

# Comparative Analysis of Investment Incentives in Ethiopia and Other East African Countries

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## Abstract

Ethiopia introduced various Economic Reform Programs including investment incentive reforms since 1992. The main reason Ethiopia introducing various investment incentive reforms including tax incentive is to create enabling environment for both domestic and foreign investors, and thereby create employment opportunity, boost economic growth and broaden the tax base. However those government assumption and stated objectives were not achieved since the role of private investment in the overall development of the country is very low and it is also lag behind some East African countries. If this so, why the government of Ethiopia introduce and implement various incentive packages requires investigation on how the tax incentives were design and implemented and make comparative analysis with relatively better performing East African countries with nearly similar level of development. Owing to this, this article tries to address those issues by employing both primary and secondary data.

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## 1. INTRODUCTION

Most reform of tax administration in developing countries including Ethiopia is usually carried out as a part of fiscal system reform. Their only focus is on problems related to; forming institutions, property rights, transaction costs, etc but they give less emphasis on organizational and implementation aspect of public finance (Tanzi, Jenkins, Sanford). According to their finding most of the past tax reforms in developing countries were on tax policies. However according to Bird, (2015) a good tax system cannot produce excellent result without proper implementation. Proper implementation of tax system is relied both on good design of the tax system and its administrators (Gill, 2000).

Ethiopia has also introduced various Economic Reform Programs including tax reforms since 1992 with the aim of encouraging trade, investment and hence development. Those reforms are geared towards promoting investment, supporting industrial development and broadening the tax base in the view of financing the need of government expenditure. One of the tax reform design and implemented in Ethiopian is designed towards promoting investment, enhancing the role of the industrial sector in the economy by giving tax incentives and decreasing the tax rate.

The Ethiopian tax incentives was revised so many times starting from 1992 onwards. For example, with the aim of encouraging private investment, investment code No. 15/1992 was issued and was in effect for four years. This code limits investments which are eligible for incentives only to manufacturing and agriculture sector. Those tax incentives include 100% exemption from custom duty on imported capital goods and tax holiday ranging from 1-7 years depending on type and location of the investment. This code is revised in 1996 by Proclamation 37/1996 and extends areas of investments eligible for incentives to Education, health, tourism and construction sectors. Furthermore capital requirements for investments in joint ventures was reduced from 500,000 USD in 1992 code to 300,000 USD in the new code and for technical consultancy services was reduced to only US\$100,000. Proclamation 37/1996 was replaced in 1998 by proclamation No.116/1998 and broaden areas of investment for the private sector to invest jointly with government in defense and telecommunication which was restricted in past code only to the government.

Accordingly, Ethiopian investment codes are further amended in 2002 (Proclamation No. 280/2002), 2002 (Proclamation No. 286/2002) and in 2012 (Proclamation No. 769/2012). Those investment codes were further broaden the investment areas to the private sector and lift restrictions in many areas for foreign investors except investment in finance; forwarding and shipping; broadcasting services; and air transport services using aircraft with a seating capacity of up to 50 passengers. Those areas of investment are restricted for domestic investors, the government and Ethiopian nationals by birth.

The significant change in Ethiopian investment policy was done in 2014 and 2016 when the government decide to establish; Industrial Zone, Investment boards and enlarge the tax holiday up to 15 years when investment is located in the industrial zones Due to these and others , FDI inflows to the country increased in absolute term but it is very low in relative term ( NBE, 2017/18). If this so, why the government of Ethiopia introduce and implement various incentive packages requires investigation on how the tax incentives were design and implemented and make comparative analysis with relatively better performing East African countries

with nearly similar level of development. Owing to this, this article tries to address those issues by employing both primary and secondary data.

## 2. Materials and Method

This study applied both primary and secondary sources of data. The primary data was collected through questionnaire, interview, and focus group discussion. Secondary data is gathered from different publication, documents, financial and non financial reports; and Ethiopian Investment Agency(EIA) & Ethiopian Revenue and Custom Authority(ERCA) proclamations. The type of questionnaire used in the study is a combination of close ended & open ended and self administered questioners and was analyzed using both descriptive and inferential statistics.

## 3. RESULT AND DISCUSSION

### 3.1. The Way Investment Incentives was Design in Ethiopia

Even though many studies indicate that, if countries objective is to increase total investment of all types, the best policy option is improving its investment climate rather than relying only on tax incentive. But many developing countries including Ethiopia heavily rely on tax incentives than improving their investment climates in order to attract specific investments. One way of designing tax incentive to attract specific investments is targeting incentives, for example all new investment, domestic or foreign, or may be very narrowly targeted, and designed with one particular investment in mind. But different investment theories indicate that tax incentives should be given only for investment both their long run and shorts run benefit outweighs its cost and for investments that could not be materialized without incentives. Therefore, tax incentives are justifiable only if they attract investments that contributed to the stated objective and if these investments will not possible without giving those incentives.

Thus, we can evaluate the Ethiopian tax incentive by addressing the question “what types of investment is the country intended to attract?” in designing its tax incentive. We can see that investment incentives are targeted to specific industries including manufacturing, agriculture and tourism sector which are considered as the engine of growth of the country. But when evaluate the result even though, there are certain achievement, but the overall result is far behind what is intended to achieve compare to the amount of tax incentives given which is 51% of government revenue and 7.52% of GDP. For example; the contribution of private investment is less than 10% in agricultural production and export, the contribution of manufacturing to GDP is only 26% and there are only less than 100 star level hotels in Ethiopia.

Another question which is important to be raised is whether tax incentive should target domestic or foreign investors. If a country only targets its tax incentive to only foreign investors it can result to loss of revenue, it may distorts competition; and may restrict the growth of domestic enterprises, or even prevent the development of a domestic sector. On the other hand if the incentives are only targeting domestic investors it may hinder the transfer of technology and the inflow of foreign capital. With this regard, the countries investment policy is biased towards public investment and domestic private investment, because there are so many investment areas that are restricted only for the public and domestic private investors. Except those restrictions, most tax incentives, including custom duty exemptions, tax holiday, export incentives and other non tax incentives are rendered equally to both domestic and foreign investors based on initially sated criteria's.

The other most common criteria in designing investment incentive is targeted to new investors. However, in practice, restricting tax incentives to new investors may be ineffective and counter-productive. For example an existing investor that plans to expand its operations may create new subsidiary or form a related corporation in order to qualify for tax holiday. With this regard, the Ethiopian tax incentive is good because it is not only directed to new investors but also for investments who expand at least 50% of their existing investment.

The other criteria many countries use in designing tax incentives is targeting large investment those exceeding a specific threshold level capital. The amount of capital required to classify large investment from medium and low investment differs from country to country. However empirical evidence indicate that qualification based on a particular threshold is difficult to justify and in some cases medium investments may be beneficial to a country than big investment.

With this regard, when we evaluate the Ethiopian tax incentive its target is medium size investments rather than targeting only large investments. This is because, the investment incentive proclamation of 2016 indicate that foreign investor is eligible for tax incentive if he invests a minimum USD 200,000 USD for a single investment project and 150,000.00 USD if the investor jointly invested with domestic investor. Furthermore, if foreign investor invests in architectural or engineering works or related technical consultancy services, technical testing and analysis or in publishing works are required to invest 100,000 USD if the investment is foreign owned and 50,000.00 USD if the investment is made jointly with a domestic investor. On the other hand there is no capital requirement for foreign investors in Export-Oriented Non-equity Based investors, but the investor is required to submit guaranteed external market access; Production know-how of products for export market;

Export business management know-how; and Export marketing know-how. From this we can observe that the Ethiopian investment proclamation is good in targeting medium investments, this is because large investments require skilled man power and better infrastructure and even there is high computation with different countries. But the problem in this investment proclamation is that it only set the capital requirement for foreign investors but not for domestic investors which are eligible for tax incentives and this could be one reason for misuse of tax incentive by domestic investors.

In addition to sectoral targeting many countries for instance Malaysia and Singapore give special tax incentives to “pioneer” industries. To get a pioneer status, an industry must manufacture products that are not produced domestically, that give especial benefit to the country. With this regard, the Ethiopian tax investment proclamation failed to address this issue, even though many countries benefit from directing investment incentives to pioneer industries.

The other important point which is indicated in the investment proclamation is directing tax incentives to locate investments in particular areas or regions within the country. With this regard the Ethiopian tax incentive give tax holiday privilege for those investors who invest outside the capital city Addis Ababa and surrounding areas between 2-4 years. But the result is the opposite, where almost 94.55% in number and 89.88% of capital is concentrated in areas where there is better infrastructure facility and human resource. Other criteria to evaluate tax incentives is related with a predetermined number of new employment created. Even though in the earlier investment proclamations there is no any article which clearly articulate the number of employment opportunities any investment eligible for tax incentives should create, in addition to the capital requirement, the 2016 investment proclamation set a minimum of 50 employment opportunities an investor should create to be eligible for tax incentive. This is another fact that shows us the Ethiopian investment is targeted medium enterprises, since the international experience shows us that enterprises that can create 50 employment opportunities are categorized as medium enterprises .

Countries try to benefit from technology transfer by attracting technologically-advanced investment through different mechanisms including; targeting tax incentives to technologically-advanced sectors; or giving incentives for the acquisition of technologically advanced equipment; and giving tax incentives for R&D. In Ethiopia even though, there are clause which relate tax incentives with technology transfer but it is not clearly defined what does it mean and how can we measure and identify it. But the proclamation gives high discretionary power to tax and investment officials and this may nurture corruption. On the other hand, there is no clear clause in the investment proclamation which relates research and development and incentives.

Most developing countries now a day's adopt export promotion policies and strategies. For this reason their tax incentives were directed towards investors which are export-oriented. However attracting export orienting investments were difficult since every developing country compute for such types of investment and such types of tax incentives are highly mobile. However, such type of incentives requires careful design because it is contrary to the WTO rule where most developing countries including Ethiopia try to accede. With this regard, Ethiopian investment proclamation and investment incentives also target investors who export at least 60% of their products.

## **3.2. Types of Investment Incentives in Ethiopia**

### **3.2.1. Tax Holiday**

In developing countries, like Ethiopia tax holidays are the most common form of tax incentive. Tax holiday in most African countries is bound for new firms and not given to existing firms. When firms are granted tax holiday, they are exempted from certain types of taxes. For example in Ethiopia, if an investor is engaged in new manufacturing, agro-processing, the production of agricultural products and investment in areas of information and communication technology (ICT) development; it was given the following forms of tax holidays:

- If the given investor exports 60 percent of his products or services, or supplies 75 percent of his products or services as an input to an exporter, he will be exempted from income tax for 5 years. And under special circumstances, the investment board may grant income tax exemption up to 7 years and the Council of Ministers may pass a decision to grant income tax exemption for more than 7 years;
- If the investor exports less than 50 percent of his products or services, or supplies his products or services only to the domestic market, he/she will be exempted from payment of income tax for 2 years;
- If an investor who exports its products or services , expand or upgrade his existing investment, at least 50 percent of his production or service capacity he/she will be exempted from income tax for 2 years;

For each type of tax incentives mentioned above, the length of the tax exemption period may be extended for two to four additional year when the investment is made in relatively under-developed regions of the country. Investors who invest in priority areas (textile and garments, leather products, agro-processing, etc.) and mainly export their products will be provided land necessary for their investment at reduced lease rates. However, investors who export hides and skins after processing below crust level are not eligible for tax holidays.

As different empirical studies shows, tax holidays may be; a complete exemption from profits tax and other

taxes, tax rate reduction, or a combination of the two. For example Ethiopian tax holiday system is a complete exemption of business income tax for the given period of time. However when we compare with other east African countries like Kenya, Djibouti, Tanzania, Rwanda, and Uganda it is totally different because those countries give both exemption and tax rate reduction. Even we compare the Ethiopian tax exemption period with that of East African counter parts it is by far different. For example, Income tax exemptions in Ethiopia was given for a period of time between 1 and 6 years, and depending on the type of investment and for areas where they are identified relatively as underdeveloped additional income tax deduction for three consecutive years after the expiry of the tax holiday period is allowed. But the problem which is observed in the Ethiopian tax incentive regulation is not only the length of the holiday period but also the determination of the number of years of the holiday period, where the regulation gives discretionary power to bureaucrats' based on certain subjective requirement and this may affect the fairness of incentives .

However the corresponding figure for Kenya is 10 years exemption plus a 10 year's reduction by 5 percent for investors which are found in the Export processing zones without giving any discretionary power and total exemption without any limit for firms in the special economic zone. The respective figure for other east African countries also different, for example in Djibouti there is comprehensive tax holiday exemption to encouraged investment which includes; exemption from land tax for construction of buildings for a period of 7 years; exemption from tax on business profits resulting from the approved activities for a maximum of 7 years; exemption from domestic consumption tax for raw materials imported and used in the first year; and exempt from the tax on building permits.

There is also another difference with Kenya, were in the Export Processing Zones (EPZ) there is comprehensive tax incentives which includes, 10 year corporate tax holiday and only 25% tax rate for next 10 years (where the normal corporate tax rate is 30%) and 10 year withholding tax holiday on dividends and other remittances to non-residents. However in the industrial zones in Ethiopia as it was indicted in the Council of Ministers amendment of; Investment Incentives( Regulation No. 312/2014) and Investment Areas Reserved for Domestic Investors ( Regulation No. 270/2012) the type of incentive given to investors was separated between developers and tenant investors of the industrial park. With regard to developers of industrial park income tax exemption for 10 years is given if the industrial park is found in Addis Ababa and in Oromia Special Zones Surrounding Addis Ababa, however if the industrial parks are constructed in other areas of the country; income tax exemption for 15 years is granted. On the other hand if the investor is tenant investor in the industrial parks or if the investor gets the park through lease from the industrial park developers the income tax incentive exemption is related with the percentage of the investor's product exported. If the investors exports 60% of its product in addition to the income tax exemption which is given to investors outside the park 2 years income tax exemption is given without making any distinction on type of investment. However, if the investor exports more than 80% of its product additional 2 years income tax exemption will be provided in industrial parks in Addis Ababa and Oromia Special Zones Surrounding Addis Ababa and 4 years income tax exemption will be provided in industrial parks in the other areas. Therefore the maximum tax exemption years in the industrial park are 15 years for park developers and between 8-11 years for the tenant investors.

Another factor which is related to tax exemption and applied in many developing counties is investment deduction. However, investment deduction in Ethiopia is not applicable, but Kenya gives 100% investment deduction without any minimum investment requirement. Even though there are certain differences, the same is true in other east African countries of Uganda, Tanzania, and Rwanda. Other incentive package that makes Ethiopia and Kenya different is that, in Kenya there is tax incentive related with training of workers of the investor but this is not applicable in Ethiopia.

With regard to length of tax holidays, many empirical studies indicated that short period tax holidays are always not effective in attracting investment of long gestation periods, rather they are effective in attracting private investments that are short term in nature. This because large and long gestation period investment take several years before they begin a profit, it may be after the tax holiday expires. Short period tax holidays can benefit from investments incentives that can bring quick profit such as textile and agro-processing industries. Therefore, when we evaluate the Ethiopian tax holiday it is very short period of time which is 5-7 years as compared with the other east African countries which ranges from 10 years up to without limit. So, it make it hard for Ethiopia to compute regionally in attract large investments, despite they are considered as engine of growth .

Tax holidays are preferred from other tax incentives because of their simplicity for both the investors and the tax authorities. Its simplicity is relied not only on the ground that no tax is paid during the holiday period, but also the investors are not required to file and report information on tax returns. But, even though it has administration costs the better approach is if investors' are required the filing and reporting of the tax return during the holiday period. This is because, in order to evaluate and approve loss carry forward and for investors who claim for depreciation, filling and reporting tax return is helpful. With this regard the Ethiopian investment tax incentive rule required investors to file and report tax return during holiday time, which is not common in

other east African countries and it is one of its strongest side.

On the other hand, tax holidays have drawback, since it is easy to manipulate and could have a room for tax avoidance and evasion. Another problem with tax holidays is that there is no mechanism to analyze its cost and benefit because of lack of proper documentation and data problem in developing countries in general and Ethiopia in particular. With this regard as the discussion with relevant authorities in ERCA and Investment commission indicate that, because the administration and evaluation of tax holidays rests on different authorities there is no mechanism of ensuring whether the tax holiday meets its objectives or not and it is also not free from manipulation, avoidance, and evasion. Similarly, the respective government organs did not evaluate on regular basis the cost and benefit of tax holidays and even the available data on tax holidays on individual investor's base was available only from 2014 onwards (ERCA,2017 data base). However, with all this drawbacks and without weighing its benefit and costs the government selects tax holidays as the main instruments of investment incentives.

The other thing which requires strong emphasis is determining when should the tax holiday starts and this may affect positively or negatively the achievement of the stated objective of the incentive and transparency of its application. There are many options which are applicable in the different countries with regard to the starting time of tax holiday. The tax holiday may start; when the investment starts production, in the first year in which the investment makes profit, and in the first year that the firm achieves a positive cumulative profit since its operations. However those alternatives have their own strength and weakness. For example, large investment projects in their early stage of operation incur losses because of high capital, training the workforce, and searching for market. If the tax holiday is applied when the investment starts production, it increases the amount of tax paid by the investor over the life of the investment. So, applying this alternative for larger projects can serve as disincentive rather than incentive. Similarly, if the investor loss during the holiday period they may be allowed to carry forward the amount of loss for a given period of time, therefore the investor is not benefited from the tax holiday because, the holiday may start when no taxes would have been paid in any event when there is no profit. In case of the second alternative when holiday starts when profits are first generated, similar situation to the first alternative can occur. However, even though, the third alternative is better in attracting large investment but it is also ambiguous as to when the cumulative net profits are positive, but if it is supported with specific rules without giving any discretionary power to officials, this method is better way to attract heavy and large investments.

When we analyze, the Ethiopian tax incentive rule with regard to when the tax holiday starts, as it is indicted in regulation 270/2012 the tax holiday will be started when the investment starts production and this will be approved by the investment commission. As the regulation gives the discretionary power to the investment commission to determine when the investment starts production, this may lead to manipulate the tax incentive and finally leads to corruption. However, most investment analyst advice countries to have rule based incentives rather than giving discretionary power, but the opposite is true in Ethiopian case. In general the Ethiopian tax incentive scheme is targeting short lived investments, since the holiday period is very short and the time where the tax holiday starts is when firms start production which is suitable for short period profit making investments.

Another related problem in the implementation of tax holidays is the treatment of depreciation during the holiday period. There are two mechanisms applied in different countries for the treatment of depreciation. One way is deducting depreciation during the holiday period and the other way is deferred it until the holiday period terminated. When we deduct depreciation in the time of holiday period, it decreases the amount of tax exempted. On the other hand deferral of the deduction until the tax holiday terminated it may overestimates the costs associated with the post holiday period and leads reduction in tax, therefore it requires critical investigation. However most countries select the deferral method since, investors can gain a generous incentive and an effective tax holiday that can attract investors. With this regard the Ethiopian tax incentive rule remains silent and gives discretionary power to officials which creates a room for manipulation and further for corruption.

### **3.2.2. Custom duty Exemption**

To encourage private investment and promote the inflow of foreign capital and technology in to Ethiopia, customs duty exemptions are provided for investors (both domestic and foreign) engaged in eligible new enterprises or expansion of projects in agriculture, manufacturing, agro-industries, construction contracting, etc. Those exemptions include 100% exemption from the payment of customs duties for investors engaged in different sectors except those in Real estate development, Publishing, Export trade, and Whole sale trade.

In Ethiopia investors which are eligible for custom duty exemption are allowed to import capital goods and construction materials necessary for the establishment of a new enterprise or the expansion or upgrading of an existing enterprise on duty free. On other hand if the investor entitled to duty-free incentives buys capital goods or construction materials from local manufacturing industries, he shall be refunded with the customs duty paid for the raw materials or components used as inputs for the production of such goods. Spare parts worth up to 15% of the total value of the imported investment capital goods are also exempted from custom duty, provided that the capital goods are also exempt from the payment of customs duties within five years from the date of

commissioning of his project. An investor granted with a customs duty exemption will be allowed to import capital goods duty free any time during the operational phase of his enterprise. Investment capital goods imported without the payment of custom duties and other taxes levied on imports may be transferred to another investor enjoying similar privileges

The custom duty exemption is possible if the investor meets the eligibility criteria, such as minimum capital (200,000 USD for foreign investors), and the investor must invest in areas of manufacturing, agriculture, agro-industries, generation, transmission and supply of electrical energy, ICT development, tourism, construction contracting, education and training, star designated hotel, specialized restaurant, architectural and engineering, consultancy works, technical testing and analysis, capital goods leasing and importation of liquefied natural gas (LNG) and bitumen. With this regard, Ethiopian custom duty exemption is comparable with other East African countries except Kenya, where Kenya provides up to 100% investment deduction without any minimum capital requirement and up to 150% investment deduction for investors who invest outside the major cities and with minimum investment 200 million Kenyan Shilling. However, the Ethiopian incentive proclamation did not set minimum capital for domestic investors and this may be one reason for widespread use of duty free goods for other purposes other than the eligible investment.

### 3.2.3. Non Fiscal Incentives

Investors who invest to produce exportable products will be allowed to import machinery and equipment necessary for their investment projects through suppliers' credit. Investors who invest in areas of agriculture, manufacturing, and agro-industry will be eligible to obtain loan up to 70 percent of their investment capital from the Development Bank of Ethiopia (DBE) if their investment is sound and feasible; In addition the government will cover up to 30 percent of the cost of infrastructure (access road, water supply, electric and telephone lines) for investors investing in industrial zone development. Business enterprises that suffer losses during the income tax exemption period can carry forward such losses and can carry forward it loss for half of the exemption period following the expiry of the exemption period.

#### 3.2.3.1. Export Incentives

The following fiscal incentives are given to all exporters with the exception of few products (e.g. semi-processed hides and skins), and no export tax is levied on export products of Ethiopia. Those export incentives include;

- **Duty Drawback scheme:** It offers investors an exemption from the payment of customs duties and other taxes levied on imported and locally purchased raw materials used in the production of export goods. Duties and other taxes paid are drawn back 100 percent at the time of the export of the finished goods.
- **Voucher scheme:** A voucher is a printed document having monetary value which is used in lieu of duties and taxes payable on imported raw materials. The beneficiaries of the voucher scheme are also exporters.
- **Bonded manufacturing warehouse scheme:** Producers not eligible for voucher scheme but having licensed for bonded manufacturing warehouse are entitled to operate such warehouse in importing of raw materials duty free.

In addition to the above fiscal incentives Ethiopia offer the following non-Fiscal export incentives to exporters,

- **Bank deposit:** Exporters are allowed to retain and deposit a bank account up to 20 percent of their foreign exchange export earnings for future use in the operation of their enterprises and no export price control is imposed by the National Bank of Ethiopia.
- **Franco-valuta:** Imports of raw materials are allowed for enterprises engaged in export processing.
- **Export credit guarantee scheme:** Exporters can benefit from the export credit guarantee scheme which is presently in place in order to ensure an exporter receives payment for goods shipped overseas in the event the customer defaults, reducing the risk of exporters' business and allowing it to keep its price competitive.
- **Remittance of Capital:** A foreign investor has the right to make the following remittance out of Ethiopia in convertible foreign currency: Profits and dividends; Principals and interest payments on external loans; Payments related to technology transfer agreements; Proceeds from the sale or liquidation of an enterprise; and Proceeds from the sale or transfer of shares or partial ownership of an enterprise to a domestic investor.

### 3.3. Requirements for tax incentives

The other important question which is raised about tax incentives is whether tax incentives are discretionary or automatic when the investment meets conditions set. Tax incentives are advisable to be limited by discretion but if we make it automatic, it is necessary to qualify conditions clearly and in detail.

#### 3.3.1. Eligibility Criteria.

When countries try to introduce and implement tax incentives, one of the most important criteria is to lay down rules and regulations regarding the eligibility criteria clearly. Tax incentive that requires eligibility criteria set certain form of verification for ensuring compliance of investors. Those criteria's may include: Obtaining approval or certification; Investors honesty; Obtaining valuations of certain assets; and To meet certain

continuing qualification requirements.

The above points are totally related with “who determines eligibility?” And this may differ from country to country, for example, in some countries like the Ethiopian case many government organs participate in the foreign investment process. However these government organs may have different priorities and responsibilities and this makes the decision for eligibility more difficult. For example the organ of the government which is responsible for economic development may favor tax incentives, in order to increase the flow of investment, without giving due attention to the revenue loss. When tax incentives are in the form of reductions or exemptions, incorporating the tax incentives in the general tax legislation, rather than in separate rules and regulation may reduce the chance of conflict or overlapping mandates and increase the monitoring of the tax incentives.

With this regard, the Ethiopian experience shows us tax incentives are not part of the general tax legislation, rather it is design independently and this may create conflict of interest between different ministries. For example, the intention of the Investment Commission is only to attract private investment, on the other hand the Tax authority focus is on reducing revenue loss due to tax incentive and Ministry of Trade intention is to minimize distortion created due to tax incentive. So due to; conflict of interest, mandates are distributed across different organs of the government and lack of coordination, there is high misuse of tax incentives in the country. Consequently, in Ethiopia tax incentives are not considered as tax expenditure and is not incorporated in government expenditure. And this may be one reason for not having complete data by the respective organ; to whom and in what amount tax incentive are given and this creates loophole for misuse of tax incentives.

In Ethiopia the basic requirements which are disclosed in the Investment Proclamation (No.769/2012) is minimum capital for foreign investor and joint venture between Ethiopian and foreigner. However, if an investor reinvests its profits or dividends generated from existing enterprise there is no requirement of minimum capital. Furthermore, all forms of investment whether it is complete ownership or joint venture are required to create at least 50 employment opportunities.

When we compare the Ethiopian requirement of investment with the other African countries, it is higher than Uganda which is only 50,000 USD and lower than Tanzania which is 500,000 USD. But when we compare with neighboring Kenya where there is no capital requirement except to get special privilege (150% investment deduction) it is by far behind. The other important difference with investment requirements from Uganda and Tanzania is that both countries set minimum capital requirement for both domestic and foreign investment. But the practice in Ethiopia is different where there is minimum capital requirement is only for foreign investors. And according to expert’s interview and official’s focus group discussion, not setting minimum capital for domestic investors is the main reason why the Ethiopian tax incentive is abused especially in star hotels and construction machinery rent investment, this because most of them did not have the capacity to build and to rent and only take investment certificates to take advantage of the custom duty exemption.

### **3.3.2. Administrative of tax incentives**

One of the major issues which is often raised in tax incentives is the way it was designed. There are two alternative ways of giving incentives; the first is incentives given on automatic base and the second is incentives granted only with the preapproval of the authorities based upon given rules (administrative discretion). Automatic base has many advantages including; when there is policy change, it makes easy to support investors and the transition make it easier. The other advantage of automatic base is that when authorities observe a sign of tax avoidance and evasion, they can easily stop the incentive.

On the other hand, when the extent and the availability of the incentive are determined administratively based up on given rule, incentives are only given to help investments economic and this would decrease cost and improve benefit of investment by targeting investments which are incremental by nature. The problem which is associated with administratively approved investment incentives are; the authority’s approval process is time consuming and the authorities that determine the incentive get information from the investors that demand incentives and this investment incentive approval process may undermine the transparency of the tax systems. While Automatic is not supported in many countries but it is helpful to decrease corruption and misuse of tax incentives.

With this regard, to determine the tax incentive as it is mentioned in the above regulation Ethiopian tax system is based on automatic base. However in some cases there is element of administration discretion base investment incentive, for example, to determine the time when the time of tax holiday starts was given the discretionary power to some officials because the regulation says tax holiday starts when firms start production but the exact time when firms start production is unknown. The other example where the Ethiopian tax regulation gives discretionary power is that the time when the depreciation starts, since the regulation is silent with this regard as to whether depreciation starts in the holiday period or differed until tax holiday expires, implicitly this gives discretionary power to the tax office. Similarly according regulation 270/2012 the time of tax holiday ranges from 1-7 years to be determined based up on certain criteria’s but those criteria’s did not least everything therefore this leaves a room for discretion.

### 3.3.3. Compliance with qualifying conditions

In administrating incentives in many countries, the first issue is to screen and determine the investor's position, if he complies with the predetermined qualifying conditions. In this case, some incentive requires initial approval and others based upon positive decision, such as; ensuring whether the investment is in a priority sector, whether he meet the employment or export targets and the environmental requirements was fulfilled. The second practice with regard to qualifying condition is ensuring whether the realistic condition was meeting: for example, the capital requirement, the foreign investment in the form of a joint venture meets the predetermined percentage, and the creation of new jobs, are some of them. To ensure whether those requirements meet by the investor the practice in different countries is different, in some of them, the respective authorities carry out this verification: and in others, the respective investment incentive giving authority asks investors to have written confirmation from the proper authority.

When we evaluate the Ethiopian tax incentive regulation and practice, in case of custom duty exemption it is given up on initial Investment Authority investment license without any other requirements. For example to approve custom duty exemption for construction materials and a vehicle, investors are asked to bring land ownership certificate, construction plan and bill of quantity which shows the amount of construction materials which is needed for the investment, but there is no any mechanism whether those construction materials are over estimated or the incentive given are used for the intended purpose. The other type of incentive which is given to investors is the tax holiday, and this was given based upon verification of the Ethiopian investment agency whether the investor meet the predetermined requirement. But the problem associated with this is that, even it may be possible to verify the export requirement for getting tax holiday, but there is no or low mechanism of ensuring whether the investor continues his export requirement in the middle of tax holiday period.

With this regard, when respondents are asked whether there is any mechanism of verification the construction materials asked are over estimated and used for the unintended purpose, as it is indicted in table 1 below majority of the respondents or 83.9% strongly disagree or disagree with the statement. In line with this, the group discussion held with officers also confirm that the mechanism to verify whether the stated amount of imported material is used for the intended purpose is very weak and due to this the vehicles which are imported are used for other purposes and the construction materials are also sold in the open market without any fear of punishments.

Similarly, when respondents asked their agreement or disagreements on the statement, there is strong midterm evaluation whether investors once meet requirement for tax holiday continue their fulfilling their obligations, majority of the respondents 80.76% strongly disagree or disagree with statement. And this implies that tax holidays are given in the first year of their operation and continue till the tax holiday period expires without investigating their current performance. This is also confirmed by the focus group discussion, and the discussant further mentioned that fail to monitor on yearly bases helps investors in some cases to divert their production for export to local market.

**Table 1: Tax Incentive Compliance**

	Strongly Disagree		Disagree		Somewhat agree		agree		Strongly agree	
	No	%	No	%	No	%	No	%	No	%
There is efficient mechanism of verification materials which are eligible for custom duty exemption are not exaggerated and used for intended purpose.	520	67.09	124	16	80	10.3	38	4.9	13	1.78
There is strong midterm evaluation whether investors once meet requirement for tax holiday continue their fulfilling their Obligations	531	68.51	95	12.25	78	10.06	35	4.5	36	4.68

### 3.3.4. Reporting and monitoring compliance

Sometimes specific Conditions may be attached to tax incentives that are required investors to perform on continues bases , for example, number of jobs created and maintained, minimum amount to export out of their production and whether the imported item( machinery, vehicles and house appliance for hotel investments) used for the intended purpose. Even though monitoring compliance increases administration cost but it is important to effectiveness of investment incentives.

However in Ethiopia, without close investigation, investors have little reason to comply with the predetermined requirements. This is supported by the respondents, as it is shown table 2 below majority of the respondents 62.07% strongly agree or agree on the statement there are discrepancies between investor predetermined requirement and performance. And, similarly when respondents are asked to give agreement or



disagreement on the statement imported items which are eligible for custom duty exemption are served for what they are supposed to serve, majority of the respondents 70.32% strongly disagree or disagree with the statement. And this is also supported by the focus group discussion with investment officials. For examples, as those officials mentioned, most vehicles which are imported for the purpose of construction machinery rent are not used for rent purpose rather they are used for other forms of freight transport. Similarly the vehicles which are imported to give the respective investment employees service in educational investment does not serve the employee's rather they serve students of the school on fee base which is illegal or out of the mandate of the school.

**Table 2: Tax Incentive Monitoring And Reporting**

	Strongly Disagree		Disagree		Somewhat agree		agree		Strongly agree	
	No	%	No	%	No	%	No	%	No	%
There is discrepancies between investor predetermined requirement and performance.	50	6.45	64	8.26	180	23.23	223	28.78	258	32.29
There is close monitoring on imported items which are eligible for custom duty exemption in order to serve what they are supposed to serve	267	34.45	278	35.87	102	13.16	72	9.29	56	7.38

The other important point which was raised by Tax officials is that VAT on export is 0% and this requires investor is to apply for a VAT refund but the proof they are asked is not on the amount of export rather and the amount of import, so this may help them to abuse the incentive, this is because the total amount of import may not be totally transfer in to exportable item rather it may be sold domestically or they may produce goods for domestic consumption.

### 3.3.5. Transparency

Giving relevant information about tax incentives to the investors in general and to the general public in particular can ensure transparency of the system. The transparency should be ensured based up on three grounds which include: legal, economic and administrative. With this regard to those points, we can evaluate the Ethiopian tax incentive system:

#### 1. Legal

In this regard theories and empirical studies designated tax incentives to have statutory basis in the countries tax laws without giving and discretionary power to officials. And even the Ethiopian tax incentive laws have statutory bases but in some cases the incentive law remains silent and gives some discretionary power to officials and this may erode the transparency of the incentive. At the same time when respondents are asked to give their agreement or disagreement on the statement the Ethiopian tax incentive system has strong statutory based and leave no room for discretion of officials, as it is indicated in table 3 below majority of the respondents or 65.7% strongly disagree and disagree with the statement. When similar question was raised to focus group discussion participants, they replied that even though the tax incentive have legal base but official's discretionary power is substantial, this is because there is no mechanism of ensuring whether it was given appropriately and no data base exist to whom was given the actual incentive.

#### 2. Economic

With the economic point of view, to ensure transparency the respective authority should clearly stated the reason for giving tax incentives and should create a public dialogue to spell out the countries policies priority areas. With respect to clarification of the reason, why tax incentives given, the Ethiopian tax system and other documents such as the economic policies clearly stated the priority areas, and why should we support those priority areas. And this is also supported by the majority of the respondents where tax incentives are clearly stated. However, with regard to creating public dialogue and give the chance to the public to prioritize the investments areas which are eligible for tax incentives, as it is indicted in the table below majority 67% strongly disagree and disagree. The reason they mentioned is that, since the tradition of Ethiopian policy making process is bottom up and even in some case there is participation the way the people participated is to share information not to engage them in policy formulation process.

**Table 3: Legal and Economic Transparency in Tax Incentive**

	Strongly Disagree		Disagree		Somewhat agree		agree		Strongly agree	
	No	%	No	%	No	%	No	%	No	%
The Ethiopian tax incentive system has strong statutory based and leave no room for discretion of officials.	57	9.25	85	3.87	67	1.55	32	7.03	34	7.29
The respective authority should clearly stated the reason for giving tax incentives	53	2.65	31	9.8	56	0.13	01	3.03	74	2.45
The government creates public dialogue and give the chance to the public to prioritize the investments areas which are eligible for tax incentives	42	4.12	55	0	32	7.03	0	0.32	6	.5
The respective organization make ex-ante and ex-post costs and benefits analysis of tax incentives	23	4.58	31	9.80	3	.96	8	.32	0	0.32

The other important economic factor that contributes to the transparency of the tax incentive system is to make ex-ante and ex-post costs and benefits analysis. With this regard, let alone making ex-ante and ex-post cost benefit analysis to be made by the respective organization, there is no clear data on the type and forms of tax incentives given. The only available data which is found in ERCA is the total amount of incentive given starting from 2006 onwards and the Ethiopian Investment Commission did not have any data base the amount and type of incentives given. This is also supported by the respondents, where majority of the respondents replied that there is no mechanism of cost and benefit analysis because we do not know the actual benefit we get and the actual cost we accrue.

### 3. Administrative:

In this regard the qualifying criteria for investment incentive should be clear, simple, specific, and objective, in order to reduce the discretion power officials that award the incentives. With this regard as it is indicted in table 4 below majority of the respondents or are indifferent, since majority of the somewhat agree on the statement.

**Table 4: Administrative Transparency in Tax Incentives**

	Strongly Disagree		Disagree		Somewhat agree		agree		Strongly agree	
	No	%	No	%	No	%	No	%	No	%
Criteria for investment incentive are clear, simple, specific, and objective, and did not give discretion power officials.	153	16.77	92	11.87	453	58.45	42	54.19	35	45.16
The decision-making process in awarding tax incentives is open	522	67.35	175	22.58	25	32.25	23	2.97	30	3.87
The tax incentive awarded is published and disclosed to the general public	222	28.65	457	58.97	66	8.52	58	7.48	12	1.55

The other contributing factor for the tax incentive to make transparent is making the decision-making process open. In this respect, as it is shown in the table 4 above almost 90% of the respondents replied that the decision making process is not open and transparent. And we can infer that there may be abuse of the tax incentives. Another mechanism that ensure transparency and accountability in the tax incentive system is publishing and disclosing of the tax incentive awarded which did not require further effort and cost to the government rather it can be helpful for the general public and researchers to use it. With this regard let alone for the public and researchers the other public officials did not have the necessary information for decision making. Similarly about 85% the respondents also strongly disagree or disagree with the statement tax incentive awarded are published and disclosed.

## 4. Conclusion And Recommendations

### 4.1. Conclusion

This article employs both primary and secondary data. The primary data was collected through questionnaire from 800 respondents, and interview, and focus group discussion of officials and investors. Secondary data is gathered from different publication, documents, financial and non financial reports; and Ethiopian Investment

Agency(EIA) & Ethiopian Revenue and Tax Authority (ERCA) rules, regulations and proclamations.

The intention of the government in providing investment incentives is to attract private investors, but the result indicates that it is failed to meet its objectives. This is because the contribution of private investment is less than 10% in agricultural production and export, the contribution of manufacturing to GDP is only 26% and there are only less than 100 star level hotels in Ethiopia compare to the amount of tax incentives given which is 51% of government revenue and 7.52% of GDP. Furthermore, the amount of employment created is not much with what is planned, and from investors who take tax incentives only 20% in number and 15% in the amount of capital they registered are operational. Furthermore, most of the investments are in areas where they can be commenced without any tax incentive and the amount of revenue forgone for one birr additional investment is about 7 birr on average. And we can conclude that; there is large revenue forgone with low; realized investment, output, employment, and export. Thus, this reduces the countries opportunities to invest public in infrastructure, public services, social support and poverty reduction programs.

The other intention of the government is balancing growth among regions., but the result is the opposite, where almost 94.55% in number and 89.88% of capital is concentrated in areas where there is better infrastructure facility and human resource.

With regard to length of tax holidays, many empirical studies indicated that short period tax holidays are always not effective in attracting investment of long gestation periods, rather they are effective in attracting private investments that are short term in nature. With this regard the Ethiopian tax holiday it is very short period of time which is 5-7 years as compared with the other east African countries which ranges from 10 years up to without limit. So, it make it hard for Ethiopia to compute regionally in attract long gestation period investments, despite they are considered as engine of growth .

Another problem with tax holidays in Ethiopia is that there is no mechanism to analyze its cost and benefit because of lack of proper documentation and data problem in developing countries in general and Ethiopia in particular. East African countries like Kenya, Tanzania, and Uganda set a target on the amount of tax incentives and the methodology of offering the tax incentives in order to determine the revenue costs associated with a particular tax incentive. However, when we analyze the Ethiopian tax incentive, there is no any monetary target and specific methodology which is applied to respective tax incentive. In general the Ethiopian tax incentive scheme is targeting short lived investments, since the holiday period is very short and the time where the tax holiday starts is when firms start production which is suitable for short period profit making investments.

Consequently, in Ethiopia tax incentives are not considered as tax expenditure and is not incorporated in government expenditure. The other important difference with investment requirements from Uganda and Tanzania is that both countries set minimum capital requirement for both domestic and foreign investment. But the practice in Ethiopia is different where there is minimum capital requirement is only for foreign investors..

Similarly, in East African countries like Kenya, Uganda, and Tanzania, investment tax incentive evasion is taken as crime and actions such as denial, withdrawal of the tax privilege and other criminal measure. was taken considered an abuse of the legislation. But the practice in Ethiopia is different even though abuse of investment tax incentives was taken as criminal activity in the tax rule, the practice is somewhat different. For example if a person is detected when abusing the tax incentive the largest measure to be taken is forced him to pay the total amount of tax incentives given but there is no practice to deny him another investment tax incentive and no mechanism of taking other criminal measures.

#### 4.2. Recommendation

Based up on the finding we can recommended that Ethiopia should:

- Design tax incentives which make the country competitive to other developing countries
- Design tax incentives only on the basis of cost-benefit analysis, and the analysis must subject to public debate, scrutiny, and parliamentary oversight.
- Ensure that any new incentive offered is grounded on legislation that makes it available to all qualifying investors, foreign or domestic. This would effectively eliminate to discretionary tax incentives.
- Ensure that tax incentives, if granted, are subject to systematic monitoring and evaluation, and are revocable if the company fails to reach agreed objective.
- Publish an annual overview of the costs of tax incentives as part of the annual budget, so the public can see the impact of tax incentives.
- Support tax incentives with other factors that enhance investment climate.

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