2017-10-13

The Design and Implementation of Tax Holiday Policy and Laws in Ethiopia: Critical Issues and Problems

Emebet, Tafere

THE DESIGN AND IMPLEMENTATION OF TAX HOLIDAY POLICY AND LAWS IN ETHIOPIA: CRITICAL ISSUES AND PROBLEMS

EMEBET TAFERE

School of Law,

Bahir Dar University

June, 2017

THE DESIGN AND IMPLEMENTATION OF TAX HOLIDAY POLICY AND LAWS IN ETHIOPIA: CRITICAL ISSUES AND PROBLEMS

A Thesis

Submitted to Partial Fulfillment of the Requirement of Degree of Masters of Laws (LLM) at School of Law, Bahir Dar University

By

EmebetTafere

Advisor

AschalewAshagre (Assistant Professor of law)

School of Law,

Bahir Dar University

June, 2017

Thesis Approval Page

The thesis titled "The Design and Implementation of tax holiday policy and laws in Ethiopia: Critical issues and problems" by Ms Emebet Tafere is approved for Degree of Master of Laws (LLM)

Board Examiners

	Name	Signature
Advisor	--------------------------	------------------
Internal Examiner	----------------------------	-------------------
External Examiner	----------------------------	-------------------

Date ---------

DECLARATION

I "the undersigned" hereby declare that this dissertation is original and has never been presented in any other institution. To the best of my knowledge and belief, I also declare that any information used has been duly acknowledged. I understand that misrepresentation or fabrication of data/ ideas/sources will constitute a sufficient ground for disciplinary action by the University and can also evoke criminal sanction from the State and civil action from the sources which have not been properly cited or acknowledged.

Signature

Name of student

University Id. Number

Date

ACKNOLGMENT

First foremost, I wish to thank God along with his mother St. Virgin Mary, for his untold and limitless support throughout my life.

Next, my sincere gratitude goes to my advisor Aschalew Ashagre (Ph.D. candidate and Ass. Prof) for his patience, scholarly, critical and remarkable comments.

I would like to thank all interviewees who willfully cooperate to give me information required to the study.

The last but not the least, I also express my deepest and heartfelt thanks to Ato Yonas, Ato Demisew, and GedamTafere ,my younger sister, for your overall support.

Table of Contents

ACRONYMS

DI	**Direct Investment**
EIB	**Ethiopian Investment Board**
EIC	**Ethiopian Investment Commission**
ETB	**Ethiopian Birr**
FDRE	**Federal Democratic Republic of Ethiopia**
ERCA	**Ethiopian Revenue and Customs Authority**
FDI	**Foreign Direct Investment**
GTP	**Gross and Transformation Plan**
IMF	**International Monetary Fund**
ICSID	**International Center for the Settlement of Investment Dispute**
ICC	**International Chamber of Commerce**
IPDC	**Industrial Park Development Corporation**
LCDs	**Least Developed Countries**
MNCs	**Multinational Corporations**
NTBs	**Non-Tariff Barriers**
OECD	**Organizations of Economic Cooperation and Development**
R & D	**Research and Development**
SADC	**Southern African Development Community**
TAs	**Tax Authorities**
UNCTAD	**United Nation Conference on Trade and Development**
USAID	**United States Agency for International Development**
VAT	**Value Added Tax**
WTO	**World Trade Organization**

ABSTRACT

This research is aimed at exploring existing gaps on the design and implementation of tax holiday policy and laws of Ethiopia. Hence, the study tries to answer questions: To what extent are the tax holiday laws of Ethiopia certain enough? What is the place of deprecation allowance and loss-carry forward under the law in order to fill the pitfalls of tax holiday relief, and make the privilege more attractive to investors? How much strong are the monitoring mechanisms by the EIC to control the activities of income tax exempted sectors? What does it look like the coordination of tax authority and investment authority/board to grant and to carry away tax holiday privilege? *To answer these questions the study analysis related provisions of investment proclamations and investment regulations. Moreover, the findings are based on a qualitative research approach by reviewing laws, analysis of secondary sources and data collected through interviews. Accordingly, promotion of infant industries and encouragement of innovation via special income tax exemption are found the neglected issues both in the investment policy of Ethiopia and the entire investment legislations. The study also found that the income tax exemption legislations are surrounded by a number of shortcomings including legal uncertainty, disproportional measures against law violators, absence of deferral deprecation allowance, discrimination between firms and failure to recognize mechanism that enables individuals to provide objective and verifiable information for the better implementation of income tax exemption laws. Additionally, the funding verified that coordination problem among the relevant organ and weak follow up are the other problems in effective implementation of income tax exemption laws. Specifically, weak coordination between EIC and TAs, between EIC and regional investment bodies, limitation on awareness creation as well as weak follow up and control of income tax exempted firms by EIC are found the other crucial problems which hinder the tax exemption regime to be effective. Based on the findings, the research recommends that necessary amendments should be made on investment legislations. Besides, EIC should devote itself on awareness creation about the income tax exempted sectors, on controlling income tax exempted sectors and it should strengthening its cooperation with the tax authorities, regional investment body and private individuals for the better implementation of income tax holiday legislations.*

Key words: Income Tax Holiday, Income Tax Holiday policy/Laws, Private Investment

CHAPTER-ONE

INTRODUCTION

1.1. Background of the study

In this globalized world, most countries cannot be competent without private investment in general and foreign direct investment (FDI) in particular. There is a consensus in most literatures about the main factors which affects firm's investment location.[1] Tax factors like transparency, simplicity, stability and certainty in the application of the tax law and in tax administration, tax rates and tax incentives are among the important factors which have significant influence on the investment decisions of the firm.[2] Developing countries like Ethiopia introduce investment incentives for various reasons. In these countries, incentives are intended to offset other disadvantages that investors may face, such as a lack of infrastructure, complicated and antiquated laws, and bureaucratic complexities, macroeconomic instability and weak administration.[3] This is because it is far harder, and takes for longer to tackle the above investment impediments for them than to put in place a grant for counterbalancing the impediments.[4] At the same time, countries which introduce incentives in turn need to acquire potential benefits including transfer of technology, foreign currency, assistance improving condition of less developing areas, employment gains and economic growth.[5]

Tax holiday is one type of tax incentives which often has been used by developing and transitional countries.[6] They rely on it, because developing countries usually do not have enough domestic capital to promote rapid economic development and that is why the heavily depend on granting temporary tax

---

[1] Organization of Economic Cooperation and Development(OECD), *Tax Incentives for Investment – A Global Perspective: Experiences in MENA and non-MENA countrie*s, 2007, p 3 [Here in after, OECD, *Tax incentives for investment global perspective*]/ Available at www.oecd>mena>competitiveness/38758855.pdf
[2] Ibid
[3] AlicjaBrodzka, 'Tax Incentive in Emerging Economics', *Business system and economics*, 2013, vol, 3, NO 1, Wroclaw, Poland, p 26 / available at https://www.mruni.eu>afc>002-brodzka last accessed on February 8/2017
[4] Paul Barbour, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Secto*r, ESAU Working Paper 14, 2005, p 7[Here in after, Paul, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Secto*r]
[5] Investment climate advisory services of the World Bank group, 'Investment Incentive the good, the bad and the agley', *background paper for the 18th Colombian investment conference,* Colombia University, November 13-14, 2013, p 5 [Here in after, Investment climate advisory services of the World Bank group, *Investment Incentive the good, the bad and the agley]*
[6]Dawit G/Medihin and Dr. Gudelia C. Saporna, 'The Impact of Tax Holiday on Investment in Ethiopia: The Case of LTO Branch, online', *European Journal of Business and Management,* 2016, Vol.8, No.31, pp. 106- 107, at paragraph 1 available at www.iist.orgISSN2222-1905(Paper)ISSN2222-2839, last accessed on March 25, 2017, M. Sornarajah, The International Law on Foreign Investment, Cambridge university press, New York, 2004, 2nd edition, p 115[Here in after, Dawit and Dr. Gudelia, *The Impact of Tax Holiday on Investment in Ethiopia: The Case of LTO Branch]*

exemptions to promote private investment.[7] Tax holiday allows new firms to be temporarily exempted from the burden of taxation.[8]

Ethiopia is not an exception on granting investment incentives in general and tax holidays in particular. Since 1991, after down fall of the Derg regime, Ethiopian turns its face from state controlled economy towards market-oriented economy, and it has implemented a series of reform programs.[9] However, under the previous regime, specifically dreg regime, the government nationalized the whole economy and had no place for private investments.[10] But later on, there was relaxation towards private investment, and the 1983 joint venture proclamation which encourage the participation of both domestic and foreign investors on the joint investment, contained tax incentives like exemption from customs duties on import of investment goods and spare parts and income tax holidays for five years in case of new projects.[11] The 1996 investment policy introduced various incentive systems to build the confidence of private investors. Unlike the dreg regime, the current regime has a great passion to attract private investment and has continued to grant various incentives. The country has introduced different fiscal and non-fiscal incentives to encourage private investments [12]. Income tax exemption to investors engaged in manufacturing, agribusiness, generation, transmission and supply of electrical energy; and ICT in which the length of time depending on the specific activity and the location of the investor, are category of fiscal incentives recognized under the country's investment law.[13] It also grants up to 15 years income tax exemptions to industrial parks developers if the investment is outside Addis Ababa.[14] To this effect the country also establishes autonomous investment board (EIB) and investment commission (EIC) for proper administration of investment incentives.[15]

It is true that the fundamental purpose of most income tax exemption law is to promote economic development by making the investment climate more attractive to private investors than it would

---

[7] Ibid

[8]United Nation Conference on Trade and Development, *Tax Incentive and Foreign Direct Investment a Global Survey*, ASIT Advisory Studies, No. 16, New York and Geneva , 2003, p 19 [Here in after UNCTD, *Tax Incentive and Foreign Direct investment a global survey*]

[9] Ethiopian Business Development Service Network, *Business Environment - Investment Policy Investment Areas-Incentives/Guarantees Taxation - Investment Opportunities Investment Procedures*, published by Ethiopian Business Development Service Network,2004, Addis Ababa, at P 3[Here in after, Ethiopian Business Development Service Network, *Business Environment - Investment Policy Investment Areas*]

[10]TaddeseLencho, 'Towards Legislative History of Modern Taxation in Ethiopia(1941- 2008)', *Journal of Ethiopian law*, vol,25, No.2, 2012, pp. 104-158, at p 141 [Here in after, Taddese ,*Towards Legislative History of Modern Taxation in Ethiopia*].

[11] Ibid

[12].EIC, Investment Guide , Incentives, 2014, at p 31 / available at www.investethiopia.gov.et/imagies/pdf/incentives.pdf

[13] Id. at p 32

[14]EIC,W*hyin Ethiopia? Opportunities and Investment process about us*,2017, p 2 Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Rgulation, 2012, Federal Negarit Gazzetta, Reg. No.270, 19th year, No 4[Here in after,Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation No.270]

[15]The Ethiopian Investment and Investment Commission Establishment Council of Minister Regulation, 2014, Federal Negarit Gazzetta, pro. No 313, 20th year, No. 63[Here in afte,r the Ethiopian Investment and Investment Commission Establishment Council of Minister Regulation, 2012]

otherwise be. Countries especially developing countries prefer to recognize tax holiday than other tax incentives due to the advantages which is peculiar to tax holiday relief itself. More importantly, tax holiday is used to reduce tax liabilities, has relatively low compliance cost, and it is simple to administer.[16]

Apart from this, tax holiday is also criticized. To begin with, it may result in a significant loss of revenue if it has concentrated on investment projects that would have occurred even in the absence of the incentives.[17] Secondly, it is criticized for attracting short-term projects, invites tax avoidance through the indefinite extension of holidays via creative resignation of existing investment as new investment, and creates competitive distortions between old and new firms. Lastly, it creates opportunities for corruption and other rent-seeking behavior associated with the granting of the relief, and this will be greater if officials have wide discretion in determining which investors or projects receive favorable treatment.[18]Considering such probability, countries are expected to be careful in formulating incentive policies and laws for that end. However, in reality, there is a problem on the effectiveness of tax holiday which results from problem of the policy, law and administration of the tax holiday relief. Due to such problems the incentive regime could result in greater amount of loss of revenue, tax avoidance, attracting only short term investment, and corruption.

Ethiopia is not unique for the above challenges of the tax holiday privilege. The problems are emanating from the investment policies, the laws and the practice of both the investment body and the investors themselves. Though there are some literatures conducted on tax holidays, they had not specifically addressed the above problems. Because of this, the researcher will critically analyze the existing gaps on the above areas and finally will design the appropriate solution for the problems by consulting the experience of other countries and using interview as one means of data collecting tool.

1.2. Statement of the Problem

Developing countries and countries in transition work on attracting private investment and tax holiday is a tool for attracting investment. But, tax holiday is not free from criticism. As a result, a country should be careful on minimizing the risks of granting the relief. If a country failed to do so, it would be difficult for the incentive regime to bring the intended advantages. Bringing the intended benefit from tax holiday relief is not an easy task. The challenges may come from gaps in the policy itself, the law, and practice of investors and government authorities.

[16] OECD, *Tax Incentives for Investment Global Perspective*, p 4

[17] kevin Fletcher, 'Tax Incentive in Cambodia', Lao PDR, and Vietnam, 2002 ,p 5 available at : www.imf.org/external/pubs/ft/seminar/2002/fdi/eng/pdf last accessed on April 7, /2017[Here in after Fletcher, *Tax Incentive in Cambodia, Lao PDR, and Vietnam*]

[18]Technical report by Nathan -MSI Group on the Effectiveness and Economic Impact of Tax Incentives in the SADC Region, 2004, p.26 available at: <pdf.usaid.gov/pdfdocs/Pnacy929.pdf , last accessed on 15/02/2017 [Here in after, Technical report by Nathan -MSI Group on the Effectiveness and Economic Impact of Tax Incentives in the SADC Region]

The Ethiopia tax holiday regime also shares these challenges. Due to such problems the government loses greater amount of revenue from tax and the problem also affects investors. To make it general, government becomes double loser; it loose greater amount of revenue that would be collected from tax, and at the same time it loses the benefit derived from investment. Mainly, this study will address the following specific problems.

A good incentive regime starts from formulating and issuing positive and comprehensive incentive policies which enable to bring economic development by attracting foreign and domestic investment. The Ethiopian investment policy rationales of granting investment incentives in general and tax holiday in particular is to encourage and expand investment by encouraging the domestic production capacities of the country, to bring transfer of technology, to bring equitable distribution across different regions of the country and improve the living standards of the people.[19] However economic growth can be persistently brought if the incentive policy granted in innovative base in addition to the above policy goals.

In a globalization process innovative oriented tax policy becomes an important factor of private investment in to high-tech industries of national economy.[20]Theoretically, the government should provide tax incentive on the condition that a company has expenditure on R & D that is expected to become in the future and to have significant externalities.[21] However, there is a problem on the Ethiopian incentive policy on encouraging innovative industries. In addition, little emphasis to small and medium scale domestic industries is also the other policy gap in the current tax holiday regime which may make the country unable to bring persistent and sustainable economic development in the long run. Accordingly, non-innovativeness and being reluctant on the promotion of infant industries have taken as the problems of tax holiday relief in the country as a result of gaps on the design of policy.

Legislation gaps are also the other problems in the effective administration of tax holiday regime in Ethiopia. For the tax holiday used to bring the intended result, the law that grants the relief should be certain and predictable. However, the current incentive laws of the country cannot be free from criticism in this regard. The amended investment proclamation No. 849/2014 authorizes the investment board to grant new and additional incentives other than what is provided in the existing regulations. But, the criteria and requirements to grant this privilege by such board are not clear, and this creates a room for abuse. Frequent amendment of legislations is also the other challenge which makes the tax holiday regime to be uncertain. If laws are subject to revision, it makes long term planning difficult for business and adds to the perceived risk of undertaking major capital incentive technologies. In Ethiopia, there is

---

[19] Investment Proclamation, 2012, Federal NegaritGazzettaproc. No. 769, 18th year, No 63, in the preamble part[Here in after. Investment Proclamation, ,proc. No. 769]

[20]OlenaLikhovets, 'Tax Incentives Effectiveness for the Innovation activity of Industrial Enterprises in Ukraine,' ,*Journal of economics and sociolog*y, vol 7, No 1, 2014, p 75, available at www.economics-sociology.eu>files>1 [Here in after,Olena, *Tax Incentives Effectiveness for the Innovation activity of Industrial Enterprises in Ukraine*

[21] Ibid

frequent revision of incentive laws (income tax exemption laws) starting from 1996 up to now. Such frequent changes may create discrimination among investors, eroding investors' confidence to stay and invest in the country, and create competitive distortion between the new and old firms.

The non- existence of deferral deduction of depreciation allowance after the end of tax holiday period is also the other legislation gap on the design of the income tax exemption laws of Ethiopia which impair long term investment decision of the investors. Granting of long period of tax exemption will not be alone sufficient enough to promote long term investment; rather it should be supported by other supplementary incentives like deprecation allowance, loss Carry forward and deductions of expenses. However the Ethiopian law only introduces loss-carry forward. So in their belief, unless the law deferred deduction of deprecations until the holiday ends, it imposes high tax burden on the firms following the completion of tax holiday, and such problem leads to investor's dissatisfaction and makes them to leave out of the country.

Furthermore, weak follow up to control the forgoing activities of firms after they grant tax holiday relief and lack of strong coordination among tax authorities and investment authorities is also the other problem in the country's incentive regime in general and tax holiday in particular which create a room for tax avoidance.

These problems compounded by the dearth of research on the issues insists the researcher to investigate the existing policy, legal and implementation gaps on the tax holiday relief of Ethiopia.

. 1.3. Objectives of the Study

The study has the following general and specific objectives

1.3.1. General objective

The objective of this study is to investigate the existing gaps on the design and implementation of tax holiday policy and laws of Ethiopia

1.3.2. Specific Objectives

- To analyze policy gaps associated with the income tax holiday regime of Ethiopia;
- To assess whether the laws which recognize tax holiday are certain and predictable enough;
- To evaluate the place of loss-carry forward and deprecation allowance under the law during tax holiday periods, and direct their contribution to attract long term investments;
- To see whether a strong follow up /monitoring system, to control the forgoing activities of firms with tax holiday relief, exists ;

- To assess the coordination of tax authority and the investment authority on combating inappropriate use of the relief by the investors; and
- To recommend solutions for the identified problems.

1.4. Research Question

1.4.1. Main research Question

What are the existing policy, legal and implementation gaps in the income tax holiday relief of Ethiopia?

1.4.2. Specific Research Questions

1. To what extent are the tax holiday laws of Ethiopia certain enough?

2. What is the place of deprecation allowance and loss-carry forward under the law in order to fill the pitfalls of tax holiday relief, and make the privilege more attractive to investors?

3. How much strong are the monitoring mechanisms by the EIC to control the activities of income tax exempted sectors?

4. What does it look like the coordination of tax authority and investment authority/board to grant and to carry away tax holiday privilege?

5. What will be the possible specific recommendations for the identified policy law and implementation gaps of income tax holiday relief?

1.5. Significance of the Study

This research is believed to have national significant in the legal environment. By showing the problems caused by legal and policy gaps, it will help the legislature to reconsider and amend laws on tax holiday privilege. As well, it will provide adequate guidance to the investment authorities and tax authority to properly administer tax holiday relief in accordance with laws. Furthermore, the study will raise the knowledge of investors by intimating them to identify the improper administration of tax holiday privilege by government officials.

1.6. Literature Review

There are various researches on investment incentives and incentive laws of Ethiopia, and many of the researches had undertaken by non- legal scholars. However it has not been possible to access a research work done to deal with all possible issues relating to the policy, legal and implementation gaps in tax holiday privilege of the country in a way this research needs to address.

Apart from the above, Assefa Ali Beshir , in his LLM thesis tried to show one issue on tax holiday regime of Ethiopia.[22] In his study, open ended list of relatively under developed region to grant tax exemption in regulation No 84/2003, was considered as the problems of the income tax holiday regime of Ethiopia.[23] According to his finding, such problem in the law gave wide discretion to the investment board, and an investor who would have invest in other relatively developed areas face a problem to convince the board in order to obtain incentives as per the regulation.[24]

Dawit Gebremiedin and Dr. Gudelia C. Saporna are also the other scholars who tried to contribute their part on tax holiday of Ethiopia although their emphasis was not on addressing legal gaps. Under their work they tried to investigate whether the tax holiday has an impact on employment opportunity, has a role on attracting new manufacturing investment and it reduce tax revenue by undertaking experimental research.[25] Their study found that tax holiday had a positive impact on attracting additional investment, creation of new employment opportunities and enhancing long term revenue of government. Besides, according to their study, abuse of tax holiday privilege by the authorities and taxpayers and possibility of evading tax were obstacles that minimize the role of tax holiday on investment.[26]

Furthermore, Abebe Nigusu in his MA thesis also identified lack of coordination among various organs of government and legal uncertainty as the problems of the country for the effective FDI attraction.[27]However, there are still areas on tax holiday system of the country in which prior research is not closely dealt. In the first place, policy gaps on tax holiday relief of the country have not been studied. In addition to this, the legal problems under the current law, with new developments, on the subject matter have not been also closely studied. Furthermore, extensive administrative problems emanate from both the investors side and the government authorities have not been deeply addressed in previous works. Problems on innovativeness of investment policy, certainty of laws, , absence of deferral deprecation allowance until the end of holiday period, , problem on coordination of tax authorities and investment commission and lack of follow up the activities of investors by the relevant authorities are among the areas which need further study. Therefore this study aimed at addressing the above and other issues arising relating to tax holiday privilege in Ethiopia.

---

[22]Assefa Ali Beshir, *Problems of Incentive Regime of Foreign Private Investment in Ethiopia: The Law and Practice*, LLM. Thesis, Addis Ababa University, Law Facility, 2005 [Unpublished avalible in Addis Ababa university main library], pp. 60-67[Here in after, Assefa, *Problems of Incentive Regime of Foreign Private Investment in Ethiopia: The Law and Practice*, LLM]

[23]Ibid

[24] Ibid

[25] Dawit and Dr. Gudelia, *The Impact of Tax Holiday on Investment in Ethiopia: The Case of LTO Branch*, , pp. 106-118

[26] Ibid

[27]Abebe Nigusu, *The Legal and Institutional Framework of FDI in Ethiopia: The shortcomings*, MA thesis, Ethiopian Civil Service University School of Diplomacy and International Relations, 2014, pp. 1- 72 [Here in after,Abebe, *The Legal and Institutional Framework of FDI in Ethiopia: The shortcomings*

1.7. Scope of the Study

The study focused on the challenges of tax holiday relief in the existing policy and laws of Ethiopia. To address policy and legal gaps, the study looked in to different laws like investment proclamations and regulations. In addition to policy and legal gaps, the study tried to explore the practical problems resulted from failure of both the EIC and investors to behave in accordance with relevant laws.

1.8. Limitation of the Study

In the process of conducting this research, there were certain challenges, among other things, time limitation and poor document handling system by the investment commission to easily access the investors were the main constraints of the study. However, these do not affect the outcome of the study since all necessary data were deeply investigated through personal efforts.

1.9. Methodology of the Study

The method employed in this study is qualitative/ interpretive research approach. The researcher has preferred to employ such approach because policy and legal gaps as well as implementation problems on tax holiday relief that the study tries to look at are relative and more dependent to the perception of stake holders.

The research is largely doctrinal legal research type. In order to address research questions which are purely doctrinal, the pertinent provision of investment proclamations and investment regulations were used as a primary data. In addition, the laws and experiences from other jurisdiction are also consulted to analyze the matter. Relevant books, journals, periodicals, and other relevant publications (brochures) of investment commission were also served as a secondary source for this research. Moreover, the research has also some empirical aspect since some of the research questions require the investigation of practice of investors and EIC. To this effect, primary data were collected.

To conduct this research, the researcher had employed semi- structured interview to collect the necessary data. The data were collected by offering predetermined flexible questions due to existence of a little bit technicalities over the subject matters especially to the investors. It is collected by interviewing the employees of EIC, members of EIB and employees of ERCA. Investors, beneficiaries of tax holiday relief, were also the other key sources to accomplish this work. Furthermore, Purposive sampling technique had employed to interview members of EIB, employees EIC and employees of ERCA. This is because the interview is not made to the above authorities arbitrary rather it aimed at interviewing those personals whose responsibility is directly related to investment incentives. But it had used simple random sampling technique to interview investors. Finally, the data gathered through interview and relevant documents were analyzed qualitatively.

1.10. Organization of the Study

This paper contains four chapters. The first chapter is an introductory part framed to present the research proposal, and holds background of the study, statement of the problem, objectives of the study, research questions, significance of the study, literature review, scope and limitation of the study, and methodology of the study. The second chapter deals with investment and investment incentives in general. In this chapter the concepts of investment and investment incentives, factors affecting investment and theories of investment are clearly addressed. In addition to this the concepts, conceptual frame work of tax incentives and their types, pros and cons of tax incentives, policy argument for and against them are also demonstrated. More importantly, this chapter gave special emphasis to the concept and pro and cones of tax holiday among variety of tax incentives. The third chapter designed to discuss elaborately the main subject matter of research, the aim of which is investigation of gaps on the design and implementation of tax holiday policy and laws of the country. This chapter devoted to dig out policy, legal and implementation problems in relation to income tax holiday relief and stand to answer research questions arise on the above areas.

Finally, the last chapter came up with the conclusion of the whole research and forwarded recommendation

CHAPTER TWO

INVSTMENTS AND INVESTMENT INCENTIVES IN GENERAL

2.1. Investments in General

Now days, investment, especially FDI, has assumed increasing importance and becoming a prime concern for policy makers.[28]Particularly, it became an increasingly important element in global economic development and integration during the 1990s.[29] The process of transition from socialism to capitalism and the integration of the Central and Eastern European countries (CEEC) into the world economy through trade and capital flows were major events that results the occurrence of FDI development contemporaneously with later. [30]Governments have policies aimed at creating stronger incentives for foreign investors to make the own country the better choice of foreign investors and to attract more private investment inflows.[31]

2.1.1. Conceptual Framework of Investment

Investment is defined differently by different scholars in the field; and Myriads of definitions exist for the term by various scholars. However, it is impossible to discuss all definitions given by these numerous scholars due to page limitation. Only definitions of scholars which seem adequate and compressive for this work have been included. ICSID defines investment in saline et al vs. Morocco's case as a contribution of money or asset which needs; certain duration of time for the project to be implemented, may involve risk and has a contribution for the host state economy.[32] OECD (1996) defines investment by illustrating its constitutive elements. Accordingly, the term investment comprises:[33]

- *Tangible and intangible, moveable and immovable, property and any related property rights, such as leases, mortgages, liens and pledges;*

---

[28]Imad A. Moosa and Buly A. Cardak, 'The Determinants of Foreign Direct Investment: An Extreme Bounds Analysis', online, *Journal of Multinational Financial Management*, No 16, 2006, pp. 199-211, at paragraph 1 , , available at www.elsevier.com/locate/econbase last accessed on April 16, 2017 [Here in after, Imad and Buly A, *The Determinants of Foreign Direct Investment: An Extreme Bounds Analysis]*

[29] Alan A. Bevan and Saul Estrin, The Determinants of Foreign Direct Investment into European Transition Economies ,online, *Journal of Comparative Economic*s, No 32, 2004, pp. 775-787, at paragraph 2, available online at www.elsevier.com/locate/jce last accessed on April 20, 2017

[30] Ibid

[31] Imad and Buly A, *The Determinants of Foreign Direct Investment: An Extreme Bounds Analysi*, at paragraph 2

[32] Grabowski, Alex (2014) 'The Definition of Investment under the ICSID Convention: A Defense of Salini', *Chicago Journal of International Law*, 2014, Vol. 15 No. 1, Article 13, p 296 Available at: http://chicagounbound.uchicago.edu/ciil/vol15/iss1/13

[33]OECD, *Definition of Investment and Investor*, 1996, pp. 4-6

- *A company or business enterprise, shares, stock, or other forms of equity participation in a company or business enterprise, bonds, debentures, and other debt of a company or business enterprise;*
- *Claims to money and claims to performance pursuant to a contract having an economic and financial value;*
- *Include intellectual property right as well as it recognizes rights such as license and investment permits constitute a form of property*.

From the given lists of elements given by the OECD, it is possible to understand investment as a contribution of tangible and intangible, movable or immovable property or other property rights including intellectual property rights, claim of money and claim of performance having an economic value, operated by a company or enterprise, and includes direct and equity participation. On the other hand, UNCTAD (2011) defines investment in two ways (narrowly and broadly). The narrower definition excludes certain specific asset for example, portfolio shares from the definition of investment.[34] This is because the risk in some portfolio investment for the investor would not be as high as that involved in direct investment.[35] However, the broad asset – based definition of investment includes: movable and immovable property and any other property rights such as mortgage, liens and pledges; shares, stocks and debentures of companies or interest in the property of such company; claims of money to any performance under contract having financial value; intellectual property rights and good will; and business concession conferred by law or under contract, including concession to search for, cultivate, extract or exploit natural resources.[36]These lists of UNCTAD are more or less similar with that of the lists of OECD (1996) for the definition investment.

Apart from above, the Ethiopian investment proclamation No 769/2012, defines investment as "expenditure of capital in cash or in kind or in both by an investor to establish a new enterprise or to expand or upgrade one that already exists."[37] According to this definition, investment is generally allocation of resources having monetary value that are expected to yield some returns over a period of time. Compared to the UNCTAD (2011) and OECD (1996) definitions, the Ethiopian investment proclamation defines investment very narrowly. Defining investment narrowly will have an effect on incentives which is grated to attract investment in specific sector. This is because activities eligible to investment incentives will be only those undertakings which included in the definition of investment.

Investment can be categorized as direct and portfolio investment. Portfolio investment involves the acquisition of stocks and shares, financial deposits and other financial assets in order to get a return or

---

[34] Untied Nation Conference on Trade and Development(UNCTAD), *Scope and Definition of Investment and Investors*, UNCTAD Series on Issues in International Investment Agreement II New York, Geneva , 2011, p. 10
[35] Ibid.
[36] Id. p. 24
[37] Investment Proclamation, 2012, Article 2(1)

surplus. On the other hand, direct investment (DI) is defined as a category of cross boarder investment made by a national of another country in foreign lands with the objective of establishing a lasting interest in an enterprise that is resident in an economy of host countries.[38]This definition includes management control by the direct investors and the firms would have lasting interests on the investments. The motivation of the DI is strategic long term relationships with the enterprise to ensure significant degree of influence by the direct investors in the management of the enterprise.[39] Here, the "lasting interest" is evidenced when the direct investor owns at least 10% of the voting power the direct investment enterprise.[40].

2.1.2. Theories of Investment

Theories are conceptual explanation of different phenomena (like political, economic and social), or a system of ideas or a set of principles on which the practice of an activity is based. Like many social, political and economic events, FDI has its own theories that explain among other things the reason why foreign firms invest outside their national territories, what factors influence them to engage on foreign lands and such related issues.[41] However, it is difficult to find universally accepted theories on private investment particularly on the role of legal frameworks (tax laws, investment laws, property laws, etc.), and administrative frameworks on investment in a comprehensive way.[42] So, this paper tries to discuss some FDI theories that touch upon legal and administrative frameworks, specifically legal and administration from work of investment incentives, found here and there in scattered way.

Although, numerous theories of FID exist, this study discusses only the following two theories due to their relevance for the subject matter.

2.1.2.1. The Eclectic Paradigm (O-L-I)

The Eclectic theory, which is also called O-L-I paradigm, is developed by John Danning in 1987. This theory of Professor Danning is a mix of three different theories of Foreign Direct Investment (O-L-I) based on the motive behind the investment from the perspective of investing firm.[43] According to Danning, there are three main aspects causing the flow of capital stock from foreign country to host

---

[38]OECD, *Detailed Benchmark Definition FDI*, fourth edition, 2008, p. 17; and International Monetary Fund Balance of Payment Manual , fifth edition, 1993

[39]OECD, Detailed Benchmark Definition for FDI(2008), p. 17

[40] Ibid.

[41] Abebe, *The Legal and Institutional Frame work of FDI in Ethiopia: The Shortcomings*, 2014 , p 8

[42] Ibid.

[43]Vintila Denisia, 'Foreign Direct Investment Theories: An Overview of the Main FDI Theories', *European Journal of Interdisciplinary Studies*,2010, Vol. 2, No 2, pp. 1044-110, at p 107[Here in after, Vintila , *Foreign Direct Investment Theories: An Overview of the Main FDI Theories*], Erdal Demirhan and Mahmut Masca, Determinants of Foreign Direct Investment Flows to Developing countries: A Cross-Sectional Analysis, *Prague Economic papers*, No, 4, 2008,pp.356-369, at p 357(Here in after, Erdal and Mahmut , *Determinants of FDI Flows to Developing Countries*)

countries.[44] The three aspects that influence the location of foreign direct investments are Ownership advantages, Location advantages and Internalization (O-L-I)advantages.[45] Generally, the paradigm offers a holistic framework to investigate the significance of factors influencing both the initial expansion and the subsequent growth of the activities of multinational enterprise in foreign market.[46]The assumption of the theory is that engaging on investment activities in a foreign market has many costs, among other things failure of knowledge about local market condition, socio-cultural, legal and many other costs.[47] Thus, the theory asserts investors investing in foreign countries should get some advantages that can offset the above cost.[48]

A. "O" Ownership advantage: it refers to intangible and or tangible assets which are, at least for a while exclusive possesses of the company and may be transferred within transnational companies at low costs, and brings either to higher incomes or reduced costs.[49] But, the operation of MNCs performed in different countries face some additional costs. Thereby the company must have certain characteristics that would triumph over operating costs on a foreign market to successfully enter there. These advantages show that what makes the firm special from others. Generally, there are three types of specific advantages.[50]

i). Monopoly advantages in the form of privileged access to markets through ownership of natural limited resources (trademark and patent which includes monopoly on particular product or brand);

ii). Technology, which contains all form of innovative activities; and

iii). Economies of large size like economies of learning, economies of scale and scope, greater access to financial capital, greater managerial skill and greater knowledge about the market and marketing techniques.

Having monopoly over its own specific advantages and obtaining them abroad leads to the firm to have a higher marginal profitability or lower marginal cost than other competitors.[51]

---

[44] Ibid.
[45] Vintila , *Foreign Direct Investment Theories: An Overview of the Main FDI Theories*, p. 107
[46]Stoian, Carmen R. and Filippaios, Fragkiskos, ' Dunning's eclectic paradigm: A holistic, Yet Context Specific Framework for Analyzing the Determinants of Outward FDI: Evidence from International Greek Investments', *International Business Review*, vol. 17, No, 3,pp.349-367, at p 353
[47] Abebe, *The Legal and Institutional Frame work of FDI in Ethiopia*, at p 10
[48] Ibid.
[49]Vintila, *Foreign Direct Investment Theories: An Overview of the Main FDI Theories* , p 108
[50] Ibid, Patricia Lindelwa Makoni, 'An Extensive Expropriation of Theories of Foreign Direct Investment', *Risk Governance and Control: Financial market and institution*, 2015, vol. 5, No.2, pp. 77-83, at p 81[Here in after, Patricia , *An Extensive Expropriation of Theories of Foreign Direct Investment*
[51] Ibid

B. "L" Locational advantage

Locational advantage is a country specific advantage, and it is a key factor to determine who will become host country for the activities of MNCs. The specific advantages are divided in to three categories:[52]

1. Economic benefits: this category consists of both qualitative and quantitative cost of production, infrastructural cost like telecommunication services and availability, transport cost market size, abundant and low cost of natural resources[53] and over all macroeconomic stability, etc.

2. Political advantages: this category of locational advantage refers to common and specific government policies which affect FDI like investment policies and laws, taxation and fiscal policies, environmental policies, property laws, political stability, exchange rate policy or overall government regulatory framework in general.

3. Social advantages: These inter alia are distance between the home and home countries, cultural diversity and attitude towards strangers.

For Trans National Corporations to reap the intended benefits from investment, they need to consider the locational advantages (economic, political and social) of host countries.

C. "I" Internalization advantages

Internalization is all about the ability of multilateral companies to internalize some activities to protect their exclusive right on their assets, and defend their competitive advantages from rivals. It addresses the question of why firms engage in FDI rather than license foreign firms to use their proprietary assetand cross-border market Internalization benefit is higher the more the firm will want to engage in foreign production rather than offering this right under license, franchise.[54]

Although, ownership, locational and internalization advantage have their own influence on the flow of foreign capital to host countries, the degree of influence of each advantage to operate in host countries varies from one advantage to the other advantage. For instance, if the first condition (ownership advantage is met, but second condition (locational advantage) is not satisfied, MNCs prefer to export to host countries instead of operating foreign direct investment there.[55] The internalization advantage will also become successful in determining the location of investment if locational advantages are fulfilled. This is because the benefits acquired through direct foreign production engagement will be higher rather than offering this right under license or franchise if and only if the locational advantages are satisfied.

[52] Ibid

[53] Muhammad Reza Fahmi, *Analyzing the Relationship Between Tax Holiday and Foreign Direct Investment in Indonesia*, MSc thesis, Asia Pacific Studies Ritsumeikanasia Pacific University, 2012, pp. 1-96, at p 23 [unpublished available at http://r-cude.ritsumei.ac.jp/bistream/10367/4740/1/512110611.pdf],[Here in after, Muhammad , *Analyzing the Relationship Between Tax Holiday and Foreign Direct Investment in Indonesia*]

[54]Vintila, *Foreign Direct Investment Theories: An Overview of the Main FDI Theories* , p 108

[55] Muhammad,*Analyzing the Relationship Between Tax Holiday and Foreign Direct Investment in Indonesia*, p. 23

Here, instead of offering their rights under license or franchise, MNCs prefer to engage in direct foreign production if a good investment environment exists in host countries. But, if the host countries investment environment (locational advantage) is not conductive, it may result less benefit from direct engagement in host countries, and in this case firms prefer to offer their rights through franchise or license. Therefore, among the three advantages, “Locational Advantage” plays a higher role to determine the location of foreign direct investment the since it has an indirect effect on the rest two advantages.

2.1.2.2. The Institutional FDI Fitness Theory

The institutional FDI fitness theory, which is based on institutional analysis, was developed by SaskiaWilhelms in 1998. The term FDI Fitness refers to a country's ability to attract, absorb, and retain FDI. The theory assumes the Darwinian concept of the survival of the fittest which suggests that it is not necessarily the biggest and strongest who survive, but rather those who adapt most cleverly and fittingly to existing conditions.[56] It is not the largest countries, but the fittest that obtain most FDI since fitness denotes a state of wakefulness, the ability to react swiftly to dangers and opportunities, creativity and flexibility in carving out a niche in which a country can survive against competitors–even when these are bigger and became more fit.[57]

The theory focused on the institutional and policy frameworks as determinants of FDI. There are four FDI fitness institutions namely socio-culture, education, market and government,[58]Wilhelms and Witter (1998) put them in pyramidal form. At the base of the pyramid, socio cultural fitness, are the oldest and more complex of all fitness institutions that determine the investment.[59] Education is the second pillar in institutional fitness since it is being necessary in ensuring an attractive environment for FDI as educating human capital enhances R&D information processing ability.[60] Above education, the third pillar is market. It includes economic and financial aspects of institutional FDI fitness in the form of physical capital and financial capital .Development of financial market are hence a prominent feature in investment decision process of MNCs.[61]The last at the top of the pyramid which is considered as a key determinant of FDI is government. Government as a fitness institution adopts protective regulation to manage market fitness, and the fitness is considered to include economic openness, law degree of trade and exchange rate intervention low corruption and greater transparency.[62] According to this theory, FDI is determined more by institutional variables like policies, laws and their implementation and less by

[56]Saskia K.S. Wilhelms and Morgan Stanley Dean Witter, Foreign Direct Investments and Its Determinants in Emerging Economies, African Economic Policy Paper Discussion Paper, No 9, 1998, p 2[Here in after Saskia K.S and Morgan, *FDI and Its Determinant in Emerging Economies]*
[57] Ibid
[58] Id. p 3
[59]Patricia, *An Extensive Expropriation of Theories of Foreign Direct Investment*, p 82
[60] Ibid
[61] Ibid
[62] Ibid

intransigent fundamentals.[63]Wilhelms and Witter (1998) try to show how FDI fitness theory interacts in various forms as follows: "Government forces shape markets, education, and socio-culture; market forces affect the government, education, and socio-culture; education affects the human capital and consequently the government, markets, and socio-cultural norms; whereas the sociocultural system is the origin of government, markets, and education."[64] This implies that the ease with which an institution can be changed and the time required for its change depends on the degree to which it is influenced by the rest institutions. Thereby change in one institution will not be an easy task unless the degree of influence of the other institution is less on the former.

2.1. 3. Determinants of Investment

An attractive investment opportunity and acceptable investment climate represent the optimal mix of high financial return and non-commercial risks.[65] Improving the investment climate, and, in particular reducing perception of political risk of host countries, are therefore important steps without which even the most profitable opportunities are likely to remain untapped.

The investment climate should be seen in this context from both global and domestic perspectives. Overall volume of investment flows and host countries effort to increase such flows are constrained or stimulated by the degree of strength and stability of the global economy.[66] For example, a faster and sustainable growth in developing countries depends to a great extent on the policies and actions of industrial countries, especially the later one growth rates, the level they adopt for interest and exchange rates, the degree of openness of the market and the level of their external aid flows. Therefore, not only domestic investment climate affects the location of investment, but also host countries economic strength and stability in the world economy plays important role on investment decisions of firms.

The domestic investment climate is multifaceted and dynamic concept. It is true that firms engaged abroad through FDI do have various motives to invest in host countries, which can be grouped in to four main categories.[67] To start with, market seeking FDI, it is through which a firm searches a new consumer for its goods and services. [68]The second one is resource seeking FDI: this group of FDI motivated by the availability of, and access to, natural resources, raw materials or low-skilled labor in a host country.[69] Strategic asset seeking FDI rather is an FDI driven by a firm's desire to acquire tangible or intangible

[63]Wanjala Mukhwana Bernadette, *Determinants of Foreign Direct Investment in Sub-Saharan Africa, with Inferences on Kenya*, Master's thesis, 2001, p. 21[Here in after, Wanjala, *Determinant of FDI in Sub-Saharan Africa*]
[64] Saskia K.S and Morgan, *FDI and Its Determinant in Emerging Economies*, p 5
[65]Paul, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector*, p iv
[66] Id. p 678
[67] Investment climate advisory services of the World Bank Group, *Investment Incentive the Good, the Bad and the Agley: Assessing the Costs, Benefits and Options for Policy Reform*, p 12
[68] Ibid.
[69] Ibid.

assets in order to strengthen its own position and/or weaken the position of its competitor.[70] The last group of FDI is efficiency seeking FDI: FDI that occurs when firms seek to decrease their costs of production by transferring production to locations with low labor costs or rationalizing their operations.[71]

In broad sense, the domestic factors affecting investments comprise many interrelated elements that can be presented in three categories, institutional and policy aspect/factors, economic and infrastructural, and legal and business facilitation aspects.[72]

2.1.3.1. Institutional and Policy Aspects

Institutional quality is a likely determinant of private investment, particularly for LCDs.[73]These aspects of investment climate particularly cover the political stability of the government of host countries, its economic policies (especially policies and behavior towards private investment, the degree of sophistication of its financial and administrative institutions as well as the administrative procedures for initiating and operating investment in the country.[74]Poor institutions that enable corruption in LCDs tend to add to investment cost and profit.[75]Besides, high sunk cost of investment makes investors to be highly sensitive to uncertainty, including political uncertainty results from poor institutions.[76]

A favorable economic condition in host countries is one of the most important variables which determine the location of investment.[77]Government can significantly improve the investment climate by adoption of the macroeconomic policies to ensure proper economic planning and efficient utilization of resources. Furthermore, this aspect includes economic, political and social stability, rules regarding entry and operations, standards of treatment of foreign operations, policies on functioning and structure of markets (esp. competition and corporate governance), privatization policy, trade policy (tariffs and NTBs), tax policy, good governance and Protection of property rights (including intellectual property).[78]

The pursuits of appropriate financial and exchange rate policies are of great importance for the location of firm's decision. The current foreign exchange constraints of many developing countries may impair

---

[70] Ibid.
[71] Ibid.
[72]Paul, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector*, p. 678, Investment climate advisory services of the World Bank Group, *Investment Incentive the Good, the Bad and the Agley*
[73]Elizabeth Asiedu, 'Foreign Direct Investment in Africa: The Role of Natural Resource, Market Size, Government Policy, Institutions and Political Instability', *Journal of world economy*, vol. 29, No. 1, 2006, pp. 63-77 [Here in after, Elizabeth , *Foreign Direct Investment in Africa:The Role of Natural Resource, Market Size, Government Policy, Institutions and Political Instability*] , James P.Walsh and Jiangyan Yu, Determinants of FDI: A Sectorial and Institutional Approach, IMF Working Paper, WP/10/187, 2010, p. 6,[Here in after, James and Jiangyan, *Determinants of FDI: A Sectorial and Institutional Approach*]
[74] Paul, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector*, p. 679
[75] Agnes Benassy, et al, 'Institutional determinant of Foreign Direct Investment,' *Journal of world economy*, vol. 3, No. 3, 2007, pp. 764-782, Agnes, et al , *Determinants of FDI: A Sectorial and Institutional Approach*, p. 6
[76] Ibid.
[77] Paul, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector* , p. 680
[78]Investment climate advisory services of the World Bank group, Investment Incentive the Good, the Bad and the Agley, p .12, , *Determinants of FDI: A Sectorial and Institutional Approach*, p. 6

confidence in the long term viability of investment in their territories and the possible risks regarding future repatriation of profit.[79]Theoretically, there is an argument on some scholars that a weaker real exchange rate might be expected to increase vertical FDI since firms take advantage of relatively low price in host market to purchase facilitators and inputs, and if production is re-exported, to increase home countries profit on goods sent to third market.[80] Other elements of institutional aspects of a good investment environment that have to be considered include, appropriate determining pricing, labor policies and laws to reduced distortion and rigidity in labour market, reasonable taxation level to encourage investment and development of financial market.[81]

Fiscal incentives cannot be a substitute for fundamental prerequisite of a good stable economic and political climate and appropriate financial and exchange rates.[82]The experiences of several African countries confirm that, despite the existence of substantial incentives, limited success in attracting significant increase in foreign investment has been achieved, not only due to small market and limited natural resources, but especially due to unstable political and economic environment.[83]

2.1.3.2. Infrastructural and Economic Factors

The infrastructural aspects of investment climate that consist of physical facilitations are also other locational determinants of investment.[84] This physical component comprises the existence of basic transportation networks (roads, ports and railways), power, water supply and sewerage system; telecommunication etc.[85] The infrastructure also covers institutional developments like accounting, legal services and such like a natures.[86]

Moreover, economic factors which comprise market seeking motive, natural resource seeking motive, strategic asset seeking motive and efficiency seeking motive of investors are other influencing factors for investment location of firms.[87]

- Market seeking motive includes access to regional and global market, country specific consumer preference, market growth and market size per capital income;

---

[79]Paul, An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector, p. 680, Investment climate advisory services of the World Bank group, Investment Incentive the Good, the Bad and the Agley, p .12
[80] James and Jiangyan, *Determinants of FDI*: *A Sectorial and Institutional Approach*, p. 5
[81] Paul, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector*, p. 680
[82] Ibid.
[83] Ibid.
[84]Ibid. Ismail Cevis and Burak Camurdan, 'The Economic Determinant of Foreign Direct Investment in Developing Countries and Transition Economies,' *e-Journal of New World Science Academy*, 2009, vol.4, No.3, p. 213[Here in After, Ismail and Burak, *The Economic Determinant of Foreign Direct Investment in Developing Countries and Transition Economies*
[85]Ibid.
[86] Demirhan and Masca, Determinant of Foreign Direct Investment Flows to Developing Countries, a Cross Sectorial Analysis, Prague Economic Papers, No, 4, 2008. P 360[Here in after, Demirhan and *Masca Determinant of Foreign Direct Investment Flows to Developing Countries*, *a Cross Sectorial Analysis*
[87]Investment climate advisory services of the World Bank group(2013),Investment Incentive the Good, the Bad and the Agley: Assessing the Costs, Benefits and Options for Policy Reform, p. 13, Demirhan and Masca, *Determinant of Foreign Direct Investment Flows to Developing Countries, a Cross Sectorial Analysis*, pp. 357-361 at p 360

- Natural resource seeking motive consists access to raw material, access to natural resources and access to low skilled labour;
- Strategic asset seeking motive includes access to skilled labour and access to new competitive advantage; and
- Efficiency seeking motive rather includes the cost of inputs, intermediary products, cost of labour and membership of a regional integration agreement conducive to the establishment of regional corporate networks etc.

Furthermore, scholars have found out that there is positive significant correlation between growth and private investment particularly, FDI, although it has been subject to controversy.[88]Charkrabarti (2001) the growth hypostasis developed by Lim (1983) maintains that a rapid growing economy provides relatively better opportunity for investors to make profit than the one growing slowly or not growing at all.[89]

2.1.3.3. Legal and Business Facilitation Aspects

The third category of factors influencing the domestic investment climate is legal nature of the host state. Basically, there are two sets of legal factors: substantive rules governing investment whether domestic rules or international agreements (bilateral and multi-lateral investment treaties[90]); and procedures to be followed in the settlement of potential disputes.[91] The later may be limited to local remedies or may extend to resort to international mechanisms for conflict resolution on an ad hoc basis or through institutional conciliation or arbitration arrangements such as those available under the ICC and ICSID. [92] Here, the parties involved in ICSID are not investors in their individual capacities and host states rather contracting states.[93] Both substantive laws of host countries (investment laws, tax laws, property laws, investment incentives etc.) and procedural laws which extend to include international dispute adjudication mechanisms have an impact on the locational decisions of investments. Additionally, business facilitation works are also the other determinants of investment. The business facilitation works include:[94]

---

[88] Demirhan and Masca, *Determinant of Foreign Direct Investment Flows to Developing Countries, a Cross Sectorial Analysis*, p. 361
[89] Ibid.
[90]Oshani Perera, Investment Incentives for Sustainable Development: The Case of Lao PDR, International Institute for Sustainable Development, 2011, p.11
[91] Paul, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector, p. 684*
[92]Ibid.
[93] Margaret Moses, *Principles and Practice of International Commercial Arbitration*, Published in the United States of America by Cambridge University Press, New York, 2008, p 13 (Here in after, Moses, Principles and Practice of International Commercial Arbitration)
[94]Sung-Hoon Lim, 'How investment promotion affects attracting Foreign Direct Investment: Analytical Argument and Empirical Analyses', *International Business Review,2008*, vol. 17, p 40; Investment climate Advisory Services of the World Bank Group(2013), investment incentive the good, the bad and the agley, p. 13, Ismail and Burak, *The economical Determinants of Foreign Direct Investment (FDI) in Developing Countries and Transition Economies*, p 214

- Investment promotion activities (image-building, actions to reduce information asymmetries, etc.);
- Investment incentives which includes fiscal non-fiscal, regulatory and other, and technical services (Reduction of hassle costs related to corruption, administrative efficiency, etc.),
- Provision of social amenities (bilingual schools, quality of life, etc.); and
- Provision of after-investment services and availability of "one-stop shop" services.

In many developing countries, government regulations are one of the major factors which hinder firms from being profitable. Corrupted system and time consuming procedure to obtain business licenses in some developing countries oblige foreign investors to be abstained from selecting these countries as the exact investment location.[95]

2.2. Investment Incentives

Countries have introduced various investment incentives because private investment influences the host country economy in numerous ways by increasing domestic investment, transfer of technology and human capital formation.[96] The economic rationale for incentives in specific sectors or locations is existence of market failure, which incentives seek to correct, and such of market failure include information asymmetries, the public-good nature of investment in research and development and infant industry protection.[97]

2.2.1. Definition of Investment Incentives

There is no agreed definition of investment. Kenneth (2007) defines them narrowly as a subsidy given to affect the location of investment; the goal may be to attract new investment or to retain the existing facilities.[98] UNCTAD (2004) defines them more broadly as it includes financial incentives (such as grants and loans at concessionary rates); fiscal incentives (such as tax holidays and reduced tax rates); subsidized infrastructure or services; and concessions or exemptions from regulations and standards.[99]Generally, investment incentives can be defined as any kinds of benefit, fiscal or non- fiscal, given by host countries in order to attract private investment.

[95]l Demirhan and Masca, *Determinant of Foreign Direct Investment Flows to Developing Countries*, a Cross Sectorial Analysis, p. 361

[96] Rizwan Qaiser Danish and Amna Akram, 'Determinants of FDI in Pakistan: An Empirical Analysis', *Journal of International Business and Economics*, Vol. 2, No 2, 2014, p 62

[97] Barbour, An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector, pp.670-678

[98] Kenneth P. Thomas, Investment Incentives: Growing Use, Uncertain Benefits, Uneven Controls, International Institute for Sustainable Development, Geneva, 2007, p. vii[Here in after, Kenneth P, *Investment Incentives: Growing Use, Uncertain Benefits, Uneven Controls, International Institute for Sustainable Development*

[99] OECD, Incentives, UNCTAD Series on Issuing in International Investment , Geneva, 2004, p 4

2.2.2. Categories of Investment Incentives

Investment incentives can be categorized as fiscal (direct and indirect) and non-fiscal incentives. Direct fiscal incentives include cash payments and payments-in-kind, while indirect fiscal incentives include indirect transfer of funds from the government to the beneficiary and transfer of liabilities from the beneficiary to government (i.e., reductions in taxes, tax holidays, accelerated depreciation allowances, investment tax allowances or deductions of qualifying expenses).[100] Whereas, non-fiscal incentives include fast-track approval processes or exemptions from certain regulations, special deals on input prices from state-owned enterprises and streamlined administrative procedures.[101]

2.3. Tax Incentives

Tax incentive can be defined as fiscal incentives that reduced the tax burden of investors to attract new investment or to retain the existing ones. It has been used to describe those special provisions of the income tax system which represent government's expenditure through that system to achieve various social and economic objectives; and provides deductions, exemptions, deferrals and preferential rates.[102] UNCTAD (2000) defines them as any incentives that reduce the tax burden of enterprises in order to induce them to invest in particular projects or sectors; they are exceptions to the general tax regime.[103].

Developing and transition countries[104] provide various types of tax incentives to attract private investment (both foreign and domestic). The rationale behind the package of tax relief incentives set up by the government is to allow investors to recover their initial expenditure while their businesses take time to get off the ground before having to pay taxes.[105] It is easier for them to provide tax credit and similar fiscal incentives because they involve forgone future revenue rather than present cash outlays.[106] However, the basic question raised by the opponent is whether the economic benefits of the additional investment attracted outweigh the revenue loss from those who would have invested without the special

---

[100]. Kenneth P, *Investment Incentives: Growing Use, Uncertain Benefits, Uneven Controls*, p.5

[101] Ibid.

[102] Stanley S. Surrey, 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures', *Harvard Law Review*, 1970, Vol. 83, No. 4, Harvard Law Review Association, p. 706, United Nation Conference on Trade Development, Tax Incentive and FDI:A Global survey, A Global survey, ASIT Advisory Study, No. 16, Geneva, 2000, pp. 16-21

[103] United Nation Conference on Trade Development, *Tax Incentive and FDI:A Global survey*, p. 12

[104] Countries which transform its economy from socialist to capitalist economic ideology

[105] Food and Agriculture organization, *Trends and Impacts of Foreign Investment in Developing Country Agriculture*, Rome, 2012, p. 70

[106] Ana Teresa, et al, *Rethinking Investment Incentives Trend and Policy Options*, Colombia University Press, 2016, pp. 131-132 available at https://books.google.com.et/books?id=shqocwAAQBAJ&printssec-frontcover&source-gbs-ge-sumary-r&cad--o [Here in after, Ana , et al, *Rethinking Investment Incentives Trend and Policy Options*]

treatments.[107] This is because the link between incentives and attraction of investment and economic growth is far from proven.[108]The debate over the efficiency of tax incentives in attracting foreign investment still intact; and ignoring the criticisms, governments continue to offer various types of tax incentives.[109]

2.3.1. Pros and Cons of Tax Incentives

Tax incentives are criticized as bad in theory and in practice.[110] They are bad in theory principally because they cause distortion: investment decisions are made that would not have been made without the inducement of special tax concessions; and they are bad in practice, being both ineffective and inefficient.[111] They are ineffective in the tax considerations are only rarely a major determinant in investment decision; they are ineffective because their cost, in terms of tax revenue forgone often far exceed any benefit they may produce.[112] Other criticisms are also frequently leveled against tax incentives for investment. However, governments are not refraining from setting various tax incentives fearing such criticisms.[113] The use of tax incentives to attract private investment has also received considerable attention in the recent tax literature, largely due to the projects undertaken by OECD against harmful tax competition.[114]

Back to the point, like any policy tools tax incentives have their own advantages and disadvantages. However, it is not an easy task to easily identify the pros and cons of various tax incentives without employing some standards, and it is important to analyze their advantages and disadvantages based on some standards. Such standards are: their effectiveness in stimulating investment, impact on revenue, economic efficiency, and impact on tax administration.[115] Thus, it is important for the government to address questions like what type of tax incentive would have the greatest impact on investment location choice of multinationals firms and what kind of investment seems to be most incentive sensitive. These

[107]Rafiq Ahmad, 'Incentive Taxation for Economic and Social Development, Department of Economics', University of the Punjab , *Pakistan Economic and Social Review*, Vol. 11, No. 2 ,1973, p. 154. Electronic copy of this document is available at: http://www.jstor.org/stable/25824746 , last accessed march 10, 2017

[108]Samuel Kasahun, *The Impact of Tax incentives in Attracting Foreign Direct investment in Ethiopia*, MA thesis, A.A.U ,College of Business and Economics, p.2, available at: <etd.aau.edu.et/bitstream/123456789/7801/1/Samuel%20kassahun.pdf> last accessed on March 13, 2017

[109]David Holland and Richard J. Vann, *Income Tax Incentives for Investment*, International Monetary Fund, 1998, p 2 [Here in after, Holland and J. Vann, *Income Tax Incentives for Investment*]

[110] Eric Zolt, Tax Incentives: Protecting the Tax Base, Paper for Workshop on Tax Incentives and Base Protection New York, 23-24, April 2015, at p.3

[111] Ibid.

[112] Ibid.

[113]Easson, Alex, 'Tax incentive for forign direct investment part I: Recent trends and countertrends,' *Bulletin for International Taxation*, vol. 55, No 7, Published by International Bureau Fiscal Documentation, Amsterdam, Netherlands, 2001, pp.266-274

[114] Alex Easson, 'Tax Incentives for Foreign Direct Investment', The *Hague:Kluwer Law International*, 2004, vol 52, No 4, pp. 1285- 1526, at p 1285

[115]Dr. Bruce Bolnick et al , *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*, a Technical Report submitted to USAID, 2004, at p XIV[Here in after Dr. Bruce, et al *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*]

two important questions should be addressed by evaluating and assessing the impact of each type of tax incentives on its effectiveness in stimulating investments, on revenue, economic efficiency and its impact on tax administrations. Thus, when evaluating tax incentive on the above standards in one way or another way, the most common advantages of the reliefs inter alia are:

- Tax incentives entail less interference in marketplace than do other non-tax incentives, thus affording private sector recipients the ability to retain authority regarding the use of the incentives.[116]
- They requires less paper work than other programs;[117]
- They obviate the need to directly target individual firms in need of assistance[118]
- They may be permanent and do not require annual budget review;[119]
- They are much easier to provide than to correct deficiencies in, for example, infrastructure or skilled labour;[120]and
- Tax incentives do not require an actual expenditure of funds or cash subsidies to investors; and, they are politically easier to provide than funds.[121]

Apart from these, tax incentives have also their own peculiar disadvantages. Bringing unintended windfalls by rewarding firms for what they would have done even in the absence of incentives, resulting undesirable inequalities, raiding state treasury, frequently undermining public accountability, having various effectiveness over the business cycles are the most common disadvantages of tax incentives.[122]More importantly, tax incentives raid state treasury because they result revenue loss. The losses in tax revenue from tax incentives mainly come from three sources; first, the forgone revenue that otherwise would have been collected from the activities undertaken; second, the forgone revenue from projects that would have been undertaken even if the investor did not receive any tax incentives; and, third, lost revenue from investors and activities that improperly claim incentives (taxpayers abuse) or shift income from related taxable firms to those firms qualifying for favorable tax treatments (tax planning).[123]

---

[116].Alibert N. Link, public *Private Partnership*, Published by springer Us, 1st edition, 2006, pp.71-75[Here in After N. Link, public *Private Partnership*]
[117] Ibid.
[118] Ibid.
[119] Ibid.
[120] (OECD), *Tax Incentives for Investment – A Global Perspective:Eexperiences in MENA and non-MENA Countries*, p. 5
[121]Ibid.
[122]N.Link, *Public /PrivatePrartnership*, pp. 71-75
[123] OECD, *Tax Incentives for Investment – A Global Perspective: Experiences in MENA and non-MENA Count* , p 6

2.3.2. Policy Arguments for and against Tax Incentives

There is worldwide debate among the various scholars on the use of tax incentives to attract private investments. The debate has held between two groups; the one who support the usefulness of tax incentives for investment, and those groups who stand against them.

2.3.2.1. Policy Arguments for Tax Incentives

Proponents of tax incentives commonly argue that government uses tax incentives mainly because of three main reasons: their need for investment, the fact that capital is mobile and market failures surrounding the decisions to invest in certain sector and location, which justifies government intervention.[124] The first element requires government to negotiate with owner of capital over the condition of investment in order to increase investment, which in turn uses to create jobs and other social and economic benefits; while the seconded element creates the competitive aspects of this relationship in so far as a given investment potentially could be located in more than one jurisdiction.[125] Generally, the following arguments are the most common issues raised by proponents that insist the importance of tax incentives in the policy debate.

- The first reason that governments give for offering tax incentives is tax competition.[126] Here, there is a belief by policy makers that tax incentives are necessary to maintain their country`s competitive position with neighboring countries.[127]
- Revenue gains are the second argument that claims the importance of tax incentives. Absence of tax incentive would result revenue losses for the country since investors would go elsewhere. Hence, the indirect revenue impact can be favorable, because the new investments that materialize through the tax incentive program will create jobs and this linkage effects that generate tax revenue.[128]
- The third argument is existence of market failures. The key market failures are externalities, infant industries, information asymmetry and uncertainty, equity, political economy.[129] Thus, there is a need to have attractive tax benefit for developing countries to satisfy the interests of investors who would otherwise not consider investing because of problems, such as unreliable or

[124]Kenneth P , *Investment Incentives: Growing Use, Uncertain Benefits, Uneven Controls*, , p. 3
[124] Ibid.
[125] Ibid.
[126] Dr. Bruce, *Effectiveness and Economic Impact of Tax Incentives in the SADC Region,* at p VIX
[127] Ibid.
[128] Kenneth P, *Investment incentives: Growing Use, Uncertain Benefits, Uneven Controls,* at p 3
[129] Ibid.

high cost infrastructure, macroeconomic instability or a weak legal and judicial system, information asymmetry and so on.[130]

In addition to the above theoretical arguments, proponents of tax incentives strengthening their stand on the usefulness of tax incentives by pointed out that they have been successfully used practically in well-known countries like Malaysia, Ireland, and Mauritius.[131]

2.3.2.2. Policy Argument against Tax Incentives

Many scholars criticized the use of investment incentives. There are five main arguments against tax incentives. **Firstly**, high and growing use of tax incentives reduces tax base; and will result the government to have insufficient fund for important programs including ones that contribute the economic developments such as education and infrastructure.[132]**Secondly**, scholars argued against tax incentives from the national point of view, state or local incentives are often irrational in the sense that investment will be made somewhere in the country, and such irrationality is only compounded when the investment concern not new jobs, but simply a shift in the existing ones.[133] They will open revenue leakage through avoidance and evasion via creating opportunities for businesses and individuals to engage in "aggressive tax planning." In the words, it may invite for tax avoidance through creative resignation of existing investment as new investments. **Thirdly**, they create opportunities for corruption and other rent-seeking behavior associated with the granting of tax incentives. Here, opportunity for corruption is much greater for tax incentives regimes where officials have wide discretion in determining which investors or projects receive favorable treatment. **Fourthly**, tax incentive programs make tax administration to be cumbersome and costly mainly in two ways.[134] First, selective incentives require applying different rules to different taxpayers, and tax authorities react to the tax planning that inevitably results from their introduction by putting into place anti avoidance measures, and these born complication in the system.[135] Second, preventing and controlling the abuse of loopholes necessitates highly skilled administrative resources. **Finally**, scholars also argue against investment incentives in general and tax incentives in particular from prisoner's dilemma analysis of investment incentives. This analysis of investment incentives posits that there is conflict between the individual incentive of local government and what is collectively best for government as a whole.[136] In the market for foreign investment, a prisoner's dilemma arises among countries when one country increase in incentives is matched by increase incentives by a competitor.[137]

---

[130]David and Richard J, *Income Tax Incentives for Investment*, p. 46, Paul, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector*, p. 16
[131] Dawit and Dr. Gudelia ,*The Impact of Tax Holiday on Investment in Ethiopia: The Case of LTO*) , p 107
[132]Paul, *An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector*, p. 17
[133] Id. p 18
[134] Ibid.
[135]Ibid.
[136] Ibid.
[137] Ibid.

A point will be reached when the incentive levels stabilize and one country will be better off: unchanged relative incentives will produce the same market share as before. Indeed, both countries may be worse off because income is transferred to firms with no gain in the market share.[138]Most of the time, countries cannot know all issues what the neighboring country thinks in its mind. Due to this reason, countries may give very generous tax incentive to win its competitor; the latter may also do the same thing. In doing so, countries may lose huge amount of revenue from tax incentive compared with the benefit obtained from investment. Thereby, the two countries may be worse of since the income is transfer to the investors instead of benefiting from the investment.

2.3.3. Classification of Tax Incentives

Governments grant various tax incentives despite the fact that the dependability of countries on the type among varieties of tax incentives differs between developing countries and developed ones. These tax incentives include: tax holidays, reduced corporate income tax, reduced or zero tariff, investment tax credit, investment allowance, preferential treatment for long term capital gains, reduced tax on dividends and interests paid abroad etc.[139]The most common types of tax incentives are the followings.

2.3.2. 1. Reduced Corporate Income Tax

Countries may provide a lower corporate income tax rate as an exception to the general tax regime to attract FDI in specific sector or areas.[140] The reduced tax rate may be targeted the income of existing investors who meet specified criteria or it may be applied to attract new investment.[141]Hong Kong (China), Indonesia, Ireland, the Lao People's Democratic Republic, Cambodia and Estonia area few countries that use this type of incentive.[142]One thing that should not been forgotten here is that a lower corporate income tax granted to all sectors without any qualification does not constitute as a tax incentives. Thus, such reduced tax rate must be given on sectorial or regional base.

2.3.2.2. Investment Allowance and Investment Tax Credit

Both, investment allowances and tax credits are forms of tax incentives that are based on the value of expenditures on qualifying investments.[143] However, there is a major difference between the two types of tax incentives. Investment allowance is used to reduce taxable income of the firm based on some percentage of deprecation while investment tax credit is used to reduce the amount of tax to be paid.[144] In

---

[138] Ibid .
[139]United Nation Conference on Trade Development, *Tax Incentive and FDI: A Global Survey*, , pp. 19-22.
[140] Id. p 19
[141] Ibid.
[142] Ibid.
[143]David and Richard, *Income Tax Incentives for Investment*, p 8 , *Tax Incentive and FDI:A Global survey, A Global survey*, p 21
[144] Holland and J Richard, *Income Tax Incentives for Investment*, p. 6

investment allowances, the rate of income tax matters since they are deducted against the tax base and their value to the investing firm depends, among other things, on the value of the corporate income tax rate applicable to the tax base.[145] However, unlike investment allowance, variation on the corporate tax rate does not affect the value of investment tax credit.[146] Investment allowance can be accelerated (faster write off) or deferral depreciation (more generous write off for qualifying capital costs). With accelerated depreciation, the cost of an asset may be written off at a rate that is faster than the economic rate of depreciation[147], and it can take the form of either a shorter period of depreciation or a special deduction in the first year[148]. The latter has a similar impact to an investment allowance in the first year, but differs in that the amount written off reduces the depreciation base for future years.[149]

3.3.2.3. Tax Holidays

Tax holiday is a time limit exemption from taxation in which the main objective of it is to attract investment on a specific sector or region as this is believe to stimulate economic growth and development.[150]The net revenue from the investment project during the holiday will not be subject to taxation. Usually, they are viewed as a simple incentive with a relatively low compliance burden (e.g.no need to calculate income tax over the holiday period) and these peculiar features tend to make this form of incentive more attractive, particularly in countries that are just establishing a corporate tax system.[151]

Although many scholars argue that tax holiday is not an effective measure of attracting investment, it has been commonly used by developing and transitional countries[152]; transitional countries prefer to grant income tax holiday because they provide a simple regime for foreign investors; and there is no need to calculate taxes in the early years of operation, at a time when the tax systems are not yet fully developed.[153]

Tax holiday is not unique from other policy tools; thus, it has its own peculiar advantages and disadvantages. In addition to the benefits that shares in common with other investment incentives (e.g. employment gain and transfer of technology), tax holidays used to reduce tax liabilities, has relatively low compliance cost, and it is simple to administer.[154] However, tax holiday is also criticized as: **first,** it may result in a significant loss of revenue if it has concentrated on investment projects that would have

[145] United Nation Conference on Trade Development, *Tax Incentive and FDI:A Global survey, A Global survey*, p. 21
[146] Ibid.
[147] Ibid .
[148] Holland and J. Richard, *Income Tax Incentives for Investment*, p. 6
[149] Id. p. 8
[150] Hans George Wille, Tax Incentive in BEPS- Perspective, the Institutional Repository (open access) at Norwegian Business School, 2015, p. 2 available at. http://brage.bibsys.no/bi
[151] United Nation Conference on Trade Development, Tax Incentive and FDI:A Global survey, A Global survey, p. 21
[152] Dawit and Dr. Gudelia , *The Impact of Tax Holiday on Investment in Ethiopia: The Case of LTO Branch*, pp. 106-107
[153] Holland and J. Richard, *Income Tax Incentives for Investment*, p 4
[154] OECD, *Tax incentives for Investment Global perspective*, p 4

occurred even in the absence of the incentives;[155]**Second**, it benefits primarily short-term investments, typical of footloose industries) in which companies can move quickly from one jurisdiction; **third**, it creates competitive distortions between old and new firms(they also tend to reward the founding of a company rather than invest in existing companies); **fourth** , it can lead to erosion of the tax base as taxpayers learn how to evade taxation of income from other sources**;** and **lastly**, it creates opportunities for corruption and other rent-seeking behavior associated with the granting of the relief, and this will be greater if officials have wide discretion in determining the extent of exemption and the areas eligible for favorable treatment.[156]

In formulating tax holiday policies and laws, countries should be careful on identifying the sources of the disadvantages of the relief and should take an attention to totally clog all possibilities causing the relief to be disadvantageous; or if is not possible, at least to minimize them.

2.3.2.4. Zero or Reduced Tariff

Tariff protection has been a common form of investment incentives in many countries, although its use has decreased over the decades as developing countries tend to lower their tariff following agreements under WTO and under various regional trade agreements. Governments can grant two types of tariff incentives.[157] On one hand, the tariff incentive may aimed at reducing or eliminating tariff on import capital equipment's and spare parts for qualifying investment project, and this enables to reduce the cost of investment.[158] On the other hand, they can increase tariff on the financial product of the investor so as to protect the domestic market from import competition.[159]However, now a days, the use of tariff protection as one form of investment incentives has decreased due to WTO agreements and various regional agreements, and many developing countries have come to the conclusion that investment stimulated through tariff protection often leads to an inefficient, high-cost, distorted industrial structure.[160]

All the above tax incentives have their own peculiar benefits and drawbacks. Hence, governments should take in to account the following four best practices on the use and design of tax incentives when they introducing them.[161]To start with, governments should assess in advance tax incentives targeted to boost investment.[162] Secondly, if introduced, the tax incentives should be evaluated (using cost-benefit tests) on a periodic basis to gauge their effectiveness.[163] Thirdly, the specific goals of a given tax incentive need to

[155] Fletcher, *Tax Incentive in Cambodia, Lao PDR, and Vietnam*, p 5
[156] OECD(2007), *Tax incentives for Investment Global Perspective*, p 4
[157]United Nation Conference on Trade Development, Tax Incentive and FDI:A Global survey, A Global survey, p 22
[158]Ibid.
[159]Ibid.
[160] Ibid.
[161]OECD, Tax Incentives for Investment – *A Global Perspective: experiences in MENA and non-MENA countries*, p 8
[162] Ibid.
[163] Ibid.

be explicit at the outset to enable them to be properly evaluated and assessed.[164] And lastly, a "Sunset clauses" calling for the expiry of the incentive should be stated to provide opportunity to assess whether the availability of the incentive should be extended or not.[165]

[164] Ibid .
[165] Ibid.

CHAPTER THREE

THE DESIGN AND INMPLMENTATION OF TAX HOLIDAY POLICY AND LAWS IN ETHIOPIA: CRITICAL ISSUES AND PROBLEMS

3. 1. Overview of Tax Incentives in Ethiopia

Attracting investment by using income tax holiday is not new phenomena in Ethiopia. It was started during the imperial period and has continued in more compressive way by the current government. The following part of the paper discusses the historical development of the tax holiday relief that took place in the four regimes.

3.1.1. Historical Background

Taxation has long history in Ethiopia, though modern taxation began after cessation of Italian occupation in 1941.[166]Thus, tax incentives are also part of tax laws. Tax incentive may serve as an indispensible tool to encourage investment and to bring economic development via the issuance and implementation of compressive and consistent positive policies.

3.1.1.1. Tax Incentives during the Imperial Period (1941-1974)

The imperial government had followed a free market economic ideology. It had taken several measures to create a conductive environment for private investment.[167] The 1950 and the 1963 policy statement of private investment, and proc. No. 242/1966, that provide for the encouragement of capital investment , were among the measures taken by the government that show the country's commitment towards investment.[168] Despite the fact that tax incentive was introduced in 1949 income tax law for the first time in the Ethiopian tax legislation history[169], it was in 1950, for the first time, that the government formalized and officially announced its investment policy.[170] The preamble of the investment policy reads as follows:-

> *The imperial has decide upon a general working policy for encouragement of foreign capital investment in Ethiopian on enterprises deemed to be beneficial to the country for the achievement of this policy, the government is prepared to grant special facilities to new enterprise stated in Ethiopia with foreign capital*.[171]

---

[166]Tddese, *Towards Legislative History of Modern Taxation in Ethiopia(1941- 2008)*, p 117
[167] Ibid
[168] Ibid.
[169] Id. pp. 117-118
[170]Assefa, *Problems of Incentive Regime of Foreign Private Investment in Ethiopia: the Law and Practice*, p 27
[171] Id. p. 28

Here, the policy statements with special facilities given to new enterprise emphasized to encourage only those enterprises which were deemed to be beneficial to the country although what is beneficial is not clearly defined in the investment policy; and this needs to interpretation. The other peculiar feature of this policy was its commitment to provide incentive schemes only for foreign investors. However, by the 1963 decree, the imperial government committed to encourage private investment (both domestic and foreign) the aim of which was to bring accelerated growth and development of economy of the empire of Ethiopia.[172]

Back to the 1949 income tax law, this legislation granted five years tax holiday period to encourage investment particularly in industrial, transport and mining sector.[173]A legal Notice No. 10/1950 under the title "Statement of Policy for the Encouragement of Foreign Capital Investment" was issued afterwards; and extends income tax exemptions to five years for newly established firms.[174] After four years of the issuance of Statement of policy for the encouragement of foreign capital investment, a separate law was also issued to agriculture and industrial expansion. This law exempted agricultural or industrial machines and parts not only from income tax but also from all kinds of taxes that were in existence at the time.[175] Besides, the 1966 proclamation provided various benefits, privilege and exemptions so as to encourage foreign and domestic investment. These were income tax exemptions, import/ export duty relief, remittance of foreign exchange, and acquisition of immovable for foreign investors.[176]The tax incentive part of this proclamation granted five years and three years income tax holiday for newly established firms with a capital of not less than ETB 200,000, and enterprise which had expanded their existing business respectively.[177]Except, industries engaged in manufacture of alcoholic beverages and liquors, all enterprises were beneficiaries of this income tax holiday privilege.[178]What is special to this law was that it did not provide investment areas reserved for the government.[179] Thus, investors could engage on any areas of activities in the economy without any restriction.[180] Even though the private sector was in good condition, the share of domestic investors was very small due to lack of entrepreneurships.[181]From the above various legislations it is clear that the imperial regime had strong ambition for the promotion of both foreign and domestic investment in the country.

---

[172] Ibid.
[173] Tddese, *Towards Legislative History of Modern Taxation in Ethiopia(1941- 2008),* pp. 149-154
[174]Ibid.
[175]Ibid, Taxes that were in existence at the time are customs duties and taxes, health and education taxes, personal or business taxes, and municipal taxes
[176]Assefa, *Problems of incentive regime of Foreign Private Investment in Ethiopia: the law and practice* p 28,Taddese, *Towards Legislative History of Modern Taxation in Ethiopia*, p. 150
[177]Ibid
[178] Ibid
[179]Tesfaye Abate, History of Investment in Ethiopia, available at http://www.abssinialaw.com/study-on-line/item/487-history-of-investment-law(online) , , last accessed on April 10,2017, paragraph 23[Here in after Tesfaye, *History of Investment law*]
[180] Ibid paragraph, 14
[181] Ibid

3.1.1.2. During the Derg Period

During that period the government nationalized the economy, and the 1974 revolution got rid of the issue of private investment and private ownership. The government imposed heavy tax burden up to 89% under 1978 income tax law.[182] But later on, there was a little relaxation towards private investment.[183]The 1983 joint venture proclamation which encourages the participation of both domestic and foreign investors on the joint investment in cooperation with the Ethiopian government, contains tax incentives like exemption from customs duties on import of investment goods and spare part; income tax holidays for five years in case of new projects; for three years in case of extension of existing projects; possible exemptions from customs duties for imports of raw materials; and from customs and transactions taxes for goods exported.[184] The intention of government was to introduce capital know how, and transfer of technology into the country. However, the law was taken as disfavors for private investors since their share was very minimal in the economy (49-1%) while that of the share of the government could grow from 51-99%.[185] The regime also improved the participation of private investment by issuing the petroleum operation law in 1986 containing tax incentives, and investment incentive law in 1990.[186]One of the objective of those investment legislations were saving or generation of foreign exchange via import -substitution production or export-promotion strategies[187]. Therefore, like the imperial period, there was an attempt to use taxation as a means to encourage private investment particularly, at the ends of its era, through joint venture investment with the government and, promote export though it was in very limited extent.

3.1.1.3. During Transitional Period

The Transitional Period had experienced an ideological change from socialist to free market economy. The Transitional government had enacted economic and investment policies directly opposite to that of the Derg regime. These policies further specified the major economic hindrance of previous periods was the restrictive policies on the activities of private sector, and so it believed that a change is needed.[188] Hence, it had created enabling conditions for the participation of domestic and foreign investors in the economy without any capital limitation and removes existing bureaucratic procedures, and had introduced laws and regulations which enable domestic and foreign private capital participation.[189] In 1992, Ethiopia embarked up on liberal economy which is deemed to be favorable for private investment.

---

182 Id. p 151

183 Ibid.

184 Taddese, *Towards Legislative History of Modern Taxation in Ethiopia*, at p 151, and TsegayeTeklu, Investment Promotion and Incentive In Ethiopia, p 359 available at https://www.eeaecon.org/sites/default/files/publication/Tesgaye%20Teklu-Investment%20Promotion%20and%20Incentives%20in%20Ethiopia.pdf last accessed on April 18, 2017[Here in after, Tsegaye, *Investment Promotion and Incentive in Ethiopia*]

185 Tesfaye, *History of Investment in Ethiopia* , paragraph, 19

186 Taddese, *Towards Legislative History of Modern Taxation in Ethiopia*, p 152

187 Tsegaye, *Investment promotion and Incentive in Ethiopia*, p 359,

188 Assefa, *Problems of incentive regime of Foreign Private Investment in Ethiopia: the law and practice*, p 30

189 Ibid

To implement this policy, the investment proclamation No 15/1992 that contains exemption from import duties for import up to the 15% of the capital invested of capital goods and spare parts; income tax holidays for three years for commencement and 2 years for expansion; exemption from export duties and such other tax incentives, was issued to encourage and expand investment.[190] But, the proclamation imposed higher capital requirement for foreign investors, but later on, proclamation No 37/1996 was enacted to rectify this higher burden on them.[191] Besides, in Proc No 37/1996 and regulation No 7/1996, investment incentives were extended to additional sectors such as education, hotels, tourism and health. The laws further, extended the period of incentives from 3 to 5 years.[192] There was also a law issued in 1993 that abolishes all kinds of taxes and duties on exported goods with the exception of coffee, [193]and could be considered as the first law in the country's history which abolishes all kinds of taxes on exported items.

In general, neglecting their drawbacks and constraints, the laws that were enacted during the transitional period seem more attractive for the growth of private investment compared to its predecessors.

3.1.1.4. Tax Incentives under the FDRE Regime

The FDRE regime has also continued on encouraging private investment. Its commitment towards the expansion of private investment has begun with the constitutional rights that the government granted private property rights to every Ethiopian citizen.[194]

The current regime has also continued to take various measures to attract private investments. Among the measures, tax incentives stand at the first place. Besides the investment laws, Ethiopia's openness to foreign investment is largely driven by the implementation of its five-year Growth and Transformation Plan (GTP), which was approved by the Ethiopian Parliament in November 2010.[195] More importantly, the investment proclamation/2012 identifies encouragement of foreign exchange earnings by encouraging expansion in volume and variety of the country's export products and service; and the improvement of their quality as well as to save foreign exchange through production of import substituting products as the main objectives of the investment policy of Ethiopia.[196] To achieve these objectives, the investment proclamation recognizes investment incentives to those areas specifically identified by the Council of Minister as eligible areas for such incentives; and the type and extent of entitlement will be also determined by regulations enacted by the minister.[197]Using this delegated power, the Council of Minister

---

[190]Taddese, *Towards Legislative History of Modern Taxation in Ethiopia*, at p 152, Tesfaye, *History of Investment*, paragraph 21

[191] Tesfaye, *History of Investment law* par, 21

[192] Id. paragraph, 30

[193] Id. p 153

[194] The Constitution of the Federal Democratic Republic of Ethiopia ,1995, Federal Negarit Gazzetta, pro.No.1 , 1st Year , No. 1, Article 40(1)[Here in after The Constitution of the Federal Democratic Republic of Ethiopia (1995)]

[195] Doing Business in Ethiopia: 2013 Country Commercial Guide for U.S. Companies, chapter 6, paragraph, 1

[196]Investment Proclamation of Ethiopia, Proc .No 769, Article 4(4)

[197] Ibid. Article 9(1) & (2)

enacted a regulation which identifies the eligible areas for investment incentives and the extent of the relief given to each activity.

.

3.1.2. Tax Incentive Varieties in Ethiopia

The country recognized two types of tax incentives under investment laws namely income tax exemption and exemption from the payment of customs duties.

3.1.2.1. Income Tax Holiday

Like many developing countries, the government of Ethiopia also heavily depends on using of income tax exemption to win the will of investors, and to make the country to be a preferable investment location. Manufacturing, agribusiness, generation, transmission and supply of electrical energy; and ICT are identified as the eligible areas for income tax holiday privilege although the length of time depending on the specific activities and the location of investment.[198] Hence, investors engaged on the above areas shall be entitled to income tax exemption as specified under the regulation No 270 /2012 attached to the schedule. Generally, the investors that could be beneficiaries of this privilege are:-

- Investors who establish a new enterprise to engaged on Manufacturing, agribusiness, generation, transmission and supply of electrical energy; and ICT activities. These firms are entitled income tax exemption from one year to nine years depending on the location of investment and types of activities.[199] However, the exemption period my reach up to fifteen years if they are industrial developers, and if it is outside Addis Ababa.[200]In addition to exemptions under the schedule, investor who establishes a new enterprise in Gambella; Benshangul/ Gumuz; Afar (except in areas within 15 kilo meters right and left of the Awash River); Somali; Guji and Borena Zones (in Oromia); or South Omo Zone, Segen (Derashe, Amaro, Konso and Burji) Area Peoples Zone, Bench-Maji Zone, Sheka Zone, Daw-ro Zone, Keffa Zone, Konta and Basketo Special Woredas (in Southern Nations, Nationalities and Peoples Region) shall be also entitled to an income tax deduction of 30% for three consecutive years after the expiry of the income tax exemption period.[201]
- Investors who expand or upgrade their existing enterprise:- investors who expand or upgrade their existing enterprise at least by 50% and 100% its production and service capacity; and introduce a

[198]EIC investment Guide 2014, Incentives, pp. 1-34, available at http://www.investEthiopia.gov.et/images/pdf/incentives.pdf. Investment commission of Ethiopia , Investment Incentive Gide line of Ethiopia ,2014,pp.1-34, last accessed on April 27, 2017

[199] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation 2012, , investment areas and income tax exemption schedule part

[200]EIC, *why in Ethiopia? Opportunities and investment process about us*, ,p 2

[201]EIC Investment Guide 2015, Ethiopia: A Preferred Location for Foreign Direct Investment in Africa, p 31,

new production of service line respectively are entitled to income tax exemptions attached on the schedule.[202]

- Investors who export at least 60 percent of their products or services, or supply the same to an exporter as production of service input will be the other categories of persons who are entitled to be free from payment of income tax for additional two years.

Here, investment laws are not the only laws which promote export; various legislations of the country also stand to promote export. Start with VAT proclamation, the export of goods and services to the extent provided in the regulation are taxed at zero rated.[203] The VAT regulation contains detailed issues on export goods and services taxed at zero rate. Under this regulations ,exports taxed at zero rated include: supply of goods where the supplier has entered the goods for export, pursuant to the Customs Proclamation, and the goods have been exported from Ethiopia by the supplier; a supply of goods where the Authority is satisfied that the goods have been exported from Ethiopia by the supplier; and a supply of goods where the goods are not situated in Ethiopia at the time of supply and are not to be entered into Ethiopia for home consumption pursuant to the Customs Proclamation by the supplier of the goods.[204]

The other area of tax law which gives the entitlement of not to pay tax to those exporters is the income tax legislation of Ethiopia. In the income tax proclamation, an amount that is specifically exempted from income tax under the law enforce in Ethiopia, are also exempted from the payment of tax under the income tax.[205] Here, "laws in force in Ethiopia" stand for Customs Proclamation, Investment Proclamations or may include other laws which exempted some incomes from payment of tax for different economic and social reasons.

Furthermore, Ethiopia recognizes three kinds of duty incentive schemes, namely duty drawback scheme, voucher scheme and bonded warehouse schemes to make effective the incentives granted to exporters.[206]Duty drawback is a scheme by which duty paid on raw materials used in the production of commodities is refunded upon exportation of the commodity processed.[207]Whereas, voucher is a printed document having monetary value, which is used in lieu of duties and taxes payable on imported raw materials; and the beneficiaries of the voucher scheme are also exporters. [208] The beneficiaries of the former are producer exporter wholly, partially or

---

[202]Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation,2012, Article 7

[203]Value Added Proclamation, 2002, Federal Negarite Gazzetta, pro.no 285, 8th year, no.33, Article 7(2)(a))[,here in after VAT proclamation 2002]

[204]Ibid, Article 35(2)

[205]Income Tax Proclamation, 2016, Federal Negarit GazzettaExra-Odinary issue, proc. No. 976, 22nd year , No. 104, article 65(1(o)),[Here in after Income Tax Proclamation 2016]

[206]The Revised Export Duty Incentives Scheme Establishing Proclamation, 2007, Federal NegarIt Gazzetta, proc.No.54, 13th year, No. 57, Article 4[here in after revised Duty Incentives Schemes Establishing Proclamation]

[207] Ibid, article 2(1)

[208] EIC investment Guide 2014, Incentives, pp. 1-34, available at http://www.investEthiopia.gov.et/images/pdf/incentives.pdf. Investment commission of Ethiopia , Investment Incentive Gide line of Ethiopia ,2014,pp.1-34

occasionally engaged in exporting their products; indirect producer exporters wholly, partially or occasionally supplying their products to producer exporters or exporters in the form of raw material or finished goods: indirect producer exporters supplying imported raw material to producer exporters without processing it; exporters; and re-exporting commodities, or raw materials, they have imported upon payment of duties, for being not in conformity with purchase specifications, damaged, short delivered or not in market demand.[209] The last type of export incentive scheme is bonded warehouse scheme. Producers wholly engaged in exporting their products , who are not eligible to use the Voucher Scheme and who have license that enables them to operate such warehouse are the beneficiaries of this scheme.[210]

3.1.2.2. Customs Duty Exemption

Like that of income tax holiday, the beneficiaries of customs duty exemptions are investors engaged in eligible new enterprises or expansion projects such as manufacturing, agriculture, agro-industries, generation, transmission and supply of electrical energy, Information and Communication Technology Development (ICT) tourism and construction contracting.[211] Investors who engage on the above sectors and export activities can enjoy:

- 100% exemption from the payment of customs duties and other taxes levied on imports is granted to all capital goods, such as plant, machinery and equipment and construction materials;
- Spare parts worth up to 15% of the total value of the imported investment capital goods. In addition, an investor granted with a customs duty exemption will be allowed to import capital goods duty free indefinitely if his/her investment is in manufacturing and agriculture, but for five years if his investment is in other eligible areas;
- 100% export tax exemption with the exception of few products (semi-processed hides and skins taxed at the rate of 150%).[212] Furthermore, customs law of the country is also the other area which grants tax incentives for exporters in addition to investment laws. Its preamble part states that, export promotion and supporting foreign trade are objectives the customs proclamation No 859/ 2014. The ambition to have expedited and modern legal framework which encourage the development of manufacturing industries and investment capability with the level of international trade practice is also identified as a one factor which leads the country to enact the customs proclamation.[213] In the substantive part of customs proclamation, it provides duty/ tax exemption with respect to import or export may be granted by law, international agreements to which Ethiopia is a party or by directives to be issued by the Minister of Finance and Economic

[209] Revised Duty Incentives Schemes Establishing Proclamation, Article 5
[210] Ibid. Article 15
[211] Investment Commission of Ethiopia , Investment Incentive Gide line of Ethiopia ,2014, at p. 30
[212] Ibid. p 5
[213] Customs Proclamation, 2014, Federal NegaritGazzetaa, Proc. No.859, 20th year , No. 82, preamble part [Here in after customs proclamation 2014

Development,[214]and exports are exempted from customs duty and other taxes. However, not all kinds of exports are eligible to be exempted from payment of tax and/or customs duties. The law excludes few products to be eligible for exemption like semi-processed hides and skins which is taxed at the rate of 150%. The aim of such exclusion is to discourage the export of unfinished product since such products have direct out come on the depth of foreign exchange earnings of the country.

Unlike many other countries,[215] Ethiopia only provides two types of tax incentives namely income tax holiday and zero-rated tariff. Other tax incentives, like investment allowance, investment tax credit, preferential treatment for long term capital gains, reduced tax on dividends and interests paid abroad, reduced corporate income tax so on are the neglected tax incentive categories in Ethiopia. Although, there is a visible improvement on the tax incentive regime of Ethiopia compared with the previous two regimes, still the tax incentive variety provided in Ethiopia is found at its infant stage, and these results to be loser in the tax competition held among different neighboring African countries.

3.2. The policy Framework of Tax Holiday relief of Ethiopia

Ethiopia does not have a single, compressive, and well-defined investment policy. The investment policy of Ethiopia is found in different documents such as in GTP I, GTP II and in investment legislations. Besides its non-comprehensiveness, the Ethiopian investment policy has been modified for more than four times within the last 20 years. Start with the main basis of GTP I, the basis for its formulation are the country's vision for the achievement of PASDEP, and the lesson drawn from its implementation.[216] For the realization of its vision, the country had identified seven strategic pillars in the GTP I. Among the seven strategic pillars, the first three pillars (sustaining rapid and equitable economic growth maintain agriculture as a major source of economic growth, and creating condition for the industry to play a key role in the economy)[217], have highly required the involvement of private investment. The GTP envisages the private sector to play a decisive role in the development of medium and large-scale manufacturing industry.[218]Accordingly, during the GTP period, the government has undertaken various measures to further improve the enabling environment for the private sector. Among other things, these measures include revision of the investment legislations and restructuring of the Investment Agency to establish a one- stop-shop service for the private investment. In the GTP, it has identified that medium and large scale enterprises play a crucial role in creating competitive economy via rapid and continuous

[214]Customs Proclamation 2014, Article 129
[215]OECD, *Tax Incentives for Investment– A Global Perspective: experiences in MENA and non-MENA countries, perspective*, p 7, Egypt for instance provides reduced corporate income tax, exemption from indirect taxes and accelerated depreciation in addition to income tax holidays; Algeria, on the other hand recognized accelerated depreciation and indirect taxes.
[216] Ethiopia Investment Agency, Invest in Mekelie Ethiopian investment policy, 2013, pp. 2-14, at p 3
[217]The Federal Democratic Republic of Ethiopia, The Second Gross and Transformation Plan 2015/2016- 2019/2020(draft), National Planning Commission, 2015, Addis Ababa, p 3
[218] Id. p 9

technological transfer and accumulation, generating hard currency, and supporting the development of small scale enterprise and economic growth as well.[219] Due to this reason, the manufacturing sector is among the most decisive area which has obtained the government's special attention. Accordingly, the government has provided various incentives including; customs duty exemption and income tax exemptions to enhance the participations of private investors in this sector.

Investment legislation is also the other area in which the investment policy of the country were found. As clearly articulated in the preamble part of the investment proclamation (2012), the objectives of the investment policy and laws are to encourage and expand private investment especially, in manufacturing sector, by strengthening the domestic production capacity, and intern to accelerate the economic development of the country and improve the living standards of the its people.[220] The role of investment to further increase the flow of capital and to speed up the transfer of technology in to the country is also taken as one objective in the investment policy of Ethiopia.[221]

Like the investment policy, Ethiopia does not have comprehensive and separated incentive policy in general and tax holiday policy in particular. However, it does not mean that the country's tax holiday regime exists in vacuum without any policy basis. It is possible to put the incentive policy of Ethiopia, particularly, the tax holiday policy, by deducting from the general investment policy of the country. Generally the tax holiday policy of the country has aimed at encouraging and promoting the involvement of private actors in the country's economic development through the instrumentality of income tax exemptions.

3.2.1. Objectives of the Income Tax Holiday Policy/Laws of Ethiopia

As already stated, the investment legislations of Ethiopia did not provide the objectives of income tax holiday policy/laws of the country in a clear, separate and well-defined manner. However, by deducting from the whole objectives of investment, the main objectives of the tax holiday regime of Ethiopia are:

- To accelerate economic development by providing tax exemptions for newly established enterprise engaged in income tax exemption eligible areas,[222] for firms which exports at least 60% of its product,[223] to those firms which expand or upgrade the existing enterprise;[224]
- To encourage balanced economic development and integrated economic activities among the regions; and for its realization the government provided longer income tax exemption period to

[219] Ibid.
[220] Investment Proclamation, ,proc. No. 769 (preamble part)
[221] Ibid
[222] Ibid, Article 5, Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, No.270, Article 5
[223] Investment Proclamation, proc. No. 769, Article 5, Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, No.270, Article 57
[224] Investment proclamation, proc. No. 769, Article 5, Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, No.270, Article 6

those firms that engaged on eligible activities and invested in regions outside Addis Ababa. Besides, the investment regulation also granted additional income tax deduction of 30% to firms engaged in investment activities on least developed regions (remote areas of the country the country) for three consecutive years after the expiry of income tax exemption periods to narrow uneven developments among the regions.[225]

- To encourage foreign exchange earnings by encouraging expansion in volume, varity and quality of the country's export product and services. For the achievement of this objective, the investment law, especially the income tax exemption law part, provided two years income tax exemption in addition to the exemptions attached in the schedule if the investor exports or supplies to the exporters at least 60% of his/her product or service input.[226]
- To create employment opportunities for the country's citizens and to advance the transfer of technology required for the development of the country.[227]

However, one thing that should not be forgotten here is that the above objectives are not entirely the objectives of income tax holiday policy/ laws of Ethiopia; rather they also indirectly link with the other incentive policies and laws of the country. In other words, the objectives of investment, investment policy, and investment law are also the objectives of tax holiday policy/law since the exemption regime directly or indirectly contribute for the achievement of the investment objectives.

3.3. Issues in Policy Framework of Tax Holiday Privilege in Ethiopia

Many countries across the world provide tax incentives so as to bring employment gains, technology transfer, encourage foreign exchange earnings, encourage infant industries etc.[228] It is also true for Ethiopia, the aim of providing investment incentives is to accelerate economic development, bring hard currency, employment gain, balanced economic development among the regions, technology transfer and engorge the participation of private actors in the economic development of the country.[229]

[225] Investment Proclamation, proc. No. 769, article 5(5 Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, No.270, article 5(2(a-f), Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, (Amended), 2014, Federal NegaritGazzetta, reg. No.312, 20th year, No. 62, Article 2(2); Regulation No. 270 under Article 5 provides an investor who invests to establish a new enterprise in a state of Gambela, Benshangul/ Gumuz, Afar(except 15 km right and left of Awash River, Somali, Guji and Borna Zones of state of Oromia, South Omo Zone, Segen(Derashe, Amaro, Konso and Burji, Bench-maji zone, Sheka zone, Dawaro Zone, Kaffa Zone or Konta and Basketo special woredas of the state of South Nation, nationalities and peopels are entiltled to an income tax deduction of 30% for three consecutive years after the expiry of the income tax exemption periods. The regulation also provides longer exemption period where firms invest in other areas outside of Addis Ababa. The Amended Regulation also grants 15 years income tax exemption if the firms invest on industrial park areas found outside Addis Ababa.

[226] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, No.270, Article 7

[227] Investment proclamation, proc. No. 769, Article 5(8)

[228] Danish and Akram , *Determinants of FDI in Pakistan: An Empirical Analysis*. p 62

[229] Investment Proclamation, proc. No. 769, Article 5 and its preamble part

3.3.1. Infant Industry Issue

Many governments do employ direct and selective policy measures to promote infant industries, though the effectiveness of the policies appears frequently not to be "first best"[230]. These measures inter alia, include preferred access to credit on preferred terms, sharing the cost of labor training, and research and development.[231]Proponents of infant industry promotion argue that incentive for infant industries can boost the market size of the domestic firms.[232] This is because a firm's productivity depends on its own output and that of all of its competition; for example, a larger industry might deepen the market, and lower the price for specialized labor and inputs.[233] Thereby, developing countries grant incentives to those infant industries the aim of which is to narrow the gaps of the big and infant industries and to make the competition field level.[234]

However, the central questions concerning infant industry promotion through the use of incentive remain unanswered.[235]These questions are; "what are the benefits, what are the costs and do the costs of the measures that could be used to promote the development of infant industries exceed the benefit obtained from the promoted infant industry?" Obviously, promotion of infant industries is warranted only if its benefit exceeds from its cost.[236]Here, the costs of infant industry promotion are thus the cost of acquiring technological mastery.[237] And, the question whether infant industries ought to be given proportional incentive depends on whether there would otherwise be adequate incentives for the acquisition of increased technological mastery, which intern depends on whether individual producers cost and benefits in a manner consistence with social objectives.[238] Firms have been found to undertake substantial technological effort in order to achieve a wide verity of technological changes (stretching capacity through various adaptations, breaking bottlenecks in particular processes, improving the use of by-products, extending the life of equipment, making accommodations to changes in raw material sources, and altering the product mix).[239] Nevertheless, a sequence of minor technological change can have a pronounced cumulative effect on productivity as shown by the experience of Brazilian steel plant.[240]

---

230 Larry E. Westphal, *Fostering Technological Mastery by Means of Selective Infant-Industry Protection*, World Bank Reprint Series: Number 253, New York: Academic Press, 1982, pp. 255-279 at p 263[Here in after, Larry E, *Fostering Technological Mastery by Means of Selective Infant-Industry Protection*]

231 Ibid.

232 Matthew J. Slaughte, Infant-Industry Protection and Trade Liberalization in Developing Countries, a Research Report submitted to USAID, Washington, 2004, pp. 1-39, at p 3[Here in after, Matthew J , *Infant-Industry Protection and Trade Liberalization in Developing Countries*]

233 Ibid.

234 Ibid.

235Larry E, *Fostering Technological Mastery by Means of Selective Infant-Industry Protection*, at p 256

236 Ibid.

237 Ibid.

238 Ibid.

239 Id. p 258

240 Id. p 259, the Brazilian steel producer increased by gradually built up its technological mastery through a carefully managed process of selectively importing technical assistance where needed to supplement its own engineering efforts.;

Generally, infant industries can obtain technological mastery in to three ways:[241]

1. **Technological mastery can be brought through their own internal experience of firm**s:[242] A number of firms in developing countries have been found to be engaged in a purposive technological effort to increase productivity by accommodating an effort that typically takes place in the context of day-to-day operations outside that of formal research and development.[243] Such effort has been found to produce large increases in productivity, which brings to substantial reductions in domestic resource costs.[244] In this case, the cost of infant industry development is the cost of providing experience needed to gain technological mastery, and this will bring to reduction on the unit cost of domestic resource cost of production over time.[245] However, the effort of bringing technological mastery through day-to day operation could not be automatically forthcoming, and all infant industries must not depend equally on internal experience to gain technological mastery.[246]
2. **Succeeding generation may obtain technological mastery from preceding generation**: This is because the use of existing technological mastery by an infant industry reduces the cost of its development by raising the level of productivity starting from the technology developed by preceding generation.[247]
3. **Technological development can be obtained from foreign technologies**:[248] These kinds of technological mastery cannot be achieved through the passive reception of technology imports rather the capacity to use technology effectively results from the effort that is associated with the assimilation of technological knowledge.[249]

The aim of granting promotional incentive for infant industries is to offset the costs that firms incur to bring technological mastery.[250] But, the government should undertake cost- benefit analysis before employing any promotional incentive for the development of infant industries.[251]

The Ethiopian income tax holiday regime does not provide any preferential treatment for the promotion of infant industries. Neither the investment proclamation nor the investment regulations recognize a favorable income tax exemption for those infant industries. However, there is an argument that the issue of infant industry promotion is totally not a neglected concept under the investment laws of the country;

---

and within seven years the plant's capacity was more than doubled from its initial nominal rating through a sequence of capacity-stretching technological changes.

[241] Larry E, *Fostering Technological Mastery by Means of Selective Infant-Industry Protection*, pp. 260-262

[242] Id. p 259

[243] Id. p 260

[244] Ibid.

[245] Id. p 262

[246] Ibid.

[247] Ibid.

[248] Id. p 261

[249] Ibid.

[250] Id. p 264

[251] Ibid.

unlike foreign investors[252], the investment proclamation grants a favorable treatment for those domestic infant industries since it does not put any capital requirement for the latter.[253]This favorable treatment for domestic industries at the entry level is enough on the government side to promote the development of infant industries.[254] In fact, what make an industry to be an infant industry is very important issues. According to Larry E. Westphalia (1982), an infant industry is any newly established types of an activity for which the existing endowment of skills and human capital does not provide immediate technological mastery. [255] This definition disqualifies the above argument since it considers infant industries are those industries which are owned by domestic investors. However, the definition extends to include even foreign newly established firms for which the existing economic endowments and human capital does not provide immediate technological development. Even though this favorable treatment by making domestic industries free from any capital requirement enables the domestic investors to enter in the investment operation, it will not help them to promote technological mastery unless the government incentivizes them at their operation level. So, absence of restriction at the entry level alone will not have such significance effect on the promotion of technological mastery by infant industries unless the government introduces appropriate incentive which offsets the cost of measures taken by those industries to promote technological advancement.

Besides, special tax holiday privilege will not be important because of the fact that all industries in Ethiopia are found at infant stage.[256]Although this view seems sound, it creates a paradox with the objective of investment and the need of having the existing investment proclamation. One of the need of enacting investment proclamation and the objectives of investment is to further increase the inflow of capital and speed up the transfer of technology into the country.[257]If it is treated all industries found in Ethiopia as an infant, from where the country could bring the advancement of transfer of technology for its development, How can the country achieve the above objective in the absence of industries with better technological development; these would be the two critical questions that has been forgotten by the above person in reaching on such conclusion. In my belief, the law does not initially start with the assumption that all industries in Ethiopia are infants. If it was assuming in the other way, it would not recognize the

---

[252] Investment Proclamation No 769, Article 11(1) provides minimum capital requirement for foreign investors. Under this provision if a foreign investor wants to engage on investment activities in pursuant with the proclamation, he/she shall be required to allocate a minimum capital of USD 200,000 for a single investment project , and under article 11(2) it is enshrined that the minimum capital required of a foreign investor investing jointly with domestic investor shall be USD 150,000

[253] Interview with Tassew Negawa, Industrial park Regulation Directorate Director of Ethiopia , on *Ethiopian Income tax holiday policy on the promotion of infant industries,* May 2,2017

[254] Ibid.

[255]Id. p 256

[256].Interview with MulatuKibret, Investment Incentives Directorate Director and member of the Investment Board, *Ethiopian Income Tax HolidayPpolicy on the Promotion of Infant Industries*, May 2, 2017

[257] Investment Proclamation No 769/ 2012 on its preamble part, article 5(8) of the same proclamation

advancement of transfer of technology in to the country as one of the objectives of investment proclamations.[258]

In interviewing the employees of Investment Commission and members of the Investment Board, their concern was not whether preferable income tax exemption to infant industries is the appropriate incentive for the promotion of infant industry technological mastery. All interviewees were not questioned the appropriateness of income tax exemption for the promotion of technological advancement, rather what they share in common is the idea that all industries found in Ethiopia, whether owned by foreigners or domestic investors, are existing at infant stage.

In fact, it is expected from the government to undertake an extensive research on the cost- benefit analysis on the promotion of industrial development cost and the benefits acquired from technological changes resulted from such promotion measures before introducing any promotional incentives.[259]In Ethiopia, the task of initiating policy on this issue is vested on the hands of the investment commission.[260] The aim of this study is not identifying the cost-benefit analysis of the income tax exemption on the promotion of infant industry technological mastery; rather, exploring whether the tax holiday policies including laws of Ethiopia provide special treatment for them or not. Obviously, infant industry promotion through favorable income tax privilege continues as a neglected issue both at the policy and law level.

3.3.2. The Issue of Innovativeness of Firms

The innovative policy can reduce budget deficits by stimulating economic growth; and it needs to be effective in case of severe recession which raises the bar as firms are challenged by lack of demand for their new products.[261]The main reason for the governments to have innovative policy is because of universal agreement that technological change is an important contributor to long term economic growth.[262]

Researches suggest that tax incentives certainly have a positive impact on innovation since the exemption part of the profit can be re-invested in to the production of innovative product, or used to compensate partly or wholly for R & D expenditure.[263]Currently, tax mechanisms of R& D stimulation became more and more popular and are recognized as one of the most effective tools affecting the innovation activity in

[258] Ibid
[259] Larry E, *Fostering Technological Mastery by Means of Selective Infant-Industry Protection*, at p 264
[260] Investment proclamation 769/2012, Article 28(2)
[261] European Commission, *A study on R&D Tax Incentives Final report*, working paper, No.52, 2014, office for official publication of the European Commission, Luxembourg, pp. 5-122, at 17 [here in after European Commission, *A study on R&D Tax Incentives Final report*(2014)]
[262] Id. at p 18
[263]Olena, *Tax Incentives Effectiveness for the Innovation Activity of Industrial Enterprises in Ukraine*, p 83

OECD countries.[264]Moreover, in the modern world it is believed that innovative oriented tax policy is an important factor of attracting FDI into high-tech industries of national economies.[265]This is because tax incentives for innovation are considered to be a neutral tool of government R&D stimulation policy in comparison with direct funding, because they are market-based.[266] Besides, tax incentives are considered to be more transparent and predictable tool of government innovative policy; as well as they are focused on increasing the quantity of innovations rather than quality compared to direct funding.[267] These incentives for R& D expenditure reward firms for the social benefit from innovation that they themselves unable to bring it.[268] R &D tax incentive scheme is widely used by the most advanced economic countries including innovation leader countries like USA and Japan.[269] The vast majority of the incentive is based on corporate income tax.[270] Particularly, United States, United Kingdom, Belgium, Spain, Portugal, France, Ireland, Netherlands, Luxemburg, Malta and Hungary have adopted patent boxes to stimulate R&D.[271]A patent box is a tax incentive that provides a reduced corporate tax rate for incomes derived from patents.[272]

Back to the point, the issue of innovation policy of Ethiopia, as the country did on infant industries, promoting innovation of firms through incentives is not clearly set as one objective in the investment policy of the country. In fact, there may be possibilities that may enable to say the Ethiopian investment laws encourage innovation. These are the points enshrined under the investment proclamation preamble part and the investment objective part. Start with the preamble part it states that "whereas, it has become necessary to enhance and promote the equitable distribution of investments among regions and benefit the society by ensuring competitiveness among investments made by investors…."[273]. By raising this phrase one may argue that the Ethiopian investment policy in general and tax holiday policy in particular recognized the promotion of innovative firms since competition brings innovation and better production. However, the laissez fair economic system which assumed a perfectly competitive system where the market is guided not by the government intervention or regulation, but by invisible hands (demand and supply), is not always a workable economic system due to the existence of market failure.[274] These market failures include problems on the quality, quantity and price of products and services. Guiding the market through supply and demand without any government intervention may result in market failures on innovation particularly, on the quality and quantity of products and services. Due to this reason, it will be

[264] Id. p 72
[265] Ibid
[266] Id. p 73
[267] Id, p 79
[268] European Commission, *A study on R&D Tax Incentives Final report* (2014) ,P 6
[269] Id. p 5
[270] Ibid
[271]Id. p 45
[272] Ibid
[273] Investment Proclamation No 769/ 2012 on its preamble part
[274] Solomon Abay(Dr), 'Designing Regulatory Roles of Government in Business: The Lesson from Theories, International practice and Ethiopia's Policy path', *Journal of Ethiopian law*, vol. 23, No 2, 2009, pp. 66-131, at p 73

difficult to conclude competition alone brings innovation unless the system allows government intervention where market failure happens.

The second point which may convince to agree otherwise may be the one stated under article 5(3). Under this provision, it is incorporated as one of the objectives of investment is to develop the domestic market through the growth of production, productivity and services. Here, one may argue that such provision extends to include promotion of innovation science growth of production, productivity and service pre-supposes innovation. However, the law is silent on how this could be achieved. Is it by granting special tax exemption for those innovative firms, by granting direct subsidies, reduced corporate tax or by employing other incentives? These questions are unaddressed issues both in the entire part of investment proclamation and the investment regulations; and they have nothing to say on the above issues.

The tax exemption granted to investors who upgrades and expands its production and service capacity is the third area which seems that the tax holiday policy of Ethiopia enables to encourage innovation. The investment incentive regulation granted income tax exemption as provided in the schedule attached thereto, if a firm expands or upgrades the existing enterprise by at least 50% the attainable production or service rendering capacity of an existing enterprise or increasing in variety, by at least 100%, by introducing a new production or service rendering line of an existing enterprise or increment by both.[275] Here, it is also not clear whether such percentage increased under the law brought by using energy consumption technologies, or by using greater manpower etc. Therefore, as long as the means of upgrading or expansion are subject to interpretation, it will be unsound to conclude in full sense and in unequivocal manner that these income tax exemptions given to those firms which upgrade or expand the existing enterprise are encouraged to boost innovation and creativity.

The Ethiopian income tax holiday regime provided income tax exemptions for selected sector although the length of time of exemption varies on the bases of the sector and the location of investment.

1. **Manufacturing sector**; the investment incentive and investment areas reserved for domestic investors Council of Minister Regulation 270/2012, provides minimum 1 year income tax exemption period for some manufacturing products (e.g. manufacturing of chocolate, candy, Biscuits and other sweets) if the investment is conducted in Addis Ababa;[276] and maximum of 15 years to industrial developers If it is

[275] Investment Proclamation 769/2012, Article 2(8), [275] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation(2012), Article 6

[276] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation(2012), as attached on the schedule

undertaken outside of Addis Ababa.[277]However, all manufacturing sectors are not considered as eligible areas for income tax exemption under the regulation.[278]

2. **Agriculture sector;** the regulation granted 2-9 years income tax exemption period if the investment conducted in Addis Ababa and other regions respectively.[279]
3. **Electric generation and transmission;** it is entitled 4 to years income tax exemption if the investment took place in Addis Ababa and 5 years if it is conducted in other areas.[280]
4. **Information Communication Technology sector;** it provided from 2 years- 5 years exemption period[281]

Even though, the tax holiday regime recognized different tax exemption period based on the location and the types of activities, still it failed to grant the exemptions based on some objective standards so as to promote innovation. To bring the intended result from tax exemptions and promote innovation, the government should put some defined standards; and these standards among other things may include; energy consumption by certain percentage, use of new generation technologies, quality and quantity product produced by the firm, etc.[282] However, the Ethiopian tax exemption regime is granted to the same duration of tax exemption period to the eligible sectors without taking in to consideration the fulfillment of some criteria like use of new generation technologies, energy consumption, produce best quality product etc.

The experiences of other countries show that the tax incentive offered for R&D may vary from enterprise to enterprise and from sector to sector. For instance, the system of tax incentives in Great Britain provides for increasing costs that reduce the taxable profit by 150% from R&D expenditures for small and medium business, by 125% from R&D expenditures for large companies.[283] Furthermore, tax exemption and tax rate reductions are the most popular fiscal tools in Ukraine, and the tax exemption type also varies from sector to sector. In the energy sector, the main types of tax benefits are:[284]

- exemption from profit taxation within the costs of investment projects;
- exemption from taxation of part of the profit; exemption from taxation of profit gained from activities related to energy efficiency; and
- Exemption from VAT on transactions of technical provision for alternative energy sources production.

---

[277]Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation (Amended) Regulation, 2014, Article 2(2)
[278] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, No.270 excludes manufacturing sectors like manufacturing of Lime, Gypsum, and similar coatings ,manufacturing of cement, printing industry, tanning hides and skins below finished level from income exemption eligibility.
[279] Ibid attached on the schedule
[280] Ibid
[281] Ibid
[282] Olena, *Tax Incentives Effectiveness for the Innovation Activity of Industrial Enterprises in Ukraine*, p 76
[283]Id. p 80
[284] Ibid

In the field of nuclear and space-rocket engineering the exemption from VAT is used for R&D into engineering.[285] Whereas, the Aviation and shipbuilding industries are entitled to tax exemption on profit obtained from their main production and R&D as well as exemption from VAT on R&D and research into engineering.[286] In the area of software production sector, the main benefits are the profit tax rate reduction up to 5% and exemption from VAT.[287]

Unlike the Britain experience, the Ethiopian tax holiday regime does not treat differently the R&D expenditure of small and mediums business. It also recognizes one type of tax incentive for every sector (income tax holiday) unlike the Ukraine experience which introduces income tax exemption and exemption from VAT which varies depending on the type of the sector.

Under the Ethiopian investment laws, bringing innovation is left to the wills of the firms as long as there is no a special treatment which favors the innovative firms based on some known standards. The practice also confirms the above facts. Income tax exemption in Ethiopia is granted without any pre-requisites; and what matters here is that whether the investment activity lays on income tax exemption eligible areas.[288] If the law imposes certain standards to give special privilege, investors will become unhappy to invest and stay here.[289] Accordingly, innovation could be brought by creating competitive environments and leaving the task of bringing innovation to the investing firms themselves instead of giving special privilege based on the fulfillment of some standards.[290] Both the investment laws and the response of the employees of the investment commission indicate how much the Ethiopian investment laws in general and tax holiday regime of the country become reluctant on the promotion and creation of innovative firms. Thereby, it will be difficult for the country to bring persistent economic growth as long as high tech-industries play a pivotal role on the overall economic development of a nation as long as the country's investment policy is being less sensitive for the promotion of R&D.

3.4. The Legal Frameworks of Tax Holiday Relief in Ethiopia and Their Shortcomings

Currently, different income tax holiday legislations are working together in Ethiopia. These legislations are the Investment Proclamation No 769/2012, the Investment Proclamation No 849 /2014, the Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation No 270/ 2012 and Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers (Amended) Regulation No 312/2014. This part of the paper discussed the

[285] Ibid
[286] Ibid
[287] Id. at p 81
[288] Interview with Mulatu Kibret, Investment incentives Directorate Director and members of the Investment Board, *Ethiopian Income Tax Holiday Policy on the promotion Innovation*, May 2, 2017
[289] Ibid
[290] Ibid

limitation of the above legislations on tax holiday relief of the country. These legislations provided income tax exemption to investors although the duration of exemptions vary based on areas of investment activities and sectors of investment.

3.4.1 The Investment Proclamation No 769/ 2012/ Amended Proclamation/2014

Investment incentive is recognized in the Investment Proclamation No 769/2012. This law grants delegated power for council of minster to enact regulations that specify the eligible areas for the exemption. The specification of investment incentive eligible areas by the Council of Minister should be in pursuant to the investment objectives enshrined under article 5 of the proclamation.[291] In other words, the investment incentive eligible areas must be aimed at achieving the investment objectives like accelerating the country's economic development, developing the domestic market through the growth of production, productivity and service, encouraging foreign exchange earnings by promoting expansion in volume, variety and quality of the country's export products and services, encourage balanced development and integrated economic activity among the regions, etc.[292]

In addition, the Investment Proclamation 769/2012 gives power for the EIC among other things to serve as a nucleus for matters of investment and promote, coordinate and enhance activities thereon[293], prepare and distribute pamphlets, brochures, films and other material and organize workshops and conduct trainings with a view to encourage and promote investment and build the image of the country.[294] It also grants power to the EIB to supervise and follow up the implementation of the proclamation the activities of the agency[295]; and recommend, where necessary, amendments to this Proclamation and regulations issued hereunder.[296] However, the investment proclamations have their own limitation on the income tax holiday relief.

3.4.1.1. Discretionary Base Income Tax Exemptions

The Investment (Amended) proclamation authorizes the Investment Board to grant new and additional incentives other than what is provided for under the existing regulations.[297] In fact, delegation is unavoidable due to technicalities of the subject matter, and enacting very detailed laws could be impossible to the legislatures. However, the basic question here is: Is the investment board the right organ to get such authorization? There are two views on this issue, the one which supports the delegation to the

[291] Investment Proclamation 769/2012, Article 23
[292] Ibid.
[293]Investment Proclamation 769/2012, Article 28(1), Investment (Amended) Proclamation, 2014, Article 2(2), The Amended proclamation replace the "Agency" appearing anywhere in the proclamation with "Commission"
[294] Investment Proclamation 769/2012,Article 28(4)
[295]Ibid, Article 29(1)
[296]Ibid ,Article 29(3)
[297] Investment (Amended) Proclamation (2014),Article 2(4)

Board and those stands against it. The one, who supports the appropriateness of the Board to do so, raises two issues to strengthen their argument in favor of the authorization of the Board. The first issue raised in favor of the need of the authorization is, it is very difficult to list out all investment incentive areas with regulations enacted by council of ministers, so it needs technical experts which reduce such burden of the council.[298] The second reason for the appropriateness of the Board is the fear of abuse of power will not be the issue since the chairman of the Board is the Prime Minister.[299]

Despite the above arguments, the appropriateness of the Board to grant additional incentive is still a critical issue and not supported by some others; and such objection mainly came from the composition of the Board. The members of the Boards are the Prime Minster as the chair person, a government official to be designated by the prime minster as vice chairperson, and government officials to be designated by the Prime Minster as a member.[300] The Board is not composed of different sectors which have well-known knowledge and expertise, and sectors which could enable the Board to be well functional come from private sectors, tax authorities' e.tc.[301] In addition, it is not clear by what criteria the Board grants incentives other than mentioned in the existing regulations. Indeed, absence of clearly demarcated power with certain criteria opens a room for the board to make an abuse erodes the tax base without any limit.[302] In this study, however, authorization of the Board to grant additional incentive is not the issue, rather what makes the study to be worried about is whether such authorization creates a room to abuse or not and whether the Board is the appropriate organ within its current situation. Thus, as long as there is no limitation on the extent of power of the Board by the primary legislations that delegate the former, the EIB could not be the appropriate organ to grant additional incentives other than provided in the existing legislations. This because giving such higher power which affects private investors and the revenue of the government to the Investment Board under its current situation, in the presence of the fact that the board members is not composed of different sectors and no clear criteria to grant incentives, will make the board inappropriate organ to do so.

3.4.1.2. Proportionality of Measures against Law Violators (Investors)

For the incentive regime of one country to attract the will of private investors, not only extent of exemptions but also proportionality, fairness of measures against law violators also matters. The investment proclamation only recognized two types of measures against miss users of the investment

---

[298] Interview with Mulatu Kibret, Investment Incentives Directorate Director and Member of the Investment Board, *The appropriateness of the Investment Board to grant Additional Incentives*, May 2, 2017, Interview with Tassew Negawa, Industrial park Regulation Directorate Director of Ethiopia , on, May 2,2017

[299] Ibid

[300] Ethiopian Investment Board and the Ethiopian Investment Commission Establishment Council of Ministers Regulation, 2014, Article 4(1)

[301] Interview with Endalelign Asrat , Education and Training Coordinator of the Big Taxpayers in ERCA Big Tax payers Branch, on *The Appropriateness of the Investment Board to grant Additional Incentives*, May 3, 2017, Interview with G/IgizihabharReda, Director of ERCA Big Tax Payers Branch, May 3, 2017

[302] Ibid

laws in general and tax exemptions in particular. These measures are suspension and revocation of investment permit.[303] The proclamation did not clearly list out what kind of faults will result the suspension of the investment permit. The law considers in general terms that all violation of provisions of investment proclamation, regulation and directives as a cause of suspension of investment permits.[304] Besides, the causes which could results revocation under the law did not take into consideration the degree of fault, for instance both obtaining licenses fraudulently or by submitting false information or statement; failing, without good cause, to renew the investment permit and misuse of incentives will result in revocation in the same way. When setting such measures the government did not take in to consideration the economic impact of the measures taken to against each fault. Thereby, the Investment Proclamation of Ethiopia does not take proportional measures based on lightness and graveness of the fault.

3.4 .2. Investment Regulation No 270/2012 and Amended Regulation 312/2014

By using its delegated power[305] from the investment proclamation, the Council of Minister enacted regulation No 270/2012, and the amended regulations No 312/14. These regulations aimed at identifying investment sectors reserved for domestic investors and investment sectors eligible for investment exemptions. The activities reserved for domestic investors are: banking, insurance and micro credit and saving services; packaging, forwarding and shipping agency services; broadcasting and mass media services; advertising translation and promotion works, attorney and legal consultancy services; preparation of traditional indigenous medicine, and air transport service using aircrafts with a seating capacity up to 50 passengers[306]. Moreover, the regulations identify sectors like manufacturing, agro processing, electric generating and transmission activities and ICT as income tax exemption eligible areas. However, the regulations which deal with income tax exemptions have their own problems, and their shortcomings will be discussed here below.

i) Making discrimination among the investment firms

The Investment Proclamation authorizes the establishment of industrial zones even at regional levels.[307] Currently, Ethiopia has many industrial development zones such as Bole Lemi, Addis Industrial Village, Kilinto and Hawassa industrial park.[308] In addition, starting from 2016, industrial development

---

[303] Investment Proclamation(2012), Article 19
[304] Ibid, Article 29(1)
[305] Investment Proclamation(2012), Article 23
[306] Investment Incentives and Investment Areas reserved for Domestic Investors Council of Ministers Regulation(2012, Article 3
[307] Investment proclamation(2012),Article 33
[308] EIC, *Extensive Development of Industrial Parks*, 2017, at paragraph 4, available at http://www.investethiopia.gov.et/investmnent-opportunities/strategic-sectors/industriy-zone-developments[Here in after EIC, *Extensive Development of Industrial parks*, 2017] last accessed on April 27/, 2017

corporation (IPDC) will develop additional parks in Dire Dawa, Mekelle, Kombolcha, Adama, Bahir Dar and Jimma.[309]

The Amended Regulation entities for industrial park developers to be exempted from income tax for 10 and 15 years if the development takes place in Addis Ababa and other areas respectively.[310] Manufacturers engaged on investment activates within industrial development zones are also exempted from the payment of income tax up to 8-10 years.[311] In the Amended Regulation, investors are entitled 2 years income tax exemption, in addition to the exemption attached in the schedule, if the investment is made in industrial development zones located in Addis Ababa and Special Zones of Oromia and if they exports 80% or above of the product from manufacturing industry or supplies as the production input to an investor exports his product.[312] Besides, the regulation also grants 4 years of additional exemption if the investment takes place in other regions outside Addis Ababa; and exports 80% or above of the product from manufacturing industry or supplies as the production input to an investor exports his product.[313] Those investors who are engaged in manufacturing sector inside industrial park and other investors who are engaged in the same sector, around the same area with the former, but outside the industrial zones are treated differently. There is no doubt on the advantages of establishing industrial development zones because of its benefit on creating competitive condition, interrelating manufacturing sectors based on value creation as well on attracting and expanding investment,[314]and the Ethiopian governments came up with the decision to develop industrial parks to provide the necessary services and facilities for the industries.[315] However, granting favorable treatment to those engaged on industrial development zones creates questions like why the law makes such discrimination? And is there any genuine rational for such special treatment? As already showed, incentives are intended to offset other disadvantages that investors may face, such as a lack of infrastructure, complicated and antiquated laws, and bureaucratic complexities, macroeconomic instability and weak administration.[316] Establishing industrial development zones simplifies the tasks of infrastructural developments by the government and helps to easily fulfill infrastructures for investors engaged in these areas. Therefore, if development zones help to easily fulfill infrastructural developments like water, telecommunication, roads, electricity etc., granting special tax exemption for investors engaged in the development zones will be absurd since at least one disadvantage infrastructural problems is solved. Giving favorable treatment to those who

[309] Ibid.
[310] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation (Amended) Regulation (2014). Article 2(2)
[311] EIC, *Extensive Development of Industrial Parks*, 2017, at paragraph 2
[312] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation (Amended) Regulation (2014). Article 2(3)
[313] Ibid.
[314] Investment proclamation No 769, preamble part
[315] Embassy of the Federal Democratic Republic of Ethiopia in Brussels, Industrial Park Developments in Ethiopia, first published by the quarterly magazine of the Embassy of Ethiopia in Brussels, 2016, at paragraph 4, available at http://medum.com@EthiopiaEU/industrial-parks-developments-in-ethiopia-f09eb704d741
[316]AlicjaBrodzka, *Tax Incentive in Emerging Economics*, at p 26

engaged in the development zones will create investors dissatisfaction with the system and result a competitive distortion between investors engaged in development zones and those engaged in outside the zone.[317]

ii). Open to abuse by officials

The income tax exemption sectors under the regulation are not exhaustively listed and lack clarity. Besides the law use ambiguous terms instead of listing all activities exhaustively like manufacturing of consumer electronic television, radio DVD and *similar equipment*, mining production and *similar activities*, *other products* etc. In addition, the developers who will be beneficiaries of 10 years and 15 years income tax holiday's period if it is conducted in industrial development zones found in Addis Ababa and outside Addis is not clearly identified in the amended regulation.[318] It lacks clarity whether the exemption extends to include all industries. These inexhaustible lists of the sector make more difficult the task of officials to grant and deny income tax exemptions since it is open to interpretation.[319] So, it is imperative to list income tax exemption sectors exhaustively and unequivocally and determine the extent of exemption for each sector as well.

iii). Failed to recognize deprecation allowance as a supplementary incentive

The basic question raised related to income tax holiday regime of a country is the treatment of depreciation allowance during the holiday period.[320] Should it be deducted during the holiday period or can it be deferred until after the holiday has terminated? [321] Depreciation allowance represents the depreciated value of the investment asset which is taken as a cost in the calculation of the income.[322] Allowing a deferral of the deduction allowance can result in a very generous incentive since it overestimates the cost associated with the post-holiday period and so leads to a further reduction in tax.[323] For instance, if the capital asset of a firm depreciated in accelerated way, the extent of time which allows deprecation as a cost of deduction may lapse before the end of the tax holiday period. These results the firms to pay more burdensome tax following the end of tax holiday periods. A complete deferral of the deduction, therefore, can a solution and lead to a generous incentive and an effective tax holiday that is much longer than intended.[324]

---

[317] Interview with KibikabAbera, Agent of Director of JIAR Marbile Manufacturing PLC, *Special Income Tax Exemption for Investors engaged on Industrial Development Zones*, May 4, 2014
[318] Investment Incentives and Investment Areas Reserved for Domestic Investor's Council of Ministers (Amended) Regulation (2014). Article 2(2)
[319] Interview with Tassew Negawa, Industrial Park Regulation Directorate Director of Ethiopia , *Shortcomings of the Investment Regulation on income Tax Exemptions*, May 2, 2017
[320] David and Richard, *Income Tax Incentives for Investment,* P 5
[321] Ibid
[322] Ibid
[323] Ibid
[324] Ibid

Provisions for deferral of depreciation vary considerably across countries. For instance, Morocco and Thailand require assets to be depreciated for tax purposes during the holiday, while Cote d'Ivoire and Malaysia permit the firm to fully depreciate assets after the holiday.[325] The following table summarizes some countries experience on deferral deprecation deduction.

Countries	Bangladesh	Cote d'Iuoire	Malaysia	Morocco	Thailand	Ethiopia
Deprecation deduction deferral	Unused and may be carry forward only when no profit is declared	All may be deferred indefinably	All may be delayed until the end of holiday	Unused and may be carry forward only when in loss periods	May not be deferred	Unused and may be carry forward only when in loss periods

Source: International Bureau of Fiscal Documentation (1987, 1988) with little modification by the author

The Ethiopian incentive regime did not recognize deferral deprecation allowance. The law, however, allows a carry forwards of losses incurred during income tax exemption periods for half of exemption periods after the expiry of income tax holiday periods.[326] In fact, when calculating losses, depreciation allowances are considered as a cost and deducted from the income. In determining the taxable income of the taxpayer for the tax year), the law allows a deduction for the amount by which the depreciable asset and business intangible of the tax payer decline in value during the year through use in driving business income.[327]However, such deduction would be useful for the investors if it was deducted after the expiry of tax holiday periods. In the country's current legal situation, deprecation allowance will be useful for investors if they only incur losses during the holiday periods because of recognition of loss carry forward under the law. But, if the firm gains profit during the holiday periods, depreciation allowance becomes useless, and impose higher tax following the ends of tax exemption periods. Thus, presence of deferral

[325]Jack M. Mintz, Corporate Tax Holidays and Investment, *The World Bank Economic Review*, 1990, Vol. 4, NO 1,published by International Bank for Reconstruction and Development , pp. 81 -1 02, at p 88

[326] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation(2012), Article 12(1)

[327] Income Tax Proclamation, 2016, ,Article 25(1]

deprecation allowance enables the country to attract long term investment.[328] Indeed, this higher tax at the end of tax holiday period causes the investor to leave out of the country.

3.4.3. Uncertainty of Legislation as a Problem of the Tax Holiday Regime

Uncertainty in the policy and laws of governments, and political instability are among the factors which determine the location of investment.[329] For the incentive regime to win the will of investors and build investors' confidence, it must be predictable, and must not to be subject to frequent revision. However, unlike the laws codified in 1960s, the current government makes busy itself on adopting plenty of laws and amended various legislations including income tax exemption laws. The main cause of such frequent amendment is failure of being predictable of laws to include what will be happen in the future. The current government had revised investment incentive regulations for three times within not more than 10 years. Meanwhile, the revised and the repealed legislations are Investment Incentives Council of Minster Regulations No 7/ 1996(Amended), Investment Areas Reserved for Domestic Investors Council of Minster Regulation No.35/1998, and Investment Areas Reserved for Domestic Investors Council of Minster Regulation No.84/2003. The 2012, Investment Regulation is also amended by new regulation No 312/2014. In such changes, there is a relaxation on the extent time of income tax exemption from the earlier to the later. This frequent amendment and repeal of legislation will result in discrimination between previously established firms and the new ones; creates competitive distortion between the old and the new investors, and finally lead to leave out of the country.[330]

In a nutshell, non-predictability and uncertainty of laws are among challenges in the income tax holiday regime of the country that hinders to attract and retain long term investment.

3.4.4. Possibilities under the Law for Individuals to Provide Information against the Misusers

The participation of private individuals on the implementation process of tax holiday laws simplifies the investment incentive administrative organs. However, the investment laws neither recognize any mechanisms that enable private individuals to provide verified and objective information against the misusers nor provide any reward for them. The investment law should take a lesson from tax administration law. The later provides a reward of up 20% of tax invaded to a person who provides verifiable and objective information of tax evasion through concealment, under reporting fraud or other

[328] Interview with Eyob, Finance Officer of Sky Plastic Factory, *The use of Deferral Deprecation Allowance on Effective Income Tax Holiday*, May 4, 2017
[329] David and Richard J. Vann, *Income Tax Incentives for Investment*, at p 2
[330] Interview with Keran, the Finance Officer of AVOL PLC, on *The effect of Frequent Change of Laws on Investment,* May, 3, 2017

improper means.[331] Like the tax administration proclamation, the investment law needs to incorporate such private information acquiring system for the better implementation of income tax exemption laws.

3.5. Implementation of Income Tax Holiday Laws in Ethiopia

Formulating policies and enacting laws without meaningful implementation will result the policies/laws to be merely collection of dead words. The former without the latter is a half way movement towards the end. Accordingly, to realize the effective implementation of tax holiday laws, the responsible government authorities must be duly established.

3.5.1. Authorities Involved in the Implementation Process

Different authorities involved in the implementation of investment legislation in general and income tax exemption laws in particular. These authorities inter alia include the investment board, the investment commission and the tax authorities both at the federal level, (Federal Revenue and Customs Authority, (ERCA)), and regional level. The task of each organ and how they involve on the implementation process is worth discussed below.

3.5.1.1. The Ethiopian Investment Board

The Ethiopian Investment Board is established by regulations to exercise its power and duties specified under article 29 of the investment proclamation No. 769/2012.[332] The Board has the Prime Minster as a chair person, a government official to be designated by the Prime Minister as a vice chairperson and government officials to be designated by the Prime Minister as members.[333] EIB involves in the implementation process of tax holiday legislation because it is authorized to make follow up and supervision of the implementation of the investment proclamations,[334] decide on policy issues arising in connection with the implementation of this Proclamation,[335] issue directives necessary for the implementation of this Proclamation and regulations issued hereunder,[336] decide on appeals submitted to it by investors against decisions of the Director General of the Investment Commission.[337]

Specifically, the EIB involves on the implementation of tax holiday laws because of its authorization to supervise and control the activates of the investment commission where it grants income tax exemptions illegally and inappropriately; and decide on appeals submitted to it by investors against decisions of the

[331] Tax Administration Proclamation, 2016, Federal Negarit Gazzetta, proc No. 983, 22nd year, No.103, Article 134(1)
[332] Ethiopian Investment Board and the Ethiopian Investment Commission Establishment Council of Ministers Regulation(2014), Article 3
[333] Ibid, Article 4
[334] Investment Proclamation 769/2012, Article 29(1)
[335] Ibid , 29 (2)
[336] Ibid, 29(4)
[337]Ibid, 29(5)

Director General of the Investment Commission on issues related to income tax exemptions. In doing so, EIB directly or indirectly involves on the implementation of income tax holiday law.

3.5.1.2. The Ethiopian Investment Commission

The Ethiopian investment commission (EIC) is established as an autonomous federal government office having its own distinct legal personality to administer investments and investment incentives.[338]EIC works for the implementation of investment laws in general and tax holiday legislation in particular directly or indirectly since it is authorized to do the following activities like:

- Providing advisory service and technical support which help strengthen regional investment organs;[339]
- Raising the awareness of investors on the contents of this Proclamation and regulations and directives;[340]
- Carrying out post-investment support and monitoring services in collaboration with organs established for such purpose;[341]
- Ensuring that the terms of the investment permit are complied with and incentives granted to investors are used for the intended purposes;[342]
- Issuing, renewing and canceling investment permits within its jurisdiction;[343]
- Collecting, compiling, analyzing, updating and disseminating any investment related information [344]; and
- Serving as a nucleus for matters of investment and promote, coordinate and enhance activities thereon.[345]

The above powers and duties of the EIC have shown that how much the commission is involved in the implementation of tax holiday laws and how much its functions have a direct or indirect linkage on the implementation of the later. Particularly, by ensuring that the investment permit is compiled with incentives granted to investors are used for intended purpose; it discharges its role on implementation of income tax holiday legislations. Thereby, it is sound to argue that the role of the EIC in the implementation of tax holiday laws is much more than the EIB.

[338] Ethiopian Investment Board and the Ethiopian Investment Commission Establishment Council of Ministers Regulation(2014), Article 7
[339] Investment Proclamation No 769(2012) Article 28(14)
[340]Ibid, Article 28(15)
[341] Ibid, Article 28(13)
[342] Ibid, Article 28(11)
[343] Ibid ,Article 28(8)
[344]Ibid, Article 28(6)
[345] Ibid , Article 28(1)

3.5.1.3. The Tax Authorities

The tax authorities (TAs) are also the other organs which play their own part on the implementation of tax holiday laws of Ethiopia. The law imposes an obligation on investors who are entitled to income tax exemption to declare, every year, the income he obtained during the exemption period to the appropriate tax collecting authority.[346]

However, the appropriate tax collecting authority varies on the basis of types of form of doing business. For instance, if the investment is conducted in the form of Share Company and private limited company, it is the concurrent power of both the federal government regional governments and irrespective of the placement area of investment.[347] Despite this, the practice shows otherwise that the relevant tax authority which is responsible for tax declaration of investing firms established in the form of S.C and PLC declare to the ERCA branch found around the business.[348] Moreover, existence of such declaration of profit and loss statement by the investor during the exemption period helps both the investor and the tax authority to easily effectuate loss carry forward after the end of holiday period if the investor incurs loss during income tax holiday period. Indirectly, it uses to make the income tax exemption laws to be more attractive.

The task of TA is not limited on receiving the loss and profit report of tax holiday firms; rather it involves on controlling the tax avoidance practice involved on the transactions conducted between tax holiday Company and non-eligible companies; and enables the granted income tax exemption to be devoted for the intended purpose. Therefore, tax authorities has undeniable role on the proper implementation of tax holiday laws.

3.5.2. Problems of Implementation of Tax Holiday Laws

Bringing full enforcement of laws is uneasy task and the challenges mainly resulted from the problems of the law itself, the administrative organs, and other concerned executive organs. The shortcomings of the laws are already discussed in the above parts of the paper, and challenges that could be taken as hindrances for better implementation of income tax exemption laws will be discussed below.

---

[346] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation(2012), Article 11

[347] The Constitution of the Federal Democratic Republic of Ethiopia (1995), Article 98(2)

[348] Interview with EndalelignAsrat, education and traiming coordinator of ERCA Big Tax Payers Brunch, *The Role of Tax Authority on the Implementation of Tax Holiday laws,* May 3, 2017

3.5.2.1. Problems of Coordination and Follow up

Coordination and collaboration among the relevant authorities is considered as the main pillar for the attainment of full implementation of tax holiday laws. The coordination may be with the tax authority, or regional government authorities.

Begin with constitution setup of enacting investment laws, it is vested to the federal government even though the constitution failed to put it in a specific and clear manner. It states that the federal government shall enact specific laws on utilization of land and other natural resources and inter-State commerce and foreign trade.[349]This legislative power includes enacting investment laws and investment incentives since the later is part of the former. Regional states are not authorized to have their own investment laws, including investment incentives. However, it does not mean that they cannot grant any investment incentives other than provided by investment legislations of the federal government. The constitution grants power to regional states to administer land and other natural resources in accordance with Federal laws.[350]By using such constitutional power, regional states provide investment incentives related to the use of land. The Amhara regional state, for instance, provides incentives like provision of land on direct allotment and low lease bases price to industrial projects established in the industry village, grace period on the land lease payment, 25 years of privilege for using the land free from payment to those investors engaged on forest development projects which could develop more than 10 hectares of forest and only 1% royalty payment to fish resource development projects.[351] Regarding income tax exemptions, however, problems on autonomy of regional states will not be an issue, since regional states could not have their own investment laws and special income tax exemption laws other than what is provided in the federal income tax holiday legislations. Therefore, the issue here will be whether strong coordination exists between the regional and federal investment authorities for the proper implementation of tax holiday laws.

Back to the main point, the investment proclamation obliges each regional investment organs to transmit to the EIC information compiled with respect to the resource potential and investment opportunities of the region as well as periodic reports on investment activities therein.[352] However, the practice shows that weak coordination exists between the EIC and regional investment boards on receiving a well periodic report on the investment activates conducted on the latter.[353] Moreover, the law is not clear on the time

[349] FDRE constitution, Article 55(2(a &b))
[350] Ibid. Article 52(d)
[351] Amhara National Regional State Investment Commission, *Investment Incentives permitted by the Federal Government and Regional States for supporting the investment Project in the Region*, 2016, Bahir Dar, pp. 56-61
[352] Investment proclamation No 769 (2012), Article 31(2)
[353] Interview with Genanaw Girmaw, Investment Projects Support and follow-up Senior Expert, *The coordination of the EIC with Regional Investment Authorities*, may 2, 2017

limit for each report should be submitted; in each year, in each 6 months, 4 years? The law failed to address these issues; and such ambiguity would have a negative contribution on well coordination of the EIC and regional investment authorities.

Another very important point for the better implementation of tax holiday laws is the coordination of tax authorities and investment authorities. Obviously, the tax authorities are standing on collecting revenue for the government. Accordingly, as revenue is concerned, the tax authority devoted itself on collecting taxes from each taxable activity. On the other hand the EIC is responsible on promoting investment; and has the task of monitoring whether the granted income tax exemptions are used for the intended purpose. For the tax authorities to properly discharge its function, it should have a full record of income tax exempted firms. These presuppose the existence of record exchange system between the commission and the tax authorities. Nevertheless, the investment proclamation did not recognize a mechanism which enables the TA to easily access the full record of income tax exemption firms. Practically, however, there is system that the tax authorities receive full record of income tax exemption firms established in the form of PLC and S.C from the Commission.[354]But it is difficult to say there is coordination in the full sense. Since there are still tax exempted firms the where about of them is not known by the tax authorities.[355]

Lack of follow-up whether the income tax exemption used for the intended purpose is also the other implementation gaps on the tax holiday law of Ethiopia. Although the law imposed the task of controlling on the commission and the law imposes an obligation to report in each three months by the investors,[356] it is not practically implemented. Practically, the commission only interacts with tax exempted companies to record a technology transfer agreement, if any, to allow duty free imports and to renew investment permit; otherwise there is no such strong monitoring and controlling system by the commission[357].

To conclude, lack of coordination between the tax authorities and investment commission, the regional authorities and the commission as well as weak monitoring of the income tax exempted company by the commission still interacts as a problem in the implementation of tax holiday laws.

3.5.2.2. Limitation on Awareness Creation

For a tax holyday to be effective and to attract private investment, the concerned government should discharge its obligation of awareness creation. The task of raising the awareness of investors on the contents of this Proclamation, regulations and directives on income tax exemptions and other issues is

[354] Interview with Endalelign Asrat , Education and Training Coordinator of the Big Taxpayers in ERCA big Tax Payers Branch ,on *The Coordination of the EIC with Tax Authorities*, *May* 3, 2017
[355] Interview with G/IgizihabharReda, Director of ERCA Big Tax Payers Branch, on *The Coordination of the EIC with Tax Authorities*, May 3, 2017
[356] Investment Proclamation No 769/2012, Article 20(1)
[357] Interview with Genanaw Girmaw, Investment Projects Support and Follow-up Senior Expert, on *Monitoring the Tax exempted Firms by the Investment Commission*, May 2, 2017, Interview with Interview with KibikabAbera, Agent of Director of JIAR Marble Manufacturing PLC ,on *Monitoring the Tax exempted Firms by the Investment Commission* , May 4, 2017

vested on the hands of the investment commission. However, during my interview, I found an investor who is engaged in income tax exemption activities but not benefited from it due to unaware of the exemptions.[358] This would be brought due to limitation on awareness creation on the income tax exemption eligible sectors. Thereby, promotional and awareness creations measures still lacks completeness and needs further work by the commission.

[358] Interview with Interview with KibikabAbera, Agent of Director of JIAR Marble Manufacturing PLC, on *Awareness Creation by the Commission on Income Tax Exempted Sectors*, May 4, 2017. Their firm is engaged on manufacturing of Marble, and even though it is tax exempted area, the firm was not benefited from it due to lack of knowledge.

CHAPTER FOUR

CONCLUSION AND RECOMMENDATION

4.1. Conclusion

The FRDE government has provided income tax holiday as on investment incentive tool to encourage private investment. For the income tax holiday to be effective, the government should be careful on designing income tax holiday policy and laws. However, the research found that policy, legal and implementation gaps are the problems of the income tax holiday relief of Ethiopia. To begin with the drawbacks of the policy, the research found that the design of Ethiopian income tax holiday as well as investment policy did not recognize in clear manner promotion of innovation as one objectives of investment. The laws which serve as an instrument to achieve policy objectives are also found that they failed to grant special income tax exemptions based on some known standards to encourage innovation of firms despite the fact that it is suggested by many researchers that tax incentive certainly have a positive impact on innovation since the exemption part of the profit can be re-invested in to the production of innovative product. The research also found that being reluctant with the promotion of infant industries is the other policy gaps on the design of the income tax holiday policy of Ethiopia. The Ethiopian income tax exemption laws treat all firms similarly whether it is big, medium or small.

Problems in the policy are not the only problems in the income tax holiday system of the country. Legislation gaps are also found the other problem that hinders the tax holiday relief to be effective. Discretionary base income tax exemption regime is also found one shortcoming on the design of income tax holiday laws. The amended investment proclamation authorized the EIB to grant new and additional exemptions other than what is provided under the existing regulations. However, the law failed to limit the powers of the board by setting some requirements, and by what criteria they grant the incentive is not clear. This opens a room for the EIB to abuse its power. Additionally, failure to exhaustively list each tax exemption sector is also found the other shortcoming of the income tax exemption laws of Ethiopia.

The research also found that the income tax holiday regime of Ethiopia creates discrimination between firms by the mere fact they are invested within industrial development parks, irrespective of the similarity of the sector. Obviously, this results competitive distortion between firms invested inside the development parks and those found outside it. Moreover uncertainty of laws is also found the other challenge in the tax holiday regime of Ethiopia. This is because frequent change of law has a negative impact on the confidence of investors to stay on investing here. Basically the main cause of the investors against frequent changes of law is its effect on competition. This frequent change brings competitive distortion between the old firms which is treated by the old law, and the new firms that is treated by the new laws.

Non-recognition of deferral deprecation allowance is also found the other shortcoming in the Ethiopian tax holiday regime. As discussed in chapter three, absence of deferral deprecation allowance will result in higher tax burden on investors after the expiry of the income tax exemption period. However, the Ethiopian investment laws have not introduced this incentive.

Moreover, the Ethiopian investment laws are also found providing disproportionate measures without taking into consideration the degree of fault of the investors. This in turn leads to investor's dissatisfaction with the existing system of the country and also leads to social and economic crisis. Besides, the country's laws also found that they do not introduce a mechanism which enables private individuals to give objective and verifiable information to facilitate the better implementation of tax holiday laws.

The paper also found that implementation gap is also the other problem on the effectiveness of income tax exemption relief of Ethiopia. Mainly, lack of coordination and collaboration between the investment commission and the tax authority, and between the commission and regional investment authorities are found the shortcoming of the income tax holiday system of the country that hinders the better and effective implementation of income tax holiday relief. Limitation on awareness creation on the tax exemption sectors still found to be another drawback of the tax holiday system of the country.

4.2. Recommendations

Based on finding of this research, the following points are recommended to establish more effective income tax holiday system in the country. The first recommendation concerns with respect to policy gaps on the tax holiday relief of Ethiopia.

As far as the essentiality of promotion of infant industries and innovation is concerned for sustainable economic growth, the investment policy should put and clearly define them as one policy objective. Besides, the investment laws which serve as an instrument to achieve the policy objectives should recognize special privilege for infant industries and innovative firms based on some objective criteria.

Apart from policy issues, this study recommends certain points that should be introduced in the existing income tax exemption legislations of Ethiopia. Accordingly, the following points are recommended.

- Legislations which narrow or totally eliminate the discretion of officials have paramount to prevent abuse of power by officials; and have huge importance to have a good income tax exemption regime that enables the country to become a better destination choice of investors. To narrow or totally eliminates discretion, the criteria and extent of power should be clearly defined by law to prevent abuses by the EIB and; for the EIB to be the appropriate body to grant additional incentives other than provided in existing regulations, its composition must be from every concerned sectors like from tax authority, private sectors, investment authority, etc. Besides, the investment legislations should exhaustively and clearly list out each tax exemption sectors in unequivocal way since such ambiguity on clarity and inclusiveness lead to further interpretation and wider discretion.

- The investment laws should recognize deferral deprecation allowance to make the tax holiday regime more generous and effective, and to retain long term investment.
- Certainty and predictability affect the decisions of investors to make the host countries as the destination of their investment engagement. However, as the finding of this study shows frequent amendment of legislations becomes the main features of the legal system of the country. The researcher is not opposing the amendments of laws since it is expected from the law to move with new developments. But, in doing so, the new law makes competitive distortion between the old and new investment firms. The amended law, therefore, should put a provision that allows the new law to retrospectively work on the old firms if it is found that more beneficial to the former.
- Additional incentives granted to firms invested with in industrial development zones make discrimination between investors who invests with in Industry Park and those who invests out of it. Since granting such special privilege to investors with in Industry Parks found that no sound and genuine justification, this law should be amended and end such discrimination.
- The measures taken against investors who violate the existing laws should be proportional with the degree of fault. Thereby, the law should incorporate various measures starting from warning up to revocation of investment permit, and if it is found necessary, incorporate penalty with fine.
- Meaningful coordination and collaboration among different stakeholders is very essential for the better implementation of tax holiday laws. However, the research found that there is a limitation on this issue. Therefore, 1) the Investment Commission should strengthen its coordination with the tax authorities, and with regional tax authorities;2) the time interval that the regional authorities report to the Commission should be clearly determined and specified under the law; 3) the Investment Commission should observe and follow the over activities of the investment firms and control them whether they use the tax exemption for the intended purpose; 4) the law should recognize a mechanism that allows the private individuals to assist the overall effective implementation of investment incentives in general and income tax exemption laws in particular.
- Last but not the least, the Investment Commission should work more on awareness creation on the existing income tax exemption laws, and eligible sectors since it is found that there are still limitations on this issue.

Bibliography

I. Books

1. Alibert N. Link, *Public /Private Partnership*, published by springer Us, 1st edition, 2006, pp.71-75
2. Margaret Moses, *Principles and Practice of International Commercial Arbitration*, Published in the United States of America by Cambridge University Press, New York, 2008
3. M. Sornarajah, *The International Law on Foreign Investment*, 2nd edition, Cambridge university press, , New York, 2004, pp. 1- 553
4. OECD, *Detailed Benchmark Definition FDI*, fourth edition, 2008

II. Journal Articles

1. Agnes Benassy, et al, 'Institutional Determinant of Foreign Direct Investment', *Journal of world economy*, vol. 3, No. 3, 2007, pp. 764-782
2. Alex Easson, Tax Incentives for Foreign Direct Investment, The *Hague:Kluwer Law International*, 2004, vol. 52, No 4, pp. 1285- 1526
3. Easson, Alex, 'Tax Incentive for Foreign Direct Investment Part I: Recent trends and countertrends', *Bulletin for International Taxation*, vol. 55, No 7, Published by International Bureau Fiscal Documentation, Amsterdam, Netherlands, 2001, pp.266-274
4. Alicja Brodzka, 'Tax incentive in emerging economics', *Business System and Economics*, 2013, vol, 3, NO 1, Wroclaw, Poland
5. Assefa Ali Beshir, *Problems of Incentive Regime of Foreign Private Investment in Ethiopia: The Law and Practice*, LLM. Thesis, Addis Ababa University, Law Facility, 2005 [Unpublished avalible in Addis Ababa university main library]
6. Dawit G/Medihin and Dr. Gudelia C. Saporna, 'The Impact of Tax Holiday on Investment in Ethiopia: The Case of LTO Branch', online, *European Journal of Business and Management*, 2016, Vol.8, No.31, pp. 106- 107
7. Elizabeth Asiedu, Foreign Direct Investment in Africa: The Role of Natural Resource, Market Size, Government Policy, Institutions and Political Instability, *Journal of world economy*, vol. 29, No. 1, 2006, pp. 63-77
8. Erdal Demirhan and MahmutMasca, 'Determinants of Foreign Direct Investment Flows to Developing Countries: A Cross-sectional Analysis', *Prague Economic papers*, No, 4, 2008, pp.356-369
9. Grabowski, Alex, 'The Definition of Investment under the ICSID Convention: A Defense of Salini' *Chicago Journal of International Law*, 2014, Vol. 15 No. 1, Article 13
10. Ismail Cevis and Burak Camurdan, 'The Economic Determinant of Foreign Direct Investment in Developing Countries and Transition Economies', *e-Journal of New World Science Academy*, 2009, vol.4, No.3

11. Jack M. Mintz, 'Corporate Tax Holidays and Investment', *The World Bank Economic Review*, 1990, Vol. 4, No 1,published by International Bank for Reconstruction and Development , pp. 81 -102
12. Larry E. Westphal, 'Fostering Technological Mastery by Means of Selective Infant-Industry Protection', World Bank Reprint Series: No. 253, New York: Academic Press, 1982, pp. 255-279
13. Olena Liakhovets, 'Tax Incentives Effectiveness for the Innovation Activity of Industrial Enterprises in Ukraine', *Economics & Sociology*, Vol. 7, No 1, 2014, pp. 72-84
14. Patricia LindelwaMakoni, 'An Extensive Expropriation of Theories of Foreign Direct Investment', *Risk Governance and Control: Financial Market and Institution*, 2015, vol. 5, No 2, pp. 77-83
15. Rizwan Qaiser Danish and Amna Akram, 'Determinants of FDI in Pakistan: An Empirical Analysis'. *Journal of International Business and Economics*, Vol. 2, No 2, 2014, p 62
16. TaddeseLencho, 'Towards Legislative History of Modern Taxation in Ethiopia(1941- 2008)', *Journal of Ethiopian law*, vol.25, No.2, 2012, pp. 104-158
17. Solomon Abay(Dr), 'Designing Regulatory Roles of Government in Business: The Lesson from Theories, International Practice and Ethiopia's Policy Path', *Journal of Ethiopian law*, vol. 23, No 2, 2009, pp. 66-131
18. Stanley S. Surrey, 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures', *Harvard Law Review*, 1970, Vol. 83, No. 4
19. Stoian, 'Carmen R. and Filippaios, Fragkiskos, Dunning's Eclectic paradigm: A Holistic, Yet Context Specific Framework for Analyzing the Determinants of outward FDI: Evidence from International Greek Investments', *International Business Review*, vol. 17, No, 3,pp.349-367
20. Sung-Hoon Lim, How investment promotion affects attracting Foreign Direct Investment: Analytical Argument and Empirical Analyses, *International Business Review,2008,* vol. 17
21. VintilaDenisia, 'Foreign Direct Investment Theories: An Overview of the Main FDI Theories,' *European Journal of Interdisciplinary Studies*,2010, Vol. 2, No 2, pp. 104-110

III. Others

1. Abebe Nigusu, *The Legal and Institutional Framework of FDI in Ethiopia: The shortcomings*, MA thesis, Ethiopian Civil Service University School of Diplomacy and International Relations, 2014, pp. 1- 72
2. Alan A. Bevan and Saul Estrin, 'The Determinants of Foreign Direct Investment into European Transition Economies', online, *Journal of Comparative Economic*s, No 32, 2004, pp. 775-787, at paragraph 2, available online at www.elsevier.com/locate/jce last accessed on April 20,2017
3. Amhara National Regional State Investment Commission, *Investment Incentives permitted by the Federal Government and Regional States for supporting the investment Project in the Region*, 2016, Bahir Dar, pp. 56-61
4. Dr. Bruce Bolnick et al, Effectiveness and Economic Impact of Tax Incentives in the SADC Region, a Technical Report submitted to USAID, 2004

5. Ethiopian Business development service network, *Business Environment - Investment Policy Investment Areas- Incentives/guarantees Taxation - Investment Opportunities Investment Procedures*, published by Ethiopian Business Development Service Network, 2004, Addis Ababa
6. Federal Democratic Republic of Ethiopia, The Second Gross and Transformation Plan 2015/2016-2019/2020, National Planning Commission, 2015, Addis Ababa
7. EIC Investment Guide 2015, Ethiopia: A Preferred Location for Foreign Direct Investment in Africa
8. Ethiopia Investment Agency, Invest in Mekelie Ethiopian Investment policy, 2013, pp. 2-14
9. EIC Investment Guide, Incentives, 2014, at p 31 / available at www.investethiopia.gov.et/imagies/pdf/incentives.pdf
10. EIC, *Extensive Development of Industrial Parks*, 2017, at paragraph 4, available at http://www.investethiopia.gov.et/investmnent-opportunities/strategic-sectors/industriy-zone-developments, last accessed on April, 27, 2017
11. European Commission, *A Study on R&D Tax Incentives Final Report*, working paper, No.52, 2014, office for official publication of the European Commission, Luxembourg, pp. 5-122
12. Food and Agriculture organization, *Trends and Impacts of Foreign Investment in Developing Country Agriculture*, Rome, 2012
13. Hans George Wille, Tax Incentive in BEPS- Perspective, the Institutional Repository (open access) at Norwegian Business School, 2015, p. 2 available at. http://brage.bibsys.no/bi
14. Imad A. Moosa and Buly A. Cardak, 'The Determinants of Foreign Direct Investment: An Extreme Bounds Analysis', online,*Journal of Multinational Financial Management*, No 16, 2006, pp. 199-211 available at www.elsevier.com/locate/econbase, last accessed on April 16, 2017
15. International Monetary Fund Balance of Payment Manual , fifth edition, 1993
16. Investment climate advisory services of the World Bank group, 'Investment Incentive the Good, the Bad and the Agley', *background paper for the 18th Colombian investment conference*, Colombia University, November 13-14, 2013
17. Jiangyan Yu, Determinants of FDI: A Sectorial and Institutional Approach, IMF Working Paper, WP/10/187, 2010
18. kenneth P. Thomas, Investment Incentives: Growing Use, Uncertain Benefits, Uneven Controls, International Institute for Sustainable Development, Geneva, 2007
19. .kevin Fletcher, Tax incentive in Cambodia, Lao PDR, and Vietnam, 2002, available at : www.imf.org/external/pubs/ft/seminar/2002/fdi/eng/pdf last accessed on 02/02/2017, last accessed on April 16, 2017
20. Matthew J. Slaughte, Infant-Industry Protection and Trade Liberalization in Developing Countries, a Research Report submitted to USAID, Washington, 2004, pp. 1-39
21. Matthew J. Slaughte, Infant-Industry Protection and Trade Liberalization in Developing Countries, a Research Report submitted to USAID, Washington, 2004, pp. 1-39

22. Muhammad Reza Fahmi, *Analyzing the Relationship Between Tax Holiday and Foreign Direct Investment in Indonesia*, MSc thesis, Asia Pacific Studies Ritsumeikanasia Pacific University, 2012, pp. 1-96[unpublished available at http://r-cude.ritsumei.ac.jp/bistream/10367/4740/1/512110611.pdf
23. Oshani Perera, Investment Incentives for Sustainable Development: The Case of Lao PDR, International Institute for Sustainable Development, 2011
24. OECD, *Detailed Benchmark Definition FDI*, fourth edition, 2008,
25. OECD, *Definition of Investment and Investor*, 1996, pp. 4-6
26. Organization of Economic Cooperation and Development (OECD), *Tax Incentives for Investment – A Global Perspective: Experiences in MENA and non-MENA countrie*s, 2007
27. Paul Barbour, An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector, ESAU Working Paper 14, 2005, London
28. Technical report by Nathan -MSI Group on the Effectiveness and Economic Impact of Tax Incentives in the SADC Region, 2004, p.26 available at: <pdf.usaid.gov/pdfdocs/Pnacy929.pdf , last accessed on 15/04/2017
29. Tesfaye Abate, History of Investment in Ethiopia, available at http://www.abssinialaw.com/study-on-line/item/487-history-of-investment-law(online) , , last accessed on April 10,2017
30. TsegayeTeklu, Investment Promotion and Incentive In Ethiopia, p 359 available at https://www.eeaecon.org/sites/default/files/publication/Tesgaye%20Teklu-Investment%20Promotion%20and%20Incentives%20in%20Ethiopia.pdf , last accessed on April 18, 2017
31. UNCTAD, *Scope and Definition of Investment and Investors*, UNCTAD Series on Issues in International Investment Agreement II New York, Geneva , 2011
32. UNCTAD, *Tax Incentive and Foreign Direct Investment a Global Survey*, ASIT Advisory Studies, No. 16, New York and Geneva, 2003
33. WanjalaMukhwana, *Bernadette, Determinants of Foreign Direct Investment in Sub-Saharan Africa*, with Inferences on Kenya, Master's thesis, 2001

IV .Laws

1. The Constitution of the Federal Democratic Republic of Ethiopia ,1995, Federal Negarit Gazzetta, pro.No.1 , 1st Year , No. 1,
2. Investment Proclamation, 2012, Federal Negarit Gazzetta,proc. No. 769, 18th year, No 63
3. Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, 2012, Federal Negarit Gazeta, reg. No.270, 19th year, No 4
4. Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, (Amended), 2014, Federal Negarit Gazzetta, reg. No.312, 20th year, No. 62

5. The Ethiopian Investment and Investment Commission Establishment Council of Minister Regulation, 2014, Federal Negarit Gazzetta, pro. No 313, 20th year, No. 63
6. Income Tax Proclamation, 2016, Federal Negarit Gazita Exra-Odinary issue, proc. No. 976, 22nd year , No. 104,
7. The Revised Export Duty Incentives Scheme Establishing Proclamation, 2007, Federal NegarIt Gazzetta, proc.No.54, 13th year, No. 57
8. Tax Administration Proclamation, 2016, Federal Negarit Gazzetta, proc No. 983, 22nd year, No.103
9. Value Added proclamation, 2002, Federal Negarite Gazzetta, pro.no 285, 8th year, No.33, Article 7(2

V. Interviews

1. Interview with TassewNegawa, Industrial park Regulation Directorate Director of Ethiopia , *Ethiopian income tax holiday policy on the promotion of infant industries,* May 2,2017
2. Interview with MulatuKibret, Investment Incentives Directorate Director and member of the Investment Board, *Ethiopian income tax holiday policy on the promotion of infant industries,* May 2, 201
3. Interview with Mulatu Kibret, Investment Incentives Directorate Director and members of the Investment Board, *The appropriateness of the Investment Board to grant Additional Exemptions* , May 2, 2017
4. Interview with Keran, the Finance Officer of AVOL PLC, on *The effect of Frequent Change of Laws on Investment,* may 3, 2017
5. Interview with Tassew Negawa, Industrial Park Regulation Directorate Director of Ethiopia, on *The Shortcomings of the Investment Regulation on income Tax Exemptions,* May 2, 2017
6. Interview with Endalelign Asrat , Education and Training Coordinator of the Big Taxpayers in ERCA Big Tax payers Branch, *on The appropriateness Investment Board to grant Additional Incentives,* may 3, 201P
7. Interview with KibikabAbera, Agent of Director of JiarMarbile Manufacturing PLC, on *Special Income Tax Exemption for Investors engaged on Industrial Development Zones*, may 4, 2014
8. Interview with Eyob, Finance Officer of Sky Plastic Factory, on *The use of Deferral Deprecation Allowance on Effective Income Tax Holiday*, May 4, 2017
9. Interview with EndalelignAsrat , Education and Training Coordinator of the Big Taxpayers in ERCA big Tax Payers Branch ,on *The Coordination of the EIC with Tax Authorities*, *May* 3, 2017
10. Interview with Genanaw Girmaw, Investment Projects Support and follow-up Senior Expert, on *The coordination of the EIC with Regional Investment Authorities*, May 2, 2017
11. Interview with G/IgizihabharReda, Director of ERCA Big Tax Payers Branch, on *The Coordination of the EIC with Tax Authorities*, May 3, 201
12. Interview with Genanaw Girmaw, Investment Projects Support and Follow-up Senior Expert ,on *Monitoring the Tax exempted Firms by the Investment Commission*, May 2, 2017

13. Interview with Interview with KibikabAbera, Agent of Director of JIAR Marble Manufacturing PLC, on *Awareness Creation by the Commission on Income Tax Exempted Sectors*, May 4,

Annex

Dear interviewees

The following are interview questions that will help to collect data/ information for partial fulfillment of master's program at school of law at Bahir Dar University *on Design and Implementation of Tax Holiday laws in Ethiopia: Critical Issues and Challenges.* The researcher will be very much grateful for your time and thorough and careful look at the questions and informative and useful answers in advance. Please, be sure that the answers you give are confidential and only used for academic purposes. Thank you in advance for taking your time to answer the following law and or implementation- specific questions.

Interview Questions

A. Questions on Tax Holiday Legal Framework

1. Are the income tax exemption laws of the country give wide discretion to officials/open to abuse?
2. How can one evaluate the appropriateness of the non-recognition of deferral deprecation allowance up to the end of tax holiday relief? And what is its effect on long term-investment?
3. How do you evaluate the certainty of income tax holiday laws?
4. How do you see the issue of innovativeness of firms and infant industry under the income tax holiday policy of Ethiopia? Under article 6 of regulation 270/ 2012 it is stated that an investor expanding or upgrading his existing enterprise by at least 50% the attainable production or service rendering capacity of an existing enterprise or increasing in variety, by at least 100%, by introducing a new production or service rendering line of an existing enterprise or increment by both, are entitled to income tax exemption attached in the schedule. Is the aim of this provision to incentivize innovative firms? Are introducing new production or service line, and producing more alone sufficient to say a firm is innovative?
5. The amended regulation(2014) provides additional 2 years and 4 years income tax exemption to firms engaged in industrial development zones established at Addis Ababa and other regions respectively.. What will be the effect of this discrimination on investment?
6. Do you think that the investment board is the appropriate organ authorized to grant new and additional incentives other than provided under regulation 270/2012?

B. Questions on Implementation of Tax Holiday in Ethiopia

1. How the commission is coordinates its work with regional investment commissions and tax authorities on the proper implementation of tax holiday? Are there periodic monitoring and reporting mechanisms between the commission and regional offices?
2. How the commissions monitor the activities of tax holiday firms? Is there periodic follow up?
3. Is there any mechanism which enables private individuals to provide verifiable and objective information against the misuse of the tax holiday relief?? Do you think that recognizing it beneficial for proper implementation of tax holiday relief?