EFFECTS OF FISCAL POLICY ON FOREIGN DIRECT INVESTMENT IN ETHIOPIA

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ABSTRACT

This paper conducts a literature survey on Foreign Direct Investment (FDI) and its relation to fiscal policy. Geographical and cultural proximity between originating and host countries, market size of the host countries, as well as other exogenous variables have been pointed out by a significant part of the literature as crucial factors in FDI decisions. Fiscal policy, as an endogenous factor, is an increasingly important tool on the countries competitiveness for attracting FDI, mainly in the Euro-zone. The papers analyzed identify some areas of fiscal policy: most papers focus analysis of fiscal policy only on the tax rate–that is, on the relationship between the income tax rate in force in the country and FDI; other papers analyze the relationship between fiscal harmonization and FDI; some papers study the relationship between the complexity of the fiscal system and FDI; while others attempt to relate other specific areas of fiscal policy–e.g. fiscal regime of thin capitalization–with FDI decisions; various other studies show the relationship between territories with non-existent (or extremely low) fiscal regimes and FDI. It is expected that this characteristics of fiscal policy, will be relevant in the decision-making process, where countries are competing with each other as potential locations for FDI.

Key Words: Fiscal Policy, Foreign Direct Investment, Ethiopia

INTRODUCTION

Sustainable and rapid economic growth of an economy depends significantly on the size of investments derives from both domestic and abroad. Investment requires usually large amount capital and technology as well as skilled manpower. However many developing economies including Ethiopia suffer from low domestic saving levels leading to a huge gap between savings and investments. Because of these facts, FDI is considered as an engine of growth as it can potentially generate productivity spillovers for the host economy, increase the volume of investment and its efficiency, expand the existing stock of knowledge, facilitate the access to leading technology, generate chains of new local suppliers, and open access to new markets. Consequently; in recent decades, there has been increasing competition among countries to attract FDI by offering a wide range of tax incentives (IMF, 2006).

The literature on tax competition has long been suggesting that increasing international integration might impose a growing pressure on tax policies, as increasing taxes on a mobile base (such as capital) in one country creates an incentive for tax payers to relocate abroad (Zodrow and Mieszkowski, 1986). Because tax base relocation is not the same to all countries, small countries have stronger incentives than large ones to cut taxes (Wilson, 1991).

Foreign direct investment is considered as an alternative source to fill the gap between savings and the required investments in the developing countries. Foreign firms bring not only financial capital but also managerial techniques as well as entrepreneurial and technological skills that lack in least developed countries (LDCs). The government's budget deficits can also be filled by profit taxes collected from transnational companies. The reason is that the welfare of the host country depends on the impact of FDI on improving total tax revenues as well as augmenting factor incomes mainly labor. Ethiopia has been providing tax incentives to encourage private investment and to promote the inflows of foreign capital since 1992. Ethiopian Government has been providing extensive tax incentives to attract FDI (Million et.al, 2016). These include tax holidays, exemption of raw material and machinery import duties and exemptions of export duties on most export goods, etc. However, the evidence that is available suggests that these initiatives led to revenue losses than the positive economic effect (IMF, 2006). Initial investment of foreign firms improves the current and the capital account of the host country. However, in the long run, substantial import of intermediate and capital goods, repatriation of profit, interest, royalties and management fees may harmfully affect the foreign exchange position of the host country (OECD 2002). Investment incentives in the form of tax reductions & exemptions, special tax allowances, low interest loans, subsidies and repatriation of capital and transfer of profits are also found to affect the inflows of FDI (Woldemeskel, 2008).

A tax policy of a country can have attraction or distraction effect on FDI **(**UNCTAD 2007). Tax incentives have been used by countries to promote investment specially FDI with the belief that it facilitate growth through creating employment and technology transfer.

A fiscal incentive in the form of tax directly affects country's tax revenue and in contrary, fiscal measures of government also affects the investment growth. Emmanuel Cleeve (2008) found that among fiscal incentives tax holidays were the most effective in attracting FDI and while the other concessions seem to cause an adverse effect, especially in countries that offered too many concessions. According to this study all fiscal incentives may not benefit the economy through attracting FDI, because some fiscal incentives may result in economic distortions. A joint study by justice network Africa and Action Aid international on tax competition in east Africa has indicated Kenya, Uganda, Tanzania and Rwanda are losing up to USD 2.8 billion a year because of the tax incentives they offer to FDI companies. Hence, they suggest these kinds of incentives should stop because they are costly and inefficient.

Dominant Factors in FDI Decisions

Concerning the dichotomy between exogenous variables and host country policies, the analysis carried out above demonstrates that the majority of authors, of both current and less recent studies, show the preponderance of exogenous factors in FDI decisions, with state policies for receiving FDI in the background.

Demekas et al. (2007); Carstensen & Toubal (2004); Janicki & Wunnava (2004); Lim (2001); Bevan & Estrin (2000); Lankes & Venables (1996); Singh & Jun (1996) all conclude that the factors of attraction (exogenous variables e.g. market size, proximity of the country to the source of investment) are the most important explanatory variables in FDI decisions. Goodspeed (2002) shows the importance of external factors in tax policy decisions, stating that *«a horizontal fiscal externality may result when two governments … tax a base that is mobile between the two jurisdictions. The tax rate set by any one of the jurisdictions is influenced by the fear that the mobile tax base will flee and leads to lower tax rates on mobile factors».* Therefore, the internal tax policy decisions of host countries are also affected by exogenous factors, inasmuch as they require knowledge of the practices (policies) followed by the competition, i.e., knowledge of the equivalent tax regimes operating in other States.

Concerning the dichotomy between tax policy and FDI-that is, the existence of a specific relationship between tax policy and FDI-studies do not reach uniform conclusions, as will be shown next.

The studies carried out deal with various areas of fiscal policy, more specifically: (i) most studies focus analysis of fiscal policy only on the tax rate-that is, on the relationship between the income tax rate in force in the country and FDI; (ii) other studies analyze the relationship between fiscal harmonization and FDI; (iii) some authors study the relationship between the complexity of the fiscal system and FDI; (iv) while others attempt to relate other specific areas (besides tax rate and harmonization) of fiscal policy-e.g. fiscal regime of thin capitalization-with FDI decisions; (v) various other studies show the relationship between territories with non-existent (or extremely low) fiscal regimes and FDI.

FDI and Tax Incentives: Ethiopian Experience

During Emperor Haile Selasie period, a liberal economic policy was followed and it was able to attract few investments though the amount is not significant (Melese and Waldkirch 2011). But liberal policy of imperial era was replaced by command system of economic during Derg. Again private sector participation in the economy get recognition and to make the investment climate attractive the EPRDF government has revised the investment code five times in the last twenty three year (1992-2014). As a result of the implementation of the above mentioned reforms, policies and strategy, agricultural and industrial production, investment and export trade has improved (Million et.al, 2016). The investment legislation has also started offering fiscal incentives and investment guarantees to foreign and domestic investors.

Tax holiday (exemption from income tax)

Any investors who invest to establish a new enterprise in manufacturing, agro-processing, production of agricultural products and information and communication technology development are entitled to income tax exemptions. Any income tax derived from approved new investment shall be exempted for periods of 1 to 8 years, depending upon the priority area of investment activities and the geographical location of the investment (Million et.al, 2016). Conditions for income tax exemption eligibility are:

1. If at least 50% of its production is to be exported; Profit Tax Exemption Years is 5 Years, if the Investment is made in relatively under-developed regions, the exemption period is 6 years.
2. If at least 75% of its production will be an input for the production of export items; Profit Tax Exemption Years is 5 Years, if the Investment is made in relatively under-developed regions, the exemption period is 6 years.
3. If the project is evaluated under a special circumstance by the BOI; Profit Tax Exemption Years is no longer than 7 Profit Tax Exemption Years. If the Investment is made in relatively under-developed regions the exemption is No longer than 8 years. However, the granting of income tax exemption for a period longer than 7 years requires the decision of the Council of Ministers.
4. If less than 50% of the production is to be exported; Profit Tax Exemption Years is 2 Years, if the Investment is made in relatively under-developed regions the exemption shall be 3 years.
5. If the production is for the local market; Profit Tax Exemption Years is 2 Years, if the Investment is made in relatively under-developed regions it will be 3 years.

In addition investors that establish new enterprise in the regions of Gambella, Benshangul, Afar, Somali, Guji and Borena and South Omo Zone are entitled to an income tax deduction of 30% for three consecutive years after the expiry of income tax exemption (Million et al. 2016).

Custom Duty Exemption

To encourage private investment and to promote the inflows of foreign capital the government of Ethiopia provide an incentive of custom duty exemption for investors engaged in eligible new enterprise or expansion project. The eligible sectors are Agriculture, manufacturing, construction, education, health, electricity and water supply and hotel and tourism. These incentives include:

1. 100% exemption from the payments of custom duties and other taxes levied on imports granted to all capital goods, such as plant, machinery and equipment and construction material.
2. Spare parts worth up to 15% of the total value of the imported investment capital good, provided that the goods are also exempt from the payments of custom duties.
3. An investor granted a custom duty exemption will be allowed to import spare parts duty free within five years from the date of commissioning of a project.
4. With the exception of few products (e.g. semi processed hide and skins 150%) no export tax is levied on export products of Ethiopia.
5. Any investors who export or supplies to an exporter as a production or service input, at least 60% of his product or service shall be entitled to income tax exemption for 2 years in addition to the exemption period provided.
6. Duty paid at the port of entry or locally, on raw materials used in the production of commodities is refunded, 100%, upon exportation of the commodity processed.

These all exemptions show the impact of fiscal policy and foreign direct investment growth. Therefore, Ethiopia enacted these all proclamation for tax holidays to attract more and more foreign investors to invest in Ethiopia.

SHORT EXPLANATION OF FINDINGS

The uniformity of the various authors' opinions regarding the existence of a relationship between certain areas of fiscal policy and FDI is only found in studies showing the relationship between tax havens and FDI and in some studies trying to show the relationship between other specific areas of fiscal policy (besides tax rate and fiscal harmonization) and FDI.

CONCLUSION

Having reviewed the literature, without claiming it to be exhaustive, on the variables affecting FDI decisions and the relationship between fiscal policy and FDI, we can conclude that a significant number of authors find that exogenous variables (namely, market size, geographical and cultural proximity between home and host countries) are preponderant in FDI decisions. However, some authors attribute relevance to policies formed by States, with various host country policies being more important in the decision process, as long as exogenous variables tend to be similar between the potential destinations considered for investment.

Many studies try to relate fiscal policies to FDI. Fiscal policies affect the investment decision more relevantly when other (e.g. economic and social) policies of the potential countries being considered for investment are convergent. In the single market of the Euro-zone countries (where there is convergence of economic and social policies) the growing tax competition among these countries and the importance they give to fiscal sovereignty-as the «last bastion» of national sovereignty is evidence of the current importance of fiscal policy in the competitiveness of Euro-zone economies.

Given this evidence, although no scientific studies are known to confirm it, we can expect certain specific measures of fiscal policy related to investment activity, implemented in Euro-zone countries-namely fiscal rulings on thin capitalization, reporting tax losses, elimination of double international economic taxation, among others-to be relevant in the decision-making process, as long as the countries from that area are competing with each other as potential locations for FDI.

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