industry is being eroded by an upsurge of unlicensed people invading concession areas targeting especially gold and gemstones.

2. Taxation

Tax policy can also influence the marginal productivity of capital by distorting investment from heavily taxed sectors into more lightly taxed sectors with lower overall productivity (Harberger, 1962, 1966). Heavy taxation on labor supply can distort the efficient use of human capital by discouraging workers from employment in sectors with high social productivity but a heavy tax burden. In other words, highly taxed countries may experience lower values of market portfolio, which will tend to retard economic growth, holding constant investment rates in both human and physical capital (Engen and Skinner, 1992).

The composition of the tax system is probably as important for economic growth as is the absolute level of taxation. Countries that are able to mobilize tax resources through broad based tax structures with efficient administration and enforcement will be likely to enjoy faster growth rates than countries with lower overall tax collections assessed inefficiently.

3. War and Terrorism

There is no doubt among economists that wars, terrorism, and political instability have a significant negative effect on the economies in which they take place. Recent economic literature investigates both the consequences of political violence and the mechanisms that transform this violence into economic damage.

According to Eckstein and Tsiddon (2004a). They used the “Blanc hard-Yaari Model” of finitely lived individuals in an infinitely lived economy and incorporate terror into the model by lowering life expectancy, which individuals translate into a reduction in the value of the future relative to the present.

The increasing spread of extremism in Africa is the result of the socio-political ferment born out of poor socio-economic conditions, which has characterized African countries ever since independence. African countries are confronted by corruption, worsening these conditions and their government’s inability to deal with extremism. These conditions made African regimes unable to offer solutions to everyday socio-economic conditions, again contributing to instability.

According to (Gitu, 2003) Following these acts of terrorism, and due to imminent terror alerts from intelligence, Western governments, led by the United States, Britain and a number of European countries, issued travel advisories to all their citizens against traveling to Kenya in 2003. The country was losing an estimated amount of over 1 billion Kenya shillings ($128million) per week. In addition to the revenue loss, at stake were over 500,000 direct jobs and another 2.5 million indirect jobs.

Industrial Strikes

The industrial action has been directed to be outlawed in 1990. The industrial action allows the employees not involved in a dispute to strike in sympathy with other workers (Barrow and Chapman, 2005). The industrial action occurs as a collective agreement in force. If the dispute between the employer and employee is not settled, the agreement for a good production is not being followed and instead driven away. As a bad result of having an industrial action, heavy fines and employer’ rights to sue are the waiting prize for the distractions and damages resulting from unprotected industrial action (Pha, 1996).

Strike is a concerted and sustained refusal by working- men to perform some or all of the services for which they were hired (Webster's Dictionary, 1995). Strike indicates a breakdown of cordial relation between employees and employers. Employees normally participate in industrial strikes due to reasons such as: Government failure (known also as institutional failure), Obnoxious Policies, Changes in offer of Appointment, Non-implementation of Agreements, Differential in compensations package and conditions of service, Challenge to Union Legitimacy, Unnecessary Delay in Payments of Salaries and other Emoluments.

Corruptions

The effect of corruption has many dimensions related to political, economic, social and environmental effects. In political sphere, corruption impedes democracy and the rule of law. In a democratic system, public institutions and offices may lose their legitimacy when they misuse their power for private interest. Corruption may also result in negative consequences such as encoring cynicism and reducing interest of political participation , political instability , reducing political competition, reducing the transparency of political decision making, distorting political development and sustaining political activity based on patronage, clienteles and money,

In our society, the impact of corruption is often manifested through political intolerance, problems of accountability and transparency to the public, low level of democratic culture, principles of consultation and participation dialogue among others. The economic effects of corruption can be categorized as minor and major. However, both in one way or the other have serious impact on the individual community and country. First and foremost, corruption leads to the depletion of national wealth.

It is often responsible for increased costs of goods and services, the funneling of scarce public resources to uneconomic high profile projects at the expense of the much needed projects such as schools, hospitals and roads, or the supply of potable water, diversion and misallocation of resources, conversion of public wealth to private and personal property, inflation, imbalanced economic development, weakling work ethics and professionalism, hindrance of the development of fair in market structures and unhealthy competition there by deterring competition. Large scale corruption hurts the economy and impoverishes entire population.

Expropriation

In the late 1990s and early 2000s,the financial crises in East Asia, Latin America, and Central Europe caused a huge drop in firm value. During these massive shocks, interestingly, some countries lost their firm values more than other countries due to the weak governance regulation systems (Lemmon and Lins (2003)). As most research suggests, this is due to the expropriation (Johnson, Boone, Breach and Friedman (1999), Claessens, Djankov and Lang (2000), and Baekel al.(2004)).Under the weak regulations systems, the controlling shareholders can expropriate the wealth in their firms, and incur damage to firm value. The expropriation can be more severe during the crisis period (Mitton (2002)).

The expropriation violates the purpose of firms, which is the maximization of the shareholders wealth. With concentrated ownership, controlling shareholders can extract wealth from the firms for their benefit, but can decrease the other shareholder's wealth. Therefore, the expropriation negatively affects the firm value in market. There are several ways of expropriation. The controlling shareholders can extract cash by selling assets, goods, or services, and obtain loans on preferential conditions.

Furthermore, for conglomerates, the controlling founders or owners can transfer assets and profits from the listed company to other unlisted companies under their control (Johnson, La Porta, Lopez-de-Silanes, and Shleifer (2000)). In emerging markets, the expropriation is more important. Unlike developed financial markets, emerging countries' financial markets do not have enough legal mechanisms for protections of minority shareholders against controlling largest shareholder.

Resource Nationalism

Resource nationalism is characterized by the tendency for states to take (or seek to take) direct and increasing control of economic activity in natural resource sectors. Practitioners of resource

Nationalism can be found in countries from Russia to Venezuela and Guinea and many in between. Increasingly, resource nationalism encompasses not only producer countries but also a variety of approaches adopted by consuming countries seeking to increase their access to natural resources in other countries. Additionally, worries about the strategies behind investments by sovereign wealth funds that are built on natural resource revenues are giving rise to defensive reactions from some investment target countries. These may mark the emergence of a third kind of .resource nationalism.

The governments of natural resource rich countries insist on governing natural resources, or doing deals, in a way that places national interests or national political interests. The implication is that nationalization is of economic and political necessity and temporary in nature. Cognizance must be taken that in the event of a government, for whatever reason, electing to nationalize a project or sector, its stewardship of the asset is vital to protect the health and integrity of the asset to ensure its residual value to the state reprivatised. This residual value resides not only in the resale value of the asset by government to private interests but its ongoing economic value to the state.

It is therefore contingent on governments not to view mines as cash cows to be milked unmercifully, and that reinvestment of the returns from mines is a vital responsibility of ownership. Unfortunately, in many instances, it is not only the over-exploitation of the mining assets on the part of the state, but in regimes with weak leadership, mines are all too often prey to corrupt politicians. This obviously compromises the economic sustainability of their operations. In this respect, generic features of nationalization in weak political economies include the fact

IV. CHALLENGES OF MANAGING POLITICAL RISKS IN MINING IN KENYA

1. Poor Mining Legislation

The mining legislation does not offer a conducive investment environment to potential and existing investors. Although Kenya has proven its mineral potential, the country is losing greatly on investments to our neighbors in Tanzania and Uganda due to lack of proper policies to guide the industry. Despite the fact that minerals are vested in the Government, it is a fact that, today, exploration and mining companies must obtain licenses or consents not only from the Commissioner of Mines and Geology but also from local authorities, through the County Councils, and from land right holders. As the two later are not coordinated in any way with the office of the Commissioner of Mines and Geology, and are not regulated by the Mining Act, what results is that the process of obtaining exploration or mining rights is considerably complicated, and there is no certainty for investors that the rules under which they operate are going to remain the same. It is a fact, for example, that County Councils have been changing their taxation rates in totally chaotic and unpredictable manner.

According to proposed Mining and Minerals Bill 2009 is in the pipeline to be presented to parliament for enactment; however most of the issues raised by the stakeholders have not been captured. The mineral industry does not have a Seasonal Paper to guide its administration. In 2007, the National Mineral

Resources and Mining Policy was approved by the Cabinet but has not yet been presented to Parliament for enactment. Furthermore no consideration has been given to issues regarding the mining industry that fall outside of the frame of the Mining Act.

2. Access to land for reconnaissance and prospecting

Sections 22 and 39 to 89 of the Mining and Minerals Bill 2009 talk about issuance of reconnaissance and prospecting licenses. Section 22(1) insinuates that one needs consent from a land owner to receive a reconnaissance and a prospecting license, even in cases where the reconnaissance may be conducted using airborne surveys. Putting in mind that a large scale reconnaissance license can occupy an area of up to 1,000 km2 and that the license has a maximum validity period of five years without further renewal, also considering that an area of 1,000 km2 may have thousands of settled people who own or claim to own the land in question and that the proposed law recommends that consent should be sought from all of these land owners; lastly putting in mind that in many cases, reconnaissance and exploration do not cause any serious land degradation or damage.

This means that it is practically impossible to attain consents from thousands of landowners to perform prospecting or exploration activities over large vast of land due to its time and money consuming nature. There is also no surety that the amount of investment channeled towards these activities will be fruitful. The recommendations stated above will ensure that time and money is well managed especially since no company is ever prepared to spend huge sums of cash on compensating landowners or paying for consent to conduct reconnaissance or prospecting when they are not even sure that the ore bodies they are interested in are economically viable for exploitation.

3. Royalties

In Kenya, businesses pay multiple taxes with a cumulative tax rate of 50.9 per cent of total profits. Although this is an improvement from the previous 74.2 per cent, this still remains high and acts as a deterrent to formalization by businesses in the informal sector. This situation is about to be worsened by the proposed royalty increments. Mining companies will have to incur extra costs due to the increased royalties.

For every metric tonne sold of raw soda or common salt, eighteen shillings per tonne is payable as royalty; for every metric tonne of products derived from the raw soda or containing raw soda or its derivatives, twenty five shillings per tonne is payable to government as royalty. According to the Royalty on Fluorspar Regulations, 2003, the rate of royalty payable in respect for every tonne of fluorspar sold is the sum of seventeen shillings. Magadi Soda Company attracts a royalty of Kshs 150 Million per annum, while Kenya Fluorspar Company Ltd pays approximately Kshs 710 Million annually on royalties only.

Gypsum, limestone and pozzolana attract a royalty of twenty shillings per tonne each payable to respective local county councils. Bamburi Cement Company Ltd attracts an annual royalty of Kshs 35 Million on all locally mined minerals and a total taxation of Kshs 1.633 Billion in 2008. If the proposed royalty system is enforced, this country will see an abnormal rise in prices of cement and other building materials. This will halt infrastructure development especially since cement is the major product used to construct various types of infrastructure. The ripple effect will also cause increase in cost of housing, which will in turn affect all sectors of the economy.

4. Absence of a modern Mining Cadastre System

According to Kenya minerals organization, argue that Kenya lacks up to date land information on mining, which should consist of datasets for decision making in mining related issues. These include geo-referencing, detailed mineral resources maps, mineral rights and ore deposit valuation data. The department of mines and geology is responsible for keeping all mining cadastre maps. These maps are mainly used to demarcate areas that are covered by existing licenses. Currently, the maps are updated manually without clear verification on the ground.

Due to lack of precision of the manually updated cadastral maps, there has arisen a problem of overriding license applications. This is a situation where two or more licensees are granted rights over the same area. Conflicts always arise as to who is the real owner of the rights over that area.

The cadastral maps are not digitalized. It therefore makes it difficult to update them accurately.

The Mines and Geological Department does not have the capacity to upgrade their cadastral systems due to lack of fiscal and technical resources.

5. Absence of Incentives (Taxes)

Currently, the mineral industry has not been able to attract substantial foreign investments due to lack of favorable incentives specific to it. This industry is in its early stages of development and requires a lot of input in regard to capital, research and infrastructure. Incentives attract international investments, which create more jobs, develop infrastructure and make mineral discoveries.

In general, investments into mining activities are risky due to long gestation periods, unknown geology and fluctuating commodity prices. However, operational mines offer numerous benefits such as employment, infrastructure development and enhanced tax revenues. Thus it is in the best interest of the government to create a tax regime that captures a fair share of the profits generated by mining activity, while not punishing marginally profitable mining operations.

V. COST OF POLITICAL RISKS

Political Risks Discourages Foreign Direct Investment (FDI)

According to (Becker, et al., 2006; Bengoa & Sanchez-Robles, 2003; Fung, Garcia-Herrero, & Siu, 2009; Hill & Munday, 1995; Kolstad & Villanger, 2008; MacDermott, 2007; Sethi, Guisinger, Phelan, & Berg, 2003; Slaughter, 2003; UNCTAD, 2009). There are multiple factors that attract or deter foreign investment. Simply put, market opportunities and location advantages of the host economy help host economies attract more FDI: Such advantages include a large domestic market, sustainable growth; sufficient economic and infrastructure development and/or high natural resources endowment, Bad investment and policy environments in host economies deter FDI.

Political instability and violence both domestic and international discourage Multinational Corporation from investing in the host economy that is subject to such risk (Büsse & Hefeker, 2005; Büsse & Hefeker, 2007; Bussmann, 2010; Büthe & Milner, 2008; Daniele & Marani, 2010; Diamonte, Liew, & Stevens, 1996; Enders, Sachsida, & Sandler, 2006; Haftel, 2006b; Jensen, 2004, 2008; Ramamurti & Doh, 2004).

A host economy with high political risk tends to discourage FDI flows into its market, since political volatility hurts the profitability of foreign investment. Three major types of political risk discourage foreign investment since they damage its profitability and survival: first, nationalization or expropriation of foreign assets, which tends to be rare, and breach of contract, which occurs more often, threaten foreign investment; second, policy instability and arbitrary regulation in FDI-related policies create uncertain investment environments and hurt the profitability of foreign investments; and third, war and political violence, including terrorist activities, can damage foreign assets immediately and discourage the productivity of a host economy in the long run (Jensen, 2008, p. 1043; MIGA, 2010).

Nationalization of foreign assets

One of the most extreme cases of political risk is nationalization and expropriation of foreign assets. Although nationalization of foreign assets has become rare even in developing nations since the 1990s, such a possibility still exists (Haftel, 2006a; Jensen, 2003a; Slaughter, 2003). For example, Chávez nationalized the last privately owned oil reserve in Venezuela in 2007, heightening tension with other foreign investors, such as BP PLC, ConocoPhillips, Exxon Mobil Corp., Chevron Corp., France's Total SA and Norway's Statoil ASA (Pearson, 2007).

Ramarmurti and Doh (2004), argue that, the real threat, however, is "administrative expropriation,").Which has become more frequent (p.164). The host government can 'squeeze' and hurt the profit of foreign investment by denying and delaying the development of investment and, thus, forcing foreign investors to renegotiate and change the terms of investment (Ramamurti & Doh, 2004).

Reduction in Economic Growth

War and political violence on both the domestic and international level deter foreign investment (Büsse & Hefeker, 2005; Büsse & Hefeker, 2007; Bussmann, 2010; Daniele & Marani, 2010; Desbordes, 2010; Haftel, 2006b; Jensen, 2008; Singh & Jun, 1995; Tarzi, 2005). Political violence, e.g., civil wars, insurrections, organized crimes and international conflicts, leads to "political instability, the disruption of the orderly economic process in the host country, and thus smaller profit," and "such events may put host governments under political and economic pressure, which may result in nationalization and expropriation of foreign assets in order to alleviate short-term difficulties" (Haftel, 2006b, p. 6).

First, international conflict deters FDI (Büsse & Hefeker, 2005; Büsse & Hefeker, 2007; Bussmann, 2010; Desbordes, 2010). Bussmann (2010) shows that the onset of fatal conflicts not only tends to reduce FDI stock with a delay of three years but FDI inflows, in turn, also decrease the war risk of host countries. Second, domestic instability and violence can also deter FDI. Ethnic tension (Büsse & Hefeker, 2005; Büsse & Hefeker, 2007) and religious tension (Desbordes, 2010; MIGA, 2010) deter foreign investment.

The recent study on Italy shows that organized crime is strongly and negatively correlated with FDI inflows since organized crime tends to limit corporations' business activities and profitability through corruption and violence (Daniele & Marani, 2010). Desbordes (2010) finds that MNCs weigh both the global, overall political risk of host countries measured by the ICRG, and diplomatic, dyadic political tension between a host country and the US when they make foreign investment. They increase the required return rate of investment as the overall political risk of a host country, measured by the ICRG, increases and diplomatic tension between the host country and the US worsens (Desbordes, 2010). Thus, host countries hoping to attract more FDI should avoid conflict and violence at home and abroad.

Lost of foreign investors confidence

According to Alomar & El-Sakka, (2011, p. 116), argue that Terrorist attacks have "grave impacts" on economy by depressing "growth, investment, and trade flows." Immediately, they cause "a loss of human and non-human capital," "uncertainties," and "retrenchment of certain industries" like travel and recreation industries. In the long run, they increase "uncertainties of any permanent threat of terrorism" and cause "added anxiety, stress, and mental disorder. Terrorist attacks can further damage attacked countries by discouraging foreign investment flows into the countries (Alomar & El-Sakka, 2011; Büsse & Hefeker, 2007; Bussmann, 2010; Enders & Sandler, 1996; Gaibulloev & Sandler, 2009; Lee, 2011; Skaperdas, 2011).6 However, some find little to no lasting effects of terrorist attacks on FDI flows (Enders, et al., 2006; Gaibulloev & Sandler, 2011).

Examining the impact of terrorism on Foreign Investors in Asia for 1970-2004, Gaibulloev and Sandler (2009) show that poorer and developing countries were less able to absorb the negative impact of terrorism than rich countries (see also Skaperdas, 2011).7 Literature argues that it is because rich and more developed countries have dominant location advantages and, thus, they are better able to diversity foreign investment and appeal to other foreign investors. In addition, Lee (2011) shows that the negative impact of terrorism is mitigated by a strong military and, thus, terrorism can deter Foreign Investments in a host country only when strong military is absent.

VI. MANAGEMENT OF POLITICAL RISKS PRIOR TO INVESTMENT

The political risk management strategies depend upon the type of risk, the degree of risk the investment carries and the stage of the investment. For example, the strategy adopted prior to the investment will be different from that adopted during the life of the project. (Sharan, V. (2008) International Financial Management) Investment will prove viable if political risk is managed from the very beginning, even before the investment is made in a foreign land.

The Political Risk Assessment

PricewaterhouseCoopers and Eurasia Group have joined together to offer a Political Risk Assessment (PRA) diagnostic and monitoring methodology, which helps executives monitor their international exposures. The PRA is a systematic approach to understanding and anticipating how current and future political events could materially affect a company's organization, and thereby helps the company better manage its international exposures. The Political Risk Assessments has three phases as the diagram below indicates

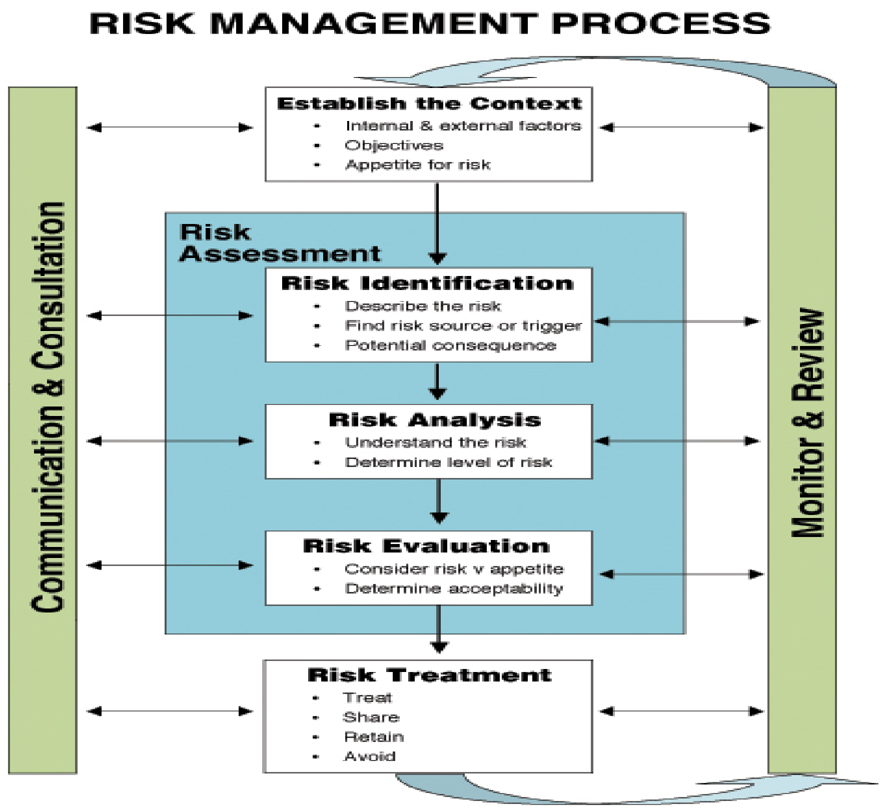

Figure 1: the three phases of Risk Assessment

Identification of the Political Risk

Analysts look at the company's current and future international investments, global supply chains, and key foreign commercial relationships. They map these against global trends, macro-level country risks, and industry specific risks to create a comprehensive picture of risk exposure. This phase also provides a check against the company's internal assessment of risk.

In the Identify stage, the risk management team will develop an evidence-based set of risk scenarios, based on both well defined and highly specific data directly relevant to the company's objectives. Data can be drawn from high quality political risk consultants, local subsidiaries and Partners, the public domain, other companies, industry associations, local organizations and other sources. Larger companies will often use specialized data-mining software configured for their specific business. Once the organization establishes a broad political risk scenario set, the risk management team can prioritize those risks that are most material to the company's business. Although most often the criteria used for prioritizing will be a simple combination of probability and impact, other criteria may include recent losses, board level concerns, or high vulnerability to extreme events.

Impact and measure Analysis

Analysts assess the company's vulnerability to risks and the potential economic and strategic impacts of risks on costs and revenues. Advisors work with the organization to test qualitative and quantitative risk scenarios and strategic responses. Armed with a very specific set of political risk scenarios, risk managers assess and quantify the impact of each scenario on the business. Discounted cash flow (DCF) analysis can be used, for example, to estimate the financial impact of specific events. In this method, analysts estimate how political risks such as a change in tax rates, regulation-related spending, delayed timelines or costs of partnering with state-owned enterprises would increase or decrease cash flow.

In the Measurement stage, political risk management increases the accuracy of capital performance estimation and also reveals opportunities for investment of capital and management resources. One of the most important aspects of measurement is the translation of projected events into readily identifiable and comprehensible metrics, such as dollar figures, an impact index, or an ability-to-influence index. Using these metrics, risk managers can assess whether the risk level surpasses the organization's risk appetite, or tolerance. Based on this input, a decision is made on whether to accept, avoid, or manage the risk.

Recommendation and Management of the political risks

Advisors work with the company to develop a plan for mitigating identified risks, pursuing potential opportunities, or seeking alternative strategies. Strategy shifts may include improving risk-management processes or decisions to enter or exit markets or to shift sourcing strategies. PwC and Eurasia Group complement this phase with ongoing monitoring of political risks and once risks have been identified and measured, an effective system for active political risk management can be put in place. The first element in managing political risks is to map potential risk management methods against the priority risks. Companies actually have a range of tools and processes at their disposal to help manage and mitigate political risk. For firms unable to identify which measures are reducing their exposures and where there are gaps, managers should choose or evaluate the most suitable management.

VII. CONCLUSIONS

The purpose of this paper has been to review the effects of political risks in mining industry in Kenya.

1. The mining industry can gain significant benefits from managing political risk and ignore this risk at their peril. Effective management of political risk enables companies to tap new revenue streams through access to markets and joint ventures that, without careful management, might seem too risky.
2. Clear management of political risk facilitates the mining system strategies in developing countries which have a high level of potential growth. What is clear is that taking political risk seriously involves companies adopting proactive steps to assess and mitigate their risks. It is therefore important to manage political risk in relation to the stage of the investment, that is, prior, during and in case of nationalization.
3. The proper management of the political risks has ability to spot crises and respond more quickly and effectively is also likely to mitigate losses, providing improved confidence in management's ability to deliver high performance as well as sustain their competitive advantages despite being in risky countries hence improve the mining industry.
4. Mining projects in challenging locations often face risks stemming from political violence, including regional conflicts, civil wars and localized violence specifically directed toward the project. The impact of political violence on a mining project can range from damage and destruction of assets to the inability to continue operations and possibly the forced abandonment of the project in its entirety. In recent years, a number of mining projects have experienced violence-related issues in many countries, including Turkana and Kwale County.
5. It is also important to consider that episodes of political violence can lead to expropriation or forced contract renegotiation, as it is not unusual for a new government in a politically unstable part of the world to reexamine the revenue-generating projects in the country, particularly when a new government is starved for cash after a long conflict.
6. The dollar revenues from a mining project can be an alluring target for a government that is experiencing prolonged current account deficits and downward pressure on its currency. While the proceeds from a mining project are usually collected in dollar-denominated off-shore accounts, there have been instances where a host government has abrogated the right to sell production and maintain project-related accounts off-shore.
7. Kenya has not had a well defined land policy over the years. This, together with the existence of many land laws, some of which are incompatible with the various land uses in the country, has caused complexity in land management and administration. To address this problem, the Government has come up with a National Land Policy 2007 whose vision is to guide the country towards efficient, sustainable and equitable use of land for prosperity and posterity. This policy will ensure that all land is put into sustainable and productive use. The policy has so far received Cabinet's approval and is currently waiting for enactment by the legislature.
8. As the global demand for minerals continues to grow and industrialized country mineral reserves dwindle, many mining companies will be forced to seek revenues in countries that present difficult political and security operating environments. While prudent management practices can help mitigate some risks, the nature of extractive projects and the difficult countries in which many of them operate result in heightened exposure to political risk for the mining industry. Fortunately, there is a large and stable political risk insurance market where companies can protect their assets against risks related to expropriation, political violence and currency inconvertibility
9. It is evident that Kenya is well endowed in mineral resources, which can be economically

Extracted to benefit the country and investors. However, there has to be good policies to govern the exploitation of the ore deposits. If the regulatory procedures are attractive enough, investors will flow into the country and offer employment to the citizenry, widenthe tax base, contribute to development of roads, schools, processing plants, hospitals etc that are required in rural areas

VIII. RECOMMENDATIONS

This paper was able to conclusively show the effects of political risk in mining industry in respect to Kenya. Of notable concern was the impact of the host countries government in reference to political risk.

1. Expropriation coverage offers protection in the event of confiscation, expropriation, nationalization and other

acts by a host government that deprive the company of its fundamental rights to its venture, mined material, equipment or other assets. Creeping expropriation a series of acts that ultimately have an expropriator effect can be included as well. Selective discrimination, forced divestiture, and losses arising from breach of contract by the host government or the non-honoring of a government payment obligation under an off-take agreement or other commercial arrangement can also be covered.

2. Political violence coverage offers protection against the damage or destruction of assets resulting from events such as war, revolution, insurrection, civil unrest, terrorism and sabotage. Coverage for business interruption is also available, as well as the forced abandonment of a project due to political violence.

3. Currency inconvertibility and non-transferability coverage protects against the inability to convert local proceeds to hard currency and repatriate the currency. An element of this coverage that is particularly relevant to the mining industry is the protection that it provides against government decrees that force the company to bring project-related revenues back onshore to local accounts.

4. To also ensure a reduction in political risk, the government has adopted a new constitution which it should ensure it is fully operational in the limited time possible. Apart from the new constitution, it has the power to ensure that political risk is minimized by educating the citizen on the important of peace. This can be done through mass media. It should also ensure activities that facilitate increase in political risk like corruption are dealt with. Proper guideline and rules should be put in place. It should not turn a blind eye on problem relating to political risk.

5. Management of Multinational Corporation companies can also help manage political risk by proper analysis of the macro and micro environment before venturing into an investment. Various techniques are available to access political risk. They include; checklist approach, Delphi approach, Quantitative analysis, Inspection visits or even a combination of these. The analysis would be based on subjectivity and objectivity of the management but should be based on facts rather than hearsay. With this analysis it would be possible to determine the level of political risk in various sectors of the industries hence manage it appropriate.

6. Concession guarantees are negotiated contracts between a company and a government that gives the company the right to operate a specific business within the government's jurisdiction, subject to certain conditions. In case of concession agreements that are found mainly in mineral explorations, the government of the host country retains ownership of the property and guarantees lease to the producer. The government is interested in earning form the venture so it does not cancel the agreement. This can be related to the oil exploration and discovery in Turkana by Tullow Oil Company. However, this is not a permanent solution. When the technology becomes standardized, the host government often cancels the agreement. Again, if a new government is formed, there is a very possibility for the cancellation of the agreement concluded by the previous regime. Patents and copyright are most implemented to safe guard this.

7. Structure Operating Environment in Political risks can be reduced through creating a linkage of dependency between the operation firm in a high-risk country and the operation of other units of the same firm in other countries. If the unit in a high-risk country is dependent on sister units in the countries for the supply of technology or raw material or for marketing of its products, or in other words, so long dependency is maintained, the former is normally not nationalized because the high-risk unit will not be in a position to operate without the imported technology or raw material. In Kenya, East Africa Portland Cement has not only focused in mining and cement production but has also embarked in recreation such as the Bamburi Nature Trail and Haller Park in Mombasa.

8. The Political support by the host-home country such as Kenyan Government in support of mining industry especially the foreign companies whom investing in Kenya. However such a relationship may change and the political alliance may be disturbed when a new government is formed. So the maintenance of political support is the key to managing political risk. An example could be the relationship between the UK and Kenyan governments as helped British Multinational Corporation to thrive in Kenya. Barclays Bank Kenya is a good example of this due to the two government relationship. UK lends funds to Kenya for political purposes and in return open Multinational Corporation companies in Kenya can reasonable cost.

9. In order to fully develop the mining industry, Kenya needs to encourage exploration and Development of new mining projects, as well as the expansion of current ones. Future investment and capital programs should be made more attractive while maintaining the few operational mines that currently exist to ensure that the human capital and mining culture that is so important to the creation of a mining industry, remains. The country has not offered sufficient incentives to attract meaningful investment into the mining sector.

10. The mineral industry potential is currently locked by the regulation procedures and requires immediate attention. The proposed Mining and Minerals Bill should be amended

To include stakeholders' inputs and presented to Parliament soonest possible for enactment. The National Mineral Resources and Mining Policy should be converted into a Seasonal paper. The Government should ensure law enforcement, giving and meeting the timeframes for granting licenses and solving disputes. The small scale miners require support in leasing of capital mining equipment and linkage to international markets to promote selling of their products.

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