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REVIEW OF THE INVESTMENT PROCLAMATION OF ETHIOPIA, 1992

FINAL REPORT

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PREFACE

This assessment of the Investment Proclamation of Ethiopia has been prepared by The Services Group under contract to Coopers & Lybrand for USAID. It has been prepared on the basis of desk research and comparative analysis, and has not included any field research. The analysis contained in this report is thus based on the content of the Investment Proclamation, rather than on extensive knowledge of the economic conditions in the country.

This report has been prepared by Kishore Rao. The opinions expressed here are those solely of the author, and do not reflect the positions of either Coopers & Lybrand or USAID.

I. INTRODUCTION

The competition among developing countries to encourage local private investment and attract foreign direct investment has grown increasingly in the past decade. Faced with shortages of external financing, the bankruptcy of the state-owned industrial sector, and the failure of inward looking economic development strategies, many countries have turned to new attempts to attract foreign firms to take on significant stakes in their economies. The principal method employed to encourage new investment has often been in the introduction of new Investment Laws or "Codes" which offer incentives and other advantages to investors.

This new openness to private investment contrasts sharply with the general environment found in many countries after independence when first establishing investment laws or codes. The orientation of these codes was largely aimed at controlling, selecting, and proactively promoting certain private investments. In support of this approach, private investment -- particularly in the industrial sector which was seen as key to economic growth -- was often screened, licensed, and monitored by government agencies. This approach was generally adopted for all foreign investment, irrespective of sector.

This focus on investment screening often led to the growth of large investment bureaucracies, whose staffs undertook extensive evaluations of projects, in addition to providing "assistance" in their financing and implementation. This heavy-handed approach to investment development was consistent with the economic development strategies in vogue at the time: a reliance on import-substitution policies and a preference for a substantial role for the public sector as an engine of economic growth; both of these strategies mandated extensive controls over domestic markets. In this view, private investment was an asset to be channeled by responsible ministries or investment boards into priority sectors and desirable activities; foreign investment was potentially an evil to be controlled and therefore was often subjected to more onerous restrictions. The responsible investment authorities would screen investments for their desirability, their profitability, their impact on existing producers, and a number of other often ill-defined criteria. As a result, receiving investment approval for a project was often a long and arduous process.

In most countries, this general approach characterized above was a substantive failure. Rather than producing rationally planned industrial development, it thoroughly discouraged private investment, encouraged and supported capital flight, maximized opportunities for corruption, and in general created an uncertain climate for private enterprise which encouraged rent-seeking behavior. The economies of many developing countries are still recovering from the adverse effects generated by several decades of these policies, even though many have recently attempted to encourage private investment and attract new foreign investment.

As countries have attempted to reform their investment laws or codes in the last decade, most have done so with the goal of liberalizing the restrictions on domestic and foreign investment, as well as offering what are perceived to be attractive fiscal and other incentives for investors in targeted or otherwise desirable sectors. This response, while introducing and improved climate

for private business, has still not created the type of investment environment which most private businessmen find truly attractive. In many instances, these reforms were only partial in nature as they were not accompanied by substantial liberalizations in other areas. As a result, their effect was often minimal, since the introduction of some tax holidays is insufficient to overcome the constraints imposed by an otherwise severely flawed policy environment.

During this same period, however, some other countries have been very successful in stimulating economic growth through the attraction of both domestic and foreign private investment. In some cases, this success has occurred in spite of the existing policy environment and investment legislation, and was due more to the inherent advantages of a country's specific factor endowments. In most cases, however, this success has been due to an understanding of the motivations of private investors, both domestic and foreign, and a commitment to a market-based resource allocation system in which the state would only marginally attempt to influence private investment decisions, if at all.

This willingness to rely on private investment as a medium to generate economic growth has only recently emerged in most African countries. Most African countries today, however are now trying to reform their economies -- with varying degrees of success -- to rely more heavily on market-based mechanisms. One key aspect of this new emphasis is liberalized investment legislation.

As more countries have adopted market-oriented investment and economic strategies, however, the competition to attract foreign investment has become increasingly intense. As a result, countries now wishing to be successful in encouraging such investment must implement wide-ranging and substantive reforms which create an environment for investment that is highly competitive with that found in their most successful or competitor countries. The introduction of what are only partial liberalizations or reforms into what was a previously a seriously negative climate for private investment is unlikely to be sufficient to elicit much new foreign investment, or to retain or stimulate much domestic investment.

With the recent change in government, Ethiopia is a relative latecomer to this competition. The country's previous economic policies have relied heavily on state-owned enterprises, and for many years have actively discouraged private investment initiatives. The analysis below will assess whether Ethiopia's Investment Proclamation of 1992 has sufficiently reversed this focus and improved the climate for private investment. In order to provide a frame of reference for this analysis, the basic elements of progressive investment legislation in developing countries worldwide will first be examined. Key aspects of the Ethiopian Proclamation will then be assessed, followed by a comparative evaluation of the Ethiopian law with the investment laws of other countries in the region. The final section of this report evaluates the overall effectiveness of the Proclamation, and provides recommendations to improve the law's competitiveness.

II. TRENDS IN INVESTMENT LEGISLATION

As noted in the previous section, many developing countries have adopted investment codes or other investment incentive measures in order to encourage increased private investment, both domestic and foreign. The incentives granted in these laws are usually intended to offset other existing distortions or disincentives to investment; if these distortions did not exist, no special investment code would be necessary. Indeed, some advanced developing countries are now addressing these distortions, rather than employing preferential investment regimes or incentives, in favor off tax provisions which are applied uniformly. Most developing countries still find it necessary or desirable, however, to have a code or law which grants incentives to investors.

There is no one formula for an investment law or code which can be universally applied. A country's macroeconomic environment, economic policy objectives, operating environment for business, and national factor endowments all affect the nature of investment incentive legislation. Some investment legislation primarily offers exemptions from the more onerous provisions of other laws or economic regulations, including measures other than taxes. It is possible, however, to note some general principles which should be applied if a country is serious about attracting private investment, particularly foreign investment.[1] Most of these principles have been adopted, to varying degrees, by countries which have recently reformed their investment laws.

Guarantee of Repatriation of Capital and Remittance of Profits. Foreign investors will generally seek a straightforward assertion of their rights to repatriate capital, whether profits or the original investment. This is one area, notwithstanding the equal treatment principle noted above, that countries without convertible currencies will not extend to domestic investors, who may still be subject to capital controls. It is, however, essential for foreign investors. Foreign investors ultimately want to earn money which they can remit to their home country, and require the assurance that their original investment can be recovered as well. Their willingness to retain profits in the host country will be determined by the internal financing needs of their investment, the general macroeconomic climate, the perceived stability of the country, and the ability to earn an appropriate return. Some countries attempt to force the retention of profits by limiting the ability to remit overseas, or by subjecting it to approval by the monetary authorities. Such provisions impede foreign investment, and simply invite evasion by investors. Recognition and understanding of the motives of foreign investors has made the guarantee of free repatriation a basic element of most foreign investment legislation.

In addition to the guaranteed repatriation of profits, a guarantee is also normally extended to foreign loan repayments. However, separately monetary authorities may limit the ability of firms to borrow abroad in hard currencies, particularly non-exporting firms.

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1 See, for example, the Multilateral Investment Guarantee Agency "Guidelines on the Treatment of Foreign Direct Investment," Draft, March, 1992; Guy Pfeffermann, "Facilitating Foreign Investment," Finance and Development, Volume XX, Number 1, March, 1992.

Limited Screening of Investments. It has been common practice in many countries to screen all investments and to require extensive feasibility studies and other demonstrations of a project's viability. Most countries have abandoned this approach in favor of very limited screening; a few have adopted a simple registration system, where no evaluation is performed by the investment authority. This approach relies on is the acceptance of the principle that private investors -- as they are risking their own funds -- are better able to evaluate project viability than are the investment authorities. In addition, where in the past approval of an investment often also entailed the conferring of trade protection and financing, this is rarely true today as countries have liberalized their trade regimes and decoupled financing decisions. Most countries now will not require approval for investments not seeking incentives, and will require only registration of foreign investments which are not be covered under the investment law or code.

Utilization of a Negative List. Despite the reduced emphasis on investment screening, governments often wish to confer certain advantages, particularly fiscal incentives, to encourage investment which satisfies certain national objectives. For these cases, it has generally proven more straightforward and transparent to specify those activities which do not qualify for incentives in a "negative list" rather than to proactively state those which do qualify or to evaluate applications on a case-by-case basis subject to (often vague) criteria. The limiting of the application of an investment law or incentives is a legitimate function which should be clearly stated in the law. For example, many African countries have elected not to confer tax and other incentives on purely commercial or trading activities, but reserve them for industrial, agricultural, or certain other activities which generate value-added in the economy. This is more easily accomplished by stating the excluded activities, than in specifying all those activities which qualify for incentives. Not only is such a list potentially limitless in detail, but it cannot fail to omit certain investments, particularly in light of new technological developments over time. Thus, a negative list is a much simpler approach to identify desired investment.

Additionally, all countries restrict foreign investment in certain sectors, often for "strategic" reasons as well as for economic goals. The U.S., for example, limits foreign ownership of firms to minority positions in the communications and transportation fields. Here again, the utilization of a simple negative list is the most straightforward means of elaborating a policy which limits foreign ownership of assets.

Utilization of Performance-Based Incentives. Using the traditional screening approach, the economic contributions of each investment project were typically assessed to evaluate their eligibility for approval and granting of incentives. This approach was based on the claims of investors in their applications, and required substantial monitoring to be effective; few countries, however, followed through effectively with such monitoring. A more effective approach to granting incentives is to link them to the achievement of certain performance criteria, so that as the project does achieve the projected economic benefits, the incentives are earned automatically. For example, a common performance-based export incentive is to grant companies which export a pro-rata exemption from profits tax based on the proportion of sales exported. Correspondingly, a performance-based job creation incentive allows for a tax credit for all or a portion of local salaries, for expenses associated with training of local employees.

Equal Treatment of Foreign and Domestic Investment. In the past, some countries have offered favorable treatment to foreign investment, while others have imposed more onerous restrictions. In general, investors prefer a clear, "level playing field" in which no one group has advantages. Foreign investors, in particular, will seek to ensure that they enjoy the same rights under law as domestic investors, particularly in terms of economic regulations and the impact of other policies.

Third Party Dispute Settlement. Foreign investors are commonly wary of having disputes referred to local courts for settlement. For these investors, it is generally preferable to designate a third party or neutral forum for dispute settlement. A number of options are available, including allowing recourse to foreign courts, arbitration, or multilateral fora such as the International Center for the Settlement of Investment Disputes at the World Bank.

Guarantees against Expropriation or Nationalization. Many developing countries have gone through stages of nationalization and/or expropriation, typically in the early years of independence. This historical track record often makes potential new investors wary, and investment laws may include an explicit limitation of the power of the government to seize assets (e.g., only for "national security" reasons), and may specify the nature of compensation to be paid. Compensation, if provided for, should generally be prompt (without undue delay), fair (market value) and effective (in the investor's original currency.) In some countries, no mention of nationalization or expropriation is made in investment laws, as the ability of the government to expropriate property is already limited to certain eminent domain cases and compensation rights are well established. Opinion differs as to whether the inclusion of clauses limiting the right of governments to expropriate or requiring compensation are actually meaningful to investors, who may not be reassured by the inclusion of such language, but give more credence to the country's previous track record.

Tax Relief. The provision of tax holidays or exemptions from corporate profits tax is standard in most investment laws. This may be done for a certain period of time, or may be effected by applying a lower rate or other tax-based incentives such as rapid write-offs or depreciation allowances, etc. The effectiveness and usefulness of tax holidays or exemptions is often debated, and there are wide ranges of opinion. In countries with high corporate profits tax rates, the provision of some tax relief for approved investments under an investment law may be an important incentive from a promotional standpoint. As noted above, however, most advanced developing countries are moving steadily to systems with generally applicable tax rates which may be effectively lowered through achieving certain performance criteria. The effect of tax simplification and tax reform programs as well has lessened the importance of tax holidays in those countries which have effectively implemented broad tax reforms.

Regulatory Relief. Some countries -- in recognizing the myriad of bureaucratic steps often required to establish a new company -- have made attempts through their investment laws to streamline these procedures. This often takes the form of the creation of a "one-stop-shop" (guichet unique) for investment approvals, in which the investment authority acts to centralize all other permits, licenses, ministerial approvals, or other procedures required for new

investments. These one-stop-shops may take several forms, depending on the degree of authority accorded to the investment agency to issue the necessary licenses, etc. In some countries, the investment agency simply acts as a facilitator or intermediary on behalf of the investor.

Investment codes may also attempt to offset or exempt companies from other regulations which may be onerous to new businesses, but which for other reasons cannot be addressed directly through reform. In Egypt, for example, companies establishing under the investment law were exempted from a number of requirements affecting companies in general in Egypt, such as employee ownership and representation on company boards.

Export Incentives. In addition to these general investment law principles, a number of additional incentives are necessary to attract export-oriented investment, which is a priority for many countries. These incentives may be included within an investment code or law, or may be part of a separate export incentive or export processing zone law. There is no standard configuration. The basic elements of export incentives are relatively straightforward, however, and extend beyond those granted domestic economic activity. These incentives may be applied on a pro-rata basis for partial exporters, or on a blanket basis for 100-percent export firms, as is commonly done in export processing zone legislation. These incentives include:

> **Guaranteed Access to Foreign Exchange.** Exporting firms require foreign exchange to purchase imported inputs and other services. These firms are net earners of foreign exchange, and therefore guaranteeing access to foreign exchange for the purchase of inputs does not lead to a net outflow of funds, but is necessary to earn foreign exchange. Exporting firms will require foreign exchange for their inputs even in times of critical shortages often experienced in developing countries, and therefore some means of assurance of access to foreign exchange is essential. This can be accomplished by a number of measures, such as allowing foreign exchange accounts (i.e., not requiring the conversion of export proceeds into local currency), use of foreign exchange retention accounts for a portion of export proceeds, use of "convertible" local currency accounts, special "windows" at commercial banks or the Central Bank, etc.
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> **Unrestricted Duty-Free Imports.** Most export operations require imports, which are typically allowed in duty-free under a variety of mechanisms. These include free zones, temporary admission programs, bonded manufacturing warehouses, duty drawback, etc. The tax-free treatment must also extend to stamp taxes, VAT, or any other indirect taxes which normally apply to imports. In addition, imports required for export production should be free from import controls, licensing or other restrictions.
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> **Tax and Regulatory Relief.** Many countries also extend additional benefits to exporting firms, often in the form of tax exemptions linked to exports. This may be in the form of a performance-based exemption, as noted above, or by applying a lower rate to exporting firms under a free zone regime. Under some regimes, exporting firms may also be exempt from other regulations which may make firms uncompetitive in global markets. These exemptions may include relaxation of restrictive labor laws or other administrative

procedures and requirements, often in conjunction with the types of regulatory relief discussed above.

These provisions are also typically complemented by other incentives or programs to promote private investment which are not explicitly stated in investment laws. These may include access to financing schemes, government-sponsored training programs, facilities and infrastructure such as industrial estates, etc. The nature of these programs is generally such that they are not suitable for inclusion in investment legislation, as they are not necessarily legal rights and/or obligations, but are rather economic programs which may not be permanent and in some cases depend on external financing and assistance.

Some countries have introduced additional measures in an attempt to capture foreign investment, particularly large projects. This may include substantial subsidization of infrastructure costs, contribution of land, conferring of domestic market protection, or monopoly licenses. Typically, these measures are negotiated on a case-by-case basis with large investors. However, these subsidies and other protective measures often have a negative impact on the general investment climate, and may have direct economic costs which exceed their benefits over the long-run, and thus may not be sustainable. Most countries have abandoned this approach of negotiating individually with potential foreign investors in favor of standardized incentives and elimination of subsidies. Case-by-case negotiations are still common in the mineral and extractive sectors, however, where the terms of specific concessions or rights may differ in each case. Nevertheless, these cases are substantially different from those mentioned above where a government contribution or exclusive economic rights are involved.

Countries which have adopted investment codes based on the principles outlined above have also changed the focus of their investment bureaucracies. With less emphasis on screening, evaluation, and control, there is much less need for large organizations with a predominantly regulatory function. Increasingly, the focus of these organization is on promotion and providing services to investors. In some countries, this transition to this new emphasis is difficult, and the organizations which had previously had a regulatory character often do not make effective promotion organizations. Other countries have found that independent organizations with predominantly private sector control and a purely promotional function are more effective than integrated investment bureaucracies when it comes to promoting new investment. Therefore, some countries have moved to an institutional separation of responsibilities for promotion and regulation. The most effective institutional structure will depend on the existing organizations in each country; however it is clear that many of the large investment bureaucracies which had developed are now forced to reorient their functions, or to reorganize in order to become much smaller and more promotion-oriented.

III. THE INVESTMENT PROCLAMATION OF ETHIOPIA, 1992

While the Ethiopian Investment Proclamation of 1992 incorporates some of the general investment principles discussed in the previous section, a number of these are adopted only partially, thus reducing their effectiveness, while others are omitted entirely. Overall, the Proclamation contains incentives that do not compare favorably to those found in many developing countries, thus placing Ethiopia at a competitive disadvantage in attracting investment.

The key sections of the Proclamation include the following elements:

Areas Restricted to Investment: Under the Proclamation, a number of investment areas are reserved solely for the government. These are defense industries; large-scale electricity production; postal and telecommunications services; large-scale transportation services, with the exception of road transport; insurance, banking, large-scale financial institutions; and import-export trade in selected products having a critical role in the economy. Small- or medium-scale investments by Ethiopian private investors in the provision of transport and electricity will reportedly be considered, however, in accordance with directives issued by the appropriate authority.[2]

The Proclamation also restricts private investment in some sectors to joint ventures with government. These investments include: large-scale engineering or metallurgical industries; capital-intensive and technology-intensive investments in large-scale mining and energy projects; large-scale pharmaceutical and fertilizer plants; and industries which supply strategic raw materials to chemical industries.

Many developing countries, when pursuing economic strategies aimed at screening foreign investment and protecting "strategic" sectors of the economy, commonly closed similar areas to non-government investment. Increasingly, however, as more countries have turned to the market-oriented approach which encourages investment and reduces the economic role of government, such restrictions have been substantially relaxed, while still reserving a small number of truly strategic sectors -- such as defense -- for the government. This is particularly true in the banking and financial sectors and import-export trade; some countries are also permitting the private provision of telecommunications services or electricity. The continued and substantial role maintained for the Ethiopian Government in the economy implies a continued mistrust of private sector investment, particularly foreign investment, that belies the intent of the investment law to foster such investment.

Investment Administration: The Proclamation establishes a Board of Investment and a Office of Investment and vests these two institutions with the responsibility for investment administration. The Board of Investment is an executive institution, chaired by the Prime

2 In addition, private domestic investment in banking and insurance is to be studied by the government, according to the proclamation.

Minister and comprised of the heads of key government agencies such as Finance, Agriculture, and the like. It has 15 members, of which 11 are voting members, and is institutionally accountable to the Council of Ministers.

The Board of Investment has oversight authority of the Office of Investment, and holds responsibility for general matters relating to investment, including, *inter alia*, development of investment policy, coordination of investment policy implementation, and supervision and reporting of investment activities.

While the Board has a supervisory or oversight role, the Office of Investment, which is accountable to the Board of Investment, serves as the chief operational agency for Ethiopian investment policy. The Office is responsible for investment promotion; the receipt, review, and approval of investment applications; the development of specific investment criteria; and investment monitoring and the development of policy implementation measures, including the design of investment regulations. The Office is headed by a General Manager, who is assisted by a Deputy General Manager.

There is no private sector representation at any point of the investment review and approval process. The members of the Board of Investment are all members of government. Similarly, both the General Manager and Deputy General Manager of the Office of Investment are appointed by the government. By contrast, private sector representation is increasingly common in other countries. Such representation has the advantage of providing direct private sector input to decision-making, enabling investment policies to be more closely attuned to business requirements. In addition, private sector representation provides some reassurance to investors that government has a pro-business orientation.

The Board and Office of Investment serve as a combined regulatory and screening body, which also holds responsibility for investment promotion. This institutional structure is common in many developing countries, and has the objective of placing both the services offered to investors and the administration of controls under a single agency. Similar institutional arrangements are found in Kenya, Zimbabwe, and Zambia, among others.

The Ethiopian body differs significantly from these other countries, however, in that the actual review and approval of investment applications is designated to the Office of Investment, which is comprised of the Director and Deputy Generals and their staff, rather than to a larger consultative group such as a board of directors or investment approval committee. Any decision by the Office may be submitted for review by the investor to the Board of Investment within ten days following the decision. Nonetheless, the vesting of investment approval with the smaller and more personalistic Investment Office, combined with the lack of private sector representation, creates an approval process which is not particularly transparent to the investor, and which vests quite a large amount of responsibility in only a few individuals. While this structure may increase the efficiency of the investment approval process, it may also increase opportunities for corruption.

Investment Certificates: The Investment Certificate is the basic instrument for authorization of an investment under the Proclamation. An investor may receive a Certificate only if the following criteria are satisfied:

- fulfillment of at least one of the government's investment objectives as stated in the Proclamation (e.g., the investment creates employment opportunities, develops the domestic market, or expands exports;
- for a foreign investor, minimum capital investment of US$500,000, of which 25 percent (US$125,000) must be deposited in cash in the National Bank; and
- for a domestic investor, total capital investment of at least 250,000 Birr.

The initial investment capital requirements are lowered to unspecified levels for high technology projects; the identification of such projects is left to a separate directive by the Board of Investments. In addition, domestic investors investing less than the minimum indicated above do not need to submit to review or to receive a Certificate.

These capital requirements are extremely high and impose an undesirable bias in favor of capital-intensive industries. Not only is this requirement inconsistent with Ethiopia's economic comparative advantage, but small firms or labor-intensive activities such as apparel assembly typically have capital requirements far below US$500,000. Many countries in the Caribbean have been highly successful in attracting large amounts of foreign investment from ventures whose initial investments were US$100,000 or less. The high capital requirements therefore unnecessarily exclude many types of productive investment.

Investment Approval Process: An application form must be submitted to the Office of Investment by any investor who meets the minimum capital requirements cited above and who wishes to establish a new enterprise or expand an existing one; to buy all or part of an existing enterprise (for foreigners only); or to conclude a technology transfer agreement.

The information to be submitted with the application form is relatively straightforward in nature, and includes:

- the memorandum of association for new enterprises;
- for expansion projects, a brief description of the planned project;
- the list of capital goods to be imported duty-free, including quality and price;
- the investor's or shareholder's nationality;
- the amount of investment capital;
- the training to be provided to Ethiopian employees; and,
- information relating the investment to the government's investment objectives as contained in the Proclamation.

The Office of Investment then forwards the completed application to the appropriate office or agency for its opinion; this review must be completed within 15 days. Should the Office decide

to approve the application, an Investment Certificate must be issued within 60 days of the application's receipt.

Following the issuance of investment approval, the investor must complete the following steps:

> Investment Registration: All enterprises must be separately registered in accordance with the Ethiopian Commercial Code. Such a practice is a common one, although in some countries registration occurs automatically when an investment is approved. Since the Ethiopian Investment Office is not a one-stop-shop, this registration must be handled by a separate authority. Nonetheless, the documentary requirements are relatively straightforward (the investor must submit a registration application, memorandum of association, and the investment certificate), and rapid -- the registration certificate must be issued within 10 days, which compares favorably with a number of other countries worldwide.
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> Investment Licensing: All investments must also be licensed or authorized by the appropriate authority for each type of enterprise. Again, since the Investment Office is not a one-stop-shop, this procedure must be completed separately, after the investment application is approved. Under the Proclamation, the license must be issued within 15 days following receipt of the license application.

Overall, the establishment of statutory time periods within which investment approval, licensing, and registration must occur is a positive characteristic of the Proclamation, and is in keeping with trends in investment legislation worldwide. Nonetheless, the 60 days required to issue investment approval -- while apparently a slight improvement over previous practice[3] -- compares less favorably to a growing number of developing countries where investment approvals are routinely issued in 30-45. Moreover, there is no automatic approval mechanism, as exists in some countries, which automatically grants investment approval after expiration of the statutory approval period.

In addition, the Proclamation is weakened by the fact that the Investment Office is not explicitly empowered to either directly issue these subsequent permits and registration, or to assist the investor in liaising with other governmental bodies. As a result, although these procedures appear on paper to be relatively simple to complete, they unnecessarily increase the burden on the investor by requiring separate visits to separate offices, and lengthen the time needed overall to complete the investment process.

Although Investment Certificates or licenses may be transferred, such transfer may not occur without the prior approval of the Investment Office. Moreover, there is no requirement that the Office may not unreasonably withhold such approval. This provision means that businesses cannot be freely bought and sold, if an investment license is an integral aspect of the operations

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[3] Ninety days were previously required to review and approve joint ventures. The Services Group, Action Plan for Foreign Direct Investment and Collaboration in Ethiopian Export Development, Vol. I, November 1990.

of the company, as it would normally be. While it may be reasonable to expect that the Office of Investment should be informed of such changes, requiring prior approval for normal business transactions can constitute a major impediment and disincentive.

Domestic investors are also given "priority consideration for investment," assuming they possess the requisite capital and technical knowledge. This provision violates the generally accepted principle, as discussed in the previous section, that foreign and domestic investors should be treated equally.[4] Inclusion of this provision implies that the Office of Investment will selectively screen and reject some foreign investments in order to give domestic investors precedence. It is more preferable and more economically efficient, however, to approve all investments which are similar in nature. This practice not only increases economic competition, but it allows the market to ultimately decide -- rather than a government bureaucrat -- which investment is most beneficial to the economy in the long-run.

Investment Incentives: Investors seeking incentives must satisfy a number of requirements additional to those necessary to receive an Investment Certificate.[5] A "positive list" of approved investment areas confers incentives on the following types of activities:

- agricultural development, including agro-processing;
- manufactured products and byproducts and a variety of manufacturing activities;
- large-scale, capital-intensive construction and building projects, as well as all water works; and,
- the "development, protection, and preservation of natural resources," (excluding mining investments which are governed by a separate investment code).

In addition, some types of rural transportation investments are eligible for incentives, as are some additional areas of investment meeting criteria established by the Board of Investment.[6]

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4 Note that the subsequent subsection to this clause was completely illegible in the only copy of the Investment Proclamation available for this analysis. As a result, further amplification of this clause is not possible.

5 The sections of the law relating to the issuance of Investment Certificates and investment approvals are extremely confusing. Apparently all foreign investments, and all domestic investments above 250,000 Birr, whether or not they are seeking incentives, require an Investment Certificate, although this is not stated explicitly. Apparently as well, the same investment approval process is utilized both for investments seeking incentives and those not seeking incentives. In some countries, however, those investments not seeking incentives are not extensively reviewed and investments are simply registered, a process requiring only a few days.

6 The illegibility of the copy of the Investment Code available for analysis prevented full comprehension or assessment of these additional areas.

Investors wishing to receive investment incentives must satisfy the following criteria:

- the investment is made in one of the positive list areas cited above, meets the government's general investment objectives, and satisfies the conditions for receiving an Investment Certificate, as discussed above;

- foreign investors are investing at least US$500,000 and domestic investors are investing at least 250,000 Birr;[7]

- the investor provides evidence -- within 30 days following the commencement of operations -- of the exact amount of capital invested; and,

- the investor produces evidence that for expansion projects -- which must be an investment equivalent to 50 percent of the firm's registered capital -- the amount invested will be kept in a separate book of accounts.

Investors making investments in certain technological areas which the Board of Investment wishes to encourage are also eligible for incentives; lower capital requirements have been established for these types of investment, although neither these types of investments, nor the lower capital requirements, are specified.

This section of the Proclamation suffers from several weaknesses. Most importantly, the production of non-traditional export products or services is excluded from the list of eligible activities. This exclusion is curious, given that one of the government's stated investment objectives is to encourage an expansion in the volume and variety of export products.

In addition, as noted in the previous section, it is preferable to include a negative list of prohibited investment activities, rather than to try and provide an all-encompassing list of general activities. For example, investments in the "manufacturing of equipment, spare parts, components and supplies, vehicle bodies and ... assemblying (sic) plants" are eligible for incentives. This broad definition, however, does not make clear whether investments in such operations as apparel or shoe assembly operations are eligible, although labor-intensive activities such as these are highly suited to Ethiopia's factor endowment. Similarly, as noted above, the minimum capital requirements create a bias in favor of capital-intensive industries; this preference of capital-intensive activities is made explicit with regard to road and building construction projects.

Finally, the requirement that evidence produced <u>after</u> the commencement of operations -- that is, the amount of capital investment -- serves as a criterion for receiving incentives is particularly discouraging to foreign investors, who prefer to know before an investment is made precisely what the incentives and other terms of investment will be.

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7 This requirement is actually redundant, as any investor satisfying the criteria to receive an Investment Certificate must have satisfied the minimum capital requirements.

The basic incentives granted to qualifying industries are:

- Duty and import tax exemption on the importation of capital goods and equipment and spare parts on up to 15 percent of the total capital invested, provided that goods of comparable quality, quantity, and price are not available in Ethiopia.
- Three-year exemption on the payment of corporate income tax, or a two-year exemption for expansion projects; this exemption may be granted for three to five years for projects in designated local areas or specific investment areas, principally high technology investments.
- Losses incurred during the tax exemption period may be carried forward for one year.
- For "Ethiopian products," exemption from duty and other taxes on exported goods and services; this exemption is not automatic, however, but may be granted at the discretion of the Board of Investment.
- Duty- and tax-free importation of raw materials for the production of export goods.
- Tax-free remittance of profits, dividends, and the returns from the liquidation of a firm in case of bankruptcy for an unlimited period; this tax holiday does not extend to the remittance of foreign loan repayments, royalty fees, or the sale of shares to domestic investors.
- Deductibility of training and research expenses.
- The right to employ expatriate experts and managers, if qualified Ethiopians are unavailable and Ethiopian replacements are trained within a limited (but undefined) period of time.

In addition, all exporting firms, whether or not they receive investment incentives, are entitled to operate foreign currency accounts and to retain a portion of their export earnings for their business use.

The overall incentives package is not particularly attractive to investors. The tax-free remittance of profits is commonly found in most countries, and therefore is really a minimum condition for encouraging investment, rather than a true incentive. As noted previously, failure to allow the free repatriation of profits usually leads to evasive actions such a transfer pricing or other methods to minimize local profits and transfer funds overseas.

The three-year tax holiday is short compared to many countries; tax holidays of 10 years or even for perpetuity are not uncommon, particularly in countries seeking to attract export-oriented investment. Although agriculture operations are targeted as one of the investment areas qualifying for incentives, such a short holiday is not meaningful to many types of agriculture, tree crop, or livestock operations owing to the common time lag between the initiation of investment and the generation of profits. Finally, the limitation of duty-free imports of capital good and equipment to only 15 percent of the total value of the project is extremely uncompetitive with most other countries, as this incentive is usually extended to all capital goods and equipment needed for the initial investment.

The attractiveness of the incentives package is also substantially weakened by the vague language used in the Proclamation and the lack of automaticity in the incentives' application. For example, the employment of expatriates is allowed if the investor can ascertain that Ethiopians of comparable quality are not available. Similarly, capital goods may be imported duty-free, if goods of comparable quality and price are not available locally. For foreign investors in particular, the lack of automaticity and transparency in the conferring of such incentives is a substantial deterrent, for it provides the possibility of arbitrary interpretation by the government.

This lack of automaticity in the granting of incentives, and the lack of explicitness in the Proclamation also substantially undermines the attractiveness of the incentives package to export-oriented investment. The duty- and tax-free importation of raw materials for exporters is an important incentive, but the legislation should also explicitly free these imports from all import controls and licensing and other restrictions. Similarly, the exemption of exports from all export taxes and duties is an important incentive, and the Ethiopian law is more generous than many in extending this incentive to the export of services, rather than limiting it to manufactured products. Nonetheless, this incentive is not provided automatically to exporters, as it is many countries, but is left to the discretion of the Board of Investment.[8] Finally, the provision allowing exporters -- both domestic and foreign -- to retain foreign exchange earnings and maintain foreign currency accounts is essential for exporters because they require assured and ready access to foreign exchange. Again, however, the strength of this provision as incentive to investors is undermined because it is not explicitly clear what proportion of foreign exchange earnings may be retained; rather, this amount is left to the directive of the National Bank of Ethiopia.

Repatriation of Funds: The Proclamation allows all foreign investors -- whether or not they receive incentives -- to freely remit profits and dividends, proceeds from the sale or liquidation of assets, and funds required for debt service or other international payments. The right of expatriate employees to remit their salaries is granted in accordance with the foreign exchange regulations of the country. Nationalization may occur in accordance with national law and confiscation of assets may occur by court order and upon payment of adequate compensation. No guarantee is made of prompt reimbursement or reimbursement in hard currency, however, thereby undermining the potential attractiveness of this guarantee to the foreign investor.

Dispute Settlement: Foreign investors may settle disputes in accordance with those international dispute settlement procedures either adopted by Ethiopia, or to which Ethiopia is a party. While this option apparently gives foreign investors recourse to resolve disputes in foreign courts or multilateral fora such as the World Bank's International Court for the Settlement of Disputes, the precise nature of such recourse is not explicit; this provision would be more attractive to foreign investors if such recourse was spelled out specifically.

[8] In addition, this provision is extended to "Ethiopian products," but the failure to define these products makes it unclear to a investor what types of exports are potentially eligible. It is also unclear how an investor applies to receive this incentive from the Board of Investment, given that investment applications are submitted to the Office of Investment.

Summary: The Ethiopian Investment Proclamation does not establish a substantively competitive investment regime. Overall, the incentives package is not sufficiently attractive to encourage foreign investors to locate in Ethiopia over other potential sites; this is particularly true for export-oriented industries. The lack of automaticity in the granting of a number of incentives particularly poses a deterrent to foreign investors, who prefer to know in advance the conditions and terms of their investment. Finally, the law is often confusing and a number of provisions lack clarity. In light of the fact that a well-drafted law can serve as a valuable promotional tool to attract potential investors, such imprecision can create a damaging initial impression as investors weigh alternative investment sites.

IV. COMPARATIVE ANALYSIS

This section briefly compares Ethiopia's investment regime with that of four other African countries -- Kenya, Zambia, Tunisia, and Tanzania. These countries are not necessarily chosen as models, but rather are selected for illustrative purposes. Table 1 compares the four countries' investment regimes across a broad number of categories.

Investment Approval Time: The 60 days investment approval time mandated by the Ethiopian Investment Proclamation compares very unfavorably to the 30-45 days found in the other countries in the region.

One-stop-shop Assistance: Of the five countries examined here, Ethiopia's Office of Investment is the only agency not explicitly empowered by law to assist investors to collect all additional permits and licenses issued by other agencies of government. Even this type of "facilitative" approach, however, is less preferable than a true one-stop-shop for investors which is empowered to issue all necessary permits, as is found in a number of export-oriented investment regimes.

Profits Tax Holiday: Relative to the other African investment regimes considered in Table 1, the 3-year tax holiday offered in Ethiopia does not compare unfavorably. Again, however, most export-oriented investment regimes (including those in Kenya and Tunisia) offer a far more generous holiday.

Expropriation Protection: In countries such as Tanzania and Kenya, an investor's right to protection from expropriation is explicitly protected; such expropriation may only occur after due process of law is completed, and full, fair, and prompt compensation must be paid. This protection is less secure in Ethiopia, where nationalization may occur in accordance with state policy and law, an no guarantee of prompt or fair compensation is made.

Screening Criteria: Despite the trend in more advanced developing countries to employ a "negative list" for screening investments, most African countries still use a positive list approach. An exception to this trend is found, however, in those countries employing separate investment codes for export-oriented investment. Under these codes -- found in countries such as Tunisia, Togo, and Cameroon -- a positive list is used whereby all firms satisfying the minimum criteria to be classified as an exporter are automatically approved.[9]

[9] For example, under Cameroon's Export Processing Zone law, all firms exporting 80 percent of their output qualify as exporting firms.

TABLE 1
COMPARATIVE INVESTMENT INCENTIVES

	ZAMBIA	ETHIOPIA	TANZANIA	TUNISIA (non-export firms)	KENYA (non-EPZ firms)
Repatriation Guarantee	Yes	Yes	Yes	Yes	Subject to the availability of foreign exchange
Profits Remittance Guarantee	75 percent	100 percent	100 percent	100 percent	Subject to the availability of foreign exchange
Expropriation Protection	Explicit	Not Explicit	Explicit	Not Explicit	Explicit
Dispute Settlement	Appeal; Arbitration, Int'l fora	Int'l fora	Arbitration; bilateral agreements; ICSID	Bilateral agreements; ICSID	n/a
Screening Criteria	Positive List	Positive List	Positive List	Positive List	Positive List
Approval Time	30 days	60 days	45 days	30 Days	Not specified in law
Profits Tax Holiday	3 - 5 years	3 years; 3-5 years for high technology investment	5 years	Reinvested profits up to 70 percent; pro rata for exporters	None

TABLE 1
COMPARATIVE INVESTMENT INCENTIVES

	ZAMBIA	ETHIOPIA	TANZANIA	TUNISIA (non-export firms)	KENYA (non-EPZ firms)
Profits Tax Rate after Holiday	45 percent	n/a	45-50 percent	35 percent	45 percent
Access to Foreign Exchange	Foreign exchange retention accounts	Foreign exchange retention accounts	Foreign exchange retention accounts	Foreign exchange accounts	No provision to hold foreign exchange
Duty-Free Inputs	Capital goods	15 percent of capital goods; 100% of inputs for exporters	Capital goods and spare parts	Temporary Admission, Drawback for exporters	Capital goods on a case by case basis
One-Stop-Shop Assistance	Facilitative; explicit	Not explicit	Facilitative; explicit	Facilitative	Facilitative
Employment Incentives	Employment tax exemption	Tax deduction for for training expenses	n/a	n/a	Tax deduction for training expenses

Duty-free Inputs: Ethiopia is the only country examined here that limits duty-free importation of capital goods to 15 percent of the total authorized capital. As noted previously, this provision is highly restrictive relative to other investment sites. The Ethiopian Proclamation does allow, however, the duty-free importation of inputs for exporters; in the investment codes of the other countries examined here, this provision is either missing, or is included in a separate investment regime for export-oriented companies (as is the case in Kenya or Tunisia).

As measured by the simple comparative analysis in Table 1, Ethiopia's Investment Proclamation does not compare highly unfavorably with the investment codes of selected countries in the African region. The key areas where the Ethiopian law compares unfavorably to these other regimes are: the time needed to approve investments; the degree of protection awarded investors against expropriation; and the limit on duty-free importation of capital goods.

Nonetheless, this relatively favorable comparison belies a number of weaknesses in the Ethiopian Proclamation. One, the investment codes of countries such as Zambia, Kenya, and Tanzania are clearer, thus aiding comprehension and enhancing the law's attractiveness as an investment promotion tool.[10] Second, although these neighboring countries are regional competitors for investment and have recently introduced new investment codes in order to attract such investment, each of these laws contain substantial flaws and weaknesses relative to leading examples of investment legislation in the Caribbean and Asia. Thus, while Ethiopia's law may be relatively comparable to others in the region, this is not necessarily sufficient to convince foreign investors to invest, given better opportunities elsewhere in the world.

Finally, it must be noted that as part of their national economic strategy a number of African countries have placed increased emphasis on expanding non-traditional exports as a way to generate employment and economic growth. To this end, a number of countries have recently established export processing zone regimes or other export incentive programs to attract export-oriented investment; these investment regimes are often established separately from a nation's standard investment code. Much of the initial export-oriented investment under these laws is likely to be foreign in nature. To attract such investment, these laws have had to incorporate the most liberal and competitive investment provisions found worldwide today -- for example, 100 percent exemptions, ranging from 10 years to perpetuity, from corporate income taxes; complete exemptions from all import and export taxes, all other taxes, and all licensing and other restrictions; complete elimination of restrictions on foreign or local ownership; completely unrestricted management of foreign currency earnings; and expedited investment approval processes. To the extent that the Ethiopian authorities wish to attract such export-oriented investment, both domestic and foreign, the Ethiopian Proclamation falls far short of offering a competitive investment regime.

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[10] This may be a problem of translation with the Ethiopian Proclamation.

V. SUMMARY AND CONCLUSIONS

As discussed in Section 3, the Ethiopian Investment Proclamation contains a number of weaknesses of varying importance and severity. Several aspects of the law, however, will pose a substantial deterrent to investors, particularly foreign ones. The Proclamation's key weaknesses are:

Overly high capital investment requirements: The minimum capital investment requirements of US$500,000 for foreign investors and 250,000 Birr for domestic ones, introduces a bias in favor of capital-intensive investment, and will exclude many types of productive investment. These requirements should be sharply reduced or even eliminated in order to encourage all possible types of investment.

Lengthy approval period: The 60 days required to approve investment applications is highly uncompetitive by international standards. Moreover, there is no default mechanism assuring automatic approval should the Office of Investment fail to issue an approval within the 60-day period.

Uncompetitive incentives package: The production of non-traditional export is excluded from the list of activities eligible for investment incentives. This is a serious omission which should be changed in any future draft of the Proclamation if the Ethiopian authorities are seriously committed to expanding exports. In addition, as discussed in Section 3, the overall incentives package is not sufficiently attractive to compel investors to choose Ethiopia over alternative investment sites elsewhere.

Lack of automaticity in the application of incentives: A number of incentives are not granted automatically but are either subject to potentially arbitrary interpretation and application. This lack of automaticity tends to deter foreign investors, who need to know up-front what the terms of investment will be in order to make an investment decision.

Insufficient export incentives: The restricted right to import capital equipment and goods duty-free is extremely uncompetitive with other investment sites. While the right of exporting firms to import inputs and export goods duty-free is an important incentive, it does not compare favorably to the overall package of fiscal, regulatory, and other incentives contained in export-oriented investment legislation in other countries.

In addition to these weaknesses, there are a number of potential implementational problems which may adversely affect the investment approval process. Neither the Board nor Office of Investment have private sector representation. As a result, these bodies are less likely to truly understand and respond to the needs of private investors. Any future modification of the Proclamation may wish to include such representation in order to demonstrate the government's commitment to an expanded private sector role in the economy.

In addition, the Office of Investment is not established as a one-stop-shop capable of issuing all needed approvals and permits, nor is it empowered to assist investors with business registration procedures and the procurement of needed authorizations. Investment agencies providing these functions are typically of far greater assistance to investors, both domestic and foreign, and their effectiveness serves as a valuable promotional tool for an investment regime.

As indicated in the comparative analysis in the previous chapter, the Ethiopian law in many respects does not compare poorly to the laws found in a number of neighboring African countries. Nonetheless, it must be noted that these laws do not represent leading examples of investment laws worldwide. If the Ethiopian authorities are seriously interested in attracting foreign investment, then the country's investment law must be sufficiently attractive to compete for foreign investors with other leading investment sites. To this end, any future Ethiopian law should be modelled after those found in countries that have highly successful track records in attracting and retaining foreign investment.

Moreover, countries such as Ethiopia which have a strong previous history of state involvement in the economy, and which have previously exhibited great antipathy and suspicion of private investment, particularly foreign investment, face a significant challenge if they are to attract new investment. Given such a historical record, it is more difficult for these countries to convincingly demonstrate to foreign investors that the government is seriously committed to a market-oriented, private sector-led development strategy. As a result, it is even more important for these countries to adopt highly competitive investment legislation which offers clear and automatic incentives to investors, opens the widest possible number of economic areas to private sector investment, and generally demonstrates a willingness to create an operating environment that is highly favorable to business. The failure to introduce widespread liberalizations into what was previously a highly unattractive environment for private investment is unlikely to be sufficient to attract much new investment, either domestic or foreign.