INCOME TAX EXEMPTION AS AN INCENTIVE TO INVESTMENT IN ETHIOPIA

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Introduction

In order to encourage development, Ethiopia offers exemption from income tax for certain kinds of enterprises which invest more than a stated amount of capital.[1] Ethiopia is not unusual in this respect; many developing countries have similar provisions.[2] The purpose of this paper is to discuss the use of income tax exemption as a technique to encourage economic development and, more particularly, to consider the desirability of the use of that technique in Ethiopia. This paper will draw heavily on the extensive research that has been done on the income tax exemption laws of Mexico[3] and Puerto Rico.[4] Very little material is available on most developing countries, including Ethiopia. The focus of this discussion of Ethiopia's income tax exemption law, therefore, is of necessity on its structure, and not on its actual implementation, except to the extent that conversations and correspondence with people who have had legal experience in Ethiopia permits.

I. History of Business Income Tax Exemption in Ethiopia

There was no exemption provision designed to promote foreign investment in either of Ethiopia's first two income tax laws, Proclamation No. 60 of 1944 and Proclamation No. 107 of 1949. Income from agricultural activities was exempted under these laws, and it continued to be until 1967[5]; but the reasons for its exemption presumably were unrelated to any attempt to attract foreign capital. Although some enterprises may have had exemptions on an *ad hoc* basis to encourage investment, the first official mention of a general policy of using income tax exemption to encourage investment was in a notice published by the Minister of Finance in 1950. It reads in part, as follows:

> The Imperial Ethiopian Government has decided upon a general working policy for the encouragement of foreign capital investment in Ethiopia of enterprises deemed to be beneficial to the country. For the achievement of this policy, the Government is prepared to grant special facilities to new enterprises started with foreign capital. The following are the benefits which are calculated to stimulate confidence on (sic) foreign investors of their status in Ethiopia:[6]

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1. Investment Proclamation of 1966, Proc. No. 242 of 1966, Negarit Gazeta, Year 26 No. 2.
2. International Chamber of Commerce, *Taxation of Income Originating in Countries in Process of Development* (1959).
3. Ross & Christensen, *Tax Incentives for Industry in Mexico* (1959), (hereinafter cited as Ross & Christensen).
4. Taylor, *Industry Tax-Exemption in Puerto Rico* (1957), (hereinafter cited as Taylor).
5. The exemption was ended in Proclamation 255 of 1967, Negarit Gazeta Year 27, No. 4 (1967).
6. Notice No. 10 of 1950, Negarit Gazeta Year 9, No. 6, p. 15 (1950).

1. TAX ...

> New enterprises will be free from payment of profit tax for five years from the date production is started.

The notice also allowed an exemption from customs duties on "necessary machinery" for the "installation of the factory;" indicated that the government would be flexible in its requirements for Ethiopian participation in enterprises initiated by foreigners; and stated that arrangements could be made for remitting a percentage of profits abroad.

The notice applied only to "enterprises deemed to be beneficial to the country" although it is not clear who was to make this determination.[7] Only "new enterprises" were to be granted the income tax exemption. No limitation to this broad category was stated in the notice, but a limitation may be inferred if the customs duty exemption section of the notice is read as modifying the income tax exemption. The former granted exemption from customs duty on machinery for "the factory," which perhaps indicated that "enterprises" in the income tax exemption provision meant manufacturing enterprises. The absence of any limitation may be inferred with equal justice, from the reference of the introductory paragraph of the notice to "enterprises deemed to be beneficial to the country." This category presumably would include enterprises other than manufacturing enterprises.

The ambiguity of the notice may be explained by the fact that it was only a "statement of policy." The notice seems to have had no legal force of itself. Rather, it seems to have been in legal effect merely as an announcement of the policies that the Minister of Finance and other government officers intended to follow in exercising the discretion given to them by other laws. The phrasing of the notice, therefore, need not have been as precise as that of an enactment having the force of law.

The next step in the evolution of Ethiopia's use of income tax exemption to encourage investment was the Income Tax Decree of 1956.[8] Article 19 of the Decree, although it did not expressly withdraw the 1950 Legal Notice, provided that:

> Industrial, transport or mining enterprises investing a capital of not less than Eth. $ 200,000 ... may be exempted from income tax. Such exemption shall not exceed a period of five years from the beginning of their activities.

The decree thus defined the enterprises eligible for the exemption, and a minimum investment requirement, E $ 200,000, was established for the first time. However, there was no requirement in the Decree that the enterprise be "new;" apparently, an existing enterprise could have qualified for exemption under the Decree. Although the Decree was more detailed than the Notice of 1950, in at least one way, it was less clear in its terminology. Whereas the Notice provided that the exemption was to be five years "from the date production is started," the Decree stated that it was to be for five years "from the beginning of (the enterprise's) activities."

7. Presumably the determination was made by the Emperor with the advice of the Minister of Finance.
8. Negarit Gazeta Year 16, No. 1, p. 1 (1956).

Since the Decree did not define "activities," the five year period might begin to run well before the enterprise engaged in any *profitable* activity, and the value of the exemption might have been considerably diminished.

The Income Tax Decree was superceded by the Income Tax Proclamation of 1961,[9] which further refined the income tax exemption provision. Article 19(a) provided that new industrial, transport and mining enterprises which invested not less than E $ 200,000 before commencement of operations would be exempted from income tax for five years from the beginning of operations. It was thus made clear that the enterprise had to be "new," that investment had to be made before operations were begun, and that the exemption period began to run when operations were begun. Although all of these requirements create definitional problems of their own, the Proclamation was considerably more clear in its terms than was the Decree.

Article 19(a) of the Proclamation also required that proof of the amount of capital invested be submitted to the Minister of Finance, and that notification of the date of commencement of operations be made within thirty days thereof. These procedural requirements do not appear to have been intended to confer any discretion on the Minister, however. Article 19 provided that the enterprise "shall be exempted . . ."[10] (Emphasis added). As long as all of the requirements of Article 19 were met, the enterprise appears to have been assured of the exemption.

Article 19(b) of the Proclamation empowered the Minister of Finance, upon recommendation of a special committee to be established by him, to grant exemption from income tax for a period "up to" five years to "*existing* industrial, transport and mining enterprises which invest additional capital of not less than five hundred thousand Ethiopian dollars . . . in the extension of the enterprise . . ."[11] (Emphasis added). The extension had to be operated as "a separate technical unit with separate accounts," and the exemption only applied to "income derived from the operation of the new extension." The same reporting conditions of Article 19(a) were also to be met. Unlike the exemption under Article 19(a), however, the Article 19(b) exemption apparently was discretionary. The Minister of Finance made his decision on the *recommendation* of a committee, and the exemption could be granted for a period of time of five years or less.

Articles 19(a) and (b) of the Proclamation of 1961 were in turn replaced by Articles 5(1) and (2) of the Investment Decree of 1963. The structure of the provision remained basically the same, but a number of changes were made in its details. Eligibility for the exemption was extended to agricultural and touristic enterprises. Article 5(2), the counterpart of Article 19(b) of the Income Tax Proclamation, applied to an extension *or expansion* of the enterprise.

The minimum investment under Article 5(2) was reduced to E $ 40,000. The period of the exemption under Article 5(2) was reduced to three years, while the Minister's discretion to provide for a shorter period seems to have been eliminated by deletion of the "up to" language.

9. Proclamation No. 173 of 1961, Negarit Gazeta Year 20 No. 13 (1961).
10. *Ibid.*
11. *Ibid.*
12. Investment Decree of 1963.

A further revision of Ethiopia's income tax exemption provisions was made by the Investment Proclamation of 1966,[13] presently in effect, which applies to all enterprises commencing operations on or after November 7, 1966. Perhaps the most significant change is the establishment, in Article 4, of a permanent Investment Committee:

> which shall have as its principal purpose the study and determination of measures to be taken with respect to facilities, tax exemptions provided in this proclamation, and relative benefits and privileges to be accorded to potential investors in order to stimulate and encourage capital investment in Ethiopia.[14]

The structure of Article 5 of the Investment Proclamation of 1966 is basically the same as that of the Investment Decree of 1963. However, the Minister of Finance is to grant exemptions upon the *determination* of the Investment Committee rather than upon its *recommendation*. In addition, the minimum investment for an extension or expansion of an existing enterprise is lowered to E$ 200,000, the same investment as must be made by a new enterprise wishing to qualify.

II. The Investment Proclamation and Foreign Laws

It will now be helpful to compare the provisions of the Investment Proclamation with the provisions of similar laws in effect in other developing countries. First we will survey the type of provisions typical of such laws, then return to the provisions of the Ethiopian law.

The period of the exemption and the extent of the relief

Income tax exemptions are granted for varying periods of time. Puerto Rico's 1948 act had a twelve year exemption period; the 1945 act reduced this to ten years.[15] In Mexico, under the 1955 law, the period of exemption is ten, seven or five years depending on whether the industry involved is considered "basic," "semi-basic" or "secondary." But an exemption period can be much shorter if it is granted under a "most favoured company" provision. Such a provision is found in both the Mexican and Puerto Rican laws.[16] It operates to grant an exemption to all companies which produce the same product but only during the period of time for which the initial tax exemption granted continues in force. Without such a provision the company receiving the exemption might enjoy a substantial advantage over its non-exempt competitors.

The extent of tax relief can also vary. The exemption may relieve a company of all or only a part of its income tax liability for the period of the exemption. Under the 1955 Mexican law, for example, the Ministry of Public Finance and Public Credit is empowered to fix the tax exemptions or reductions to be granted after consulting with the Ministry of Economy;[17] as of 1959, the exemption extend-

13. Proclamation No. 242 of 1966, Negarit Gazeta, Year 26 No. 2 (1966).
14. *Ibid.*
15. Kaufman, *Income Tax Exemption and Economic Development* (1959) p. 27 (hereinafter cited as Kaufman).
16. *Ibid.*
17. Law for the Development of New and Necessary Industries, Official Gazette, Jan. 4, 1955, Art. I (hereinafter cited as 1955 Mexican Law).

ed only to 40% of the tax due.[18] On the other hand, complete income tax relief is provided for in the 1948 and 1954 Puerto Rican acts, which also extend the exemption to property taxes and various municipal levies.[19]

Eligibility for exemption

Income tax exemption laws usually do not give tax relief to all enterprises. According to Heller and Kaufman:

> The most commonly encountered criterion (and in many statutes the only explicitly stated one) employed to ensure that ... income tax exemption (is) granted only to enterprises actually in need of a tax preference is that the product the enterprise manufactures be "new" to the country.[20]

The Mexican law of 1955, for example, grants exemption only to "new" or "necessary" industries.[21] Both these classifications are subdivided into "basic," "semi-basic" and "secondary"[22] in order to determine the length of time for which the exemption is to be granted. Which of the latter categories a given industry falls into depends on its importance to the development of the Mexican economy. The 1948 and 1954 Puerto Rican laws grant income tax exemption to "new" industries and to a list of existing industries, the encouragement of which is considered desirable.[23] Similarly, the 1952 Ghana Income Tax Ordinance gives exemption to "pioneer industries," defined as industries which are "not being carried on in Ghana and ... (for which) there is ... favourable prospect for further development."[24] The Philippine law extends exemption to "new *and* necessary" industries: the firm must also "operate on a commercial basis, contribute to a stable and well-balanced national economy, and in most cases import less than 60% of costs."[25] The laws of these four countries appear to have a common objective: to encourage the development of industries which either have not been established at all or which are established but not on a scale adequate to the need of the country.

A common additional criterion limits exemptions to industrial enterprises. For instance, to qualify under the 1948 Puerto Rican act, an enterprise had to produce a "manufactured product," defined as "not only all products transformed from raw material into articles of commerce finished by hand or machinery, but also any product the value of which, in the judgment of the Executive Council, is substantially increased by processing, assembling or extracting."[26] The 1955 Mexican act required that an enterprise seeking tax exemption add at least 10% to the value of the product it manufactured.[27] This requirement was meant to insure that "the enterprise

18. Kauffman, p. 27.
19. *Id.* at, p. 28
20. Heller and Kauffman, Tax Incentives for Industry in Less Developed Countries (1959) p. 42 (hereinafter cited as Heller & Kauffman).
21. Ross & Christensen, p. 55.
22. *Ibid.*
23. Kauffman, *op. cit.*
24. A.H. Smith, *Tax Relief for New Industries in Ghana*, 11 National Tax Journal 362 (1958).
25. Kauffman, p. 27.
26. Taylor, p. 51.
27. Ross & Christensen, p. 69.

(would) contribute substantially to the national economy."[28] There was also a requirement that 60% of all manufacturing costs be incurred within Mexico. This requirement imposed "a limit upon the percentage of direct costs which may be represented by raw materials from foreign sources."[29]

Provisions of this sort, limiting the exemption to manufacturing enterprises or requiring that the enterprise add a certain percentage to the value of the product, at least in part reflect a judgment as to the general course the country's development should take. To the extent that such provisions are effective, they tend to steer investment away from trade and the relatively simple processing of agricultural and other primary products (cleaning coffee, for example) to industry.

The Ethiopian law

The Investment Proclamation differs in a number of respects from these laws. In general, these differences consist in the proclamation's more general terms, and concomitant lack of attention to a number of common and important problems.

The proclamation does not have a "most favoured company" clause. Under Article 5, an exemption can only be granted or disallowed. If a newly established enterprise would have a competitive advantage over an exising enterprise because of its tax exemption, then the Committee must choose between granting the exemption together with the advantage and denying the exemption outright. If an existing enterprise could also be granted the exemption under a "most favoured company" clause, this problem would not arise.[30]

The proclamation also tends to be less strict in its requirements for eligibility for exemption. Under most statutes, "the conferral of benefits is confined to taxpayers who conduct their activities in corporate form ... (and benefits) are also typically confined to corporations that are domestically organised."[31] But in Ethiopia, as in Israel and Puerto Rico,[32] exemption may be granted to enterprises of almost all types,[33] without regard to the legal form or nationality of the enterprise.

A more important difference of this kind is that, unlike other nations, Ethiopia does not require that the exemption-seeking enterprise be in a "new," "necessary" or "pioneer" industry. The absence of such a requirement may mean that enterprises which do not require tax preference in order to become established will nevertheless receive it, depriving the nation of tax revenues which would be used to finance further development. To justify the absence of such a requirement, it might be argued that Ethiopia is at a lower level of economic development than many developing countries, and hence almost all enterprises may be considered "new," "necessary" or as contributing to Ethiopia's economic development. In addition, Article 5 of the proclamation provides that the exemption shall be granted by the

28. *Ibid.*
29. *Id.* at p. 70.
30. This problem may not be acute at the present stage of Ethiopia's economic development since there are so few existing enterprises which competition could seriously affect. It will become more acute, however, as economic development progresses.
31. Heller & Kauffman, p. 24.
32. *Id.* at, p. 34, note 68.
33. The only major omission is commercia enterprises.

Minister of Finance "upon the determination of the Investment Committee."[34] This determination can perhaps be used to limit exemption to enterprises that the Investment Committee feels would advance economic development in Ethiopia.

If the committee does have discretion of this kind, its determinations obviously are very important to the administration of the proclamation. The precise role of the Committee in the grant or denial of an application for exemption under the proclamation is not clear, however, and this ambiguity could cause uncertainty in the mind of a potential investor. Article 5 of the proclamation tells the investor relatively little in this respect. For him to estimate his chances of receiving an exemption, he should also know the more detailed standards used by the Committee in applying the statutory requirements and also whether the Committee considers factors in addition to those enumerated in the statute, such as the value of the enterprise to Ethiopia's economic development.[35] An outline of the standard applied by the committee could be published under Article 12 of the proclamation, which empowers the comittee to issue regulations; the writer understands, however, that the Committee has been slow to articulate and make generally known the standards it uses in making its decisions in the past. If the Committee is to make consistent determinations in a way which will further Ethiopia's economic development, it will have to develop general policies to facilitate its decision-making process and, equally important, make those policies known to the public.

One fruitful area for elaboration by the Committee is the definition of "industrial enterprise," one of the categories of enterprise specified in the proclamation as eligible for exemption. The lack of a definition of this term in the proclamation leaves open several important questions. Is an enterprise "industrial" if it adds only a small percentage of value to what it produces — for example a plant for assembling radios or buses from imported parts or a coffee cleaning plant? Should a certain percentage of the direct cost of the product be derived from Ethiopia before the Investment Committee determines, under Article 3 (2), that an enterprise is an "industrial" one? Questions such as these are answered to some extent by the Mexican and Puerto Rican laws, which include more complete definitions of the enterprises to be exempted.

III. The Value of Income Tax Exemptions in Attracting Investment

The fundamental purpose of most income tax exemption laws is to promote economic development by making the investment climate more attractive than it would otherwise be. The law may be framed in terms that would cover both domestic and foreign investors, as is the Ethiopian law.[36] However, developing countries usually do not have enough domestic capital to promote rapid economic development, and so it is primarily to the foreign investor that a tax exemption law is directed.

34. Investment Proclamation of 1966, Art. 5.

35. Of course, how applicants in a similar position have been treated in the past will also be helpful in estimating one's own chances of success.

36. See, e.g., 1955 Mexican Law, Art. I: "The purpose of the present law is the development of national industry through the granting of tax concessions which stimulate the establishment of new industrial activities and the better development of existing ones."

Thus, the crucial question in evaluating an income tax exemption law is whether it is effective in attracting foreign capital which would not have come, absent the exemption. If the enterprises that receive the exemption would have been established in any event, the government has sacrificed tax revenues and received nothing in return.

Many countries cite Puerto Rico's apparently successful income tax exemption policy as a reason for adopting a similar policy of their own. Taylor points out, however, that Puerto Rico is in a unique position vis-a-vis developing areas, and that this should be kept in mind in appraising the country's tax exemption policy:

> Puerto Rico is the only area in the world that has the singular advantage of being within the tariff area of the mainland United States but not subject to federal taxes.[37]

and

> Puerto Rico ... is a unique tax exemption case; it is the only area within the United States economic and political complex in which it is possible for mainland enterpreneurs to obtain a virtually complete tax holiday for a limited period of time.[38]

The special relationship of the island to the United States is probably not given sufficient weight in determining whether income tax exemption will be as successful in other developing economies as it is thought by some to have been in Puerto Rico.

On the other hand, a survey by Taylor of companies which had recently located in Puerto Rico does give some support to the view that income tax exemptions have contributed to Puerto Rico's development. Forty-one out of forty-three companies cited the availability of the exemption as an advantage of Puerto Rico as an industrial location.[39] In answer to the question, "Would you have started your new business in the absence of tax exemption?," thirty-seven out of forty-four firms questioned (84 per cent) "answered that they would not have initiated operations in the absence of this subsidy."[40] However, Taylor discounts somewhat the impression these responses create, because of the "post-mortem nature of the inquiry."[41] He reasons that established firms have an interest in preserving tax exempt status, and so may tend to over-emphasize it as a motivating factor to encourage the government to retain the subsidy.

Ross and Christensen made a similar survey of Mexican firms. Their conclusion as to the effectiveness of income tax exemption as a stimulus is particularly interesting since Mexco's position is more akin to that of other developing countries than is Puerto Rico's. Ross and Christensen found that:

> There appears to be no instance in the recent past when tax exemption was *the* decisive factor in an investment decision in Mexico; in fact, there is probably no situation in which it was even a decisive factor .... (It) appears

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37. Taylor, p. 5.
38. *Ibid.*
39. Taylor, p. 124.
40. *Id.* at p. 129.
41. *Ibid.*

that in most cases the tax exemption possibility is not even taken into serious consideration when considering an investment in Mexico.[42]

If the purpose of income tax exemption is to attract foreign investment which would not otherwise have come, these findings indicate that such measures have not been successful in Mexico and they raise serious doubts as to the contribution they may make elsewhere.[43] Other commentators have also expressed doubts as to the effectiveness of a tax exemption measure.[44]

One major reason for doubting the effectiveness of income tax exemption provisions is that it appears that income taxes are not an important factor influencing potential investors. Heller and Kaufman comment that:

> in evaluating the utility of tax incentives, one crucial factor to be considered is that for many economically less developed countries the tax system is relatively unimportant, compared to other factors impeding development.

and

> since tax incentives are but one, and, especially in economically backward countries, only a marginal factor (in an investment decision), it is probably illusory to attribute any but marginal significance to their impact on the prospective investor's estimate of the congeniality of the "investment climate."[45]

The force of these observations is even greater if the income tax rates in the exempting country are low. The basic rate on business income in Ethiopia is 20%.[46] A surtax of 10% is imposed on income in excess of E $ 30,000[47] and an additional surtax of 10% is imposed on income in excess of E $ 150,000.[48] These levels are raised in the case of corporations having paid-up capital of E $ 5,000,000[49] or more. Only in a few cases would the effective rate[50] of tax on all income exceed 25%, which is a very modest tax rate by world standards.

Similarly, Taylor points out that tax exemption by state and local governments within the United States as an incentive for relocation of firms has not worked, because this factor alone is not enough to overcome other obstacles to investment in the locality such as "the cost of labor ... the distance from markets and the

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42. Ross & Christensen, 101.
43. Kauffman also doubts that the Puerto Rican income tax exemption provisions "were necessary elements in the investment decision." Kauffman p. 37.
44. See Heller & Kauffman, *op. cit.*
45. Heller & Kauffman, 60.
46. A Proclamation to Provide for Payment of Income Tax, Proclamation No. 173, Negarit Gazeta Year 20, No. 13, Art. 12(b) (i) (1961), as amended by Proc. No. 255 of 1967, Negarit Gazeta Year 27, No. 4.
47. Proclamation No. 173, *op. cit. supra* p. 61, Art. 13(a).
48. Proclamation No. 173, *op. cit. supra* p. 62, Art. 13(b).
49. Proclamation No. 173, *op.cit. supra* p. 62, Art. 14.
50. The effective rate of tax is the total tax paid by the taxpayer divided by his total income. The *marginal* rate of tax, on the other hand, is the rate at which the taxpayer is taxed on each *additional* dollar of income. A taxpayer subject to both 10 per cent surtaxes under Schedule C is taxed at a marginal rate of 40 percent - the government takes 40 cents out of each additional dollar of income. But his effective rate of tax will be lower because the 40 percent rate applies to only the top part of his income; the rest is taxed at 20% or 30%.

source of raw materials."[51] The exemption has usually been of property taxes, which are relatively low. Ethiopia is in a position in the world community somewhat similar to that of a state which grants a property tax exemption in the United States. Exemption from a low tax, even in the case where the exemption is taken into consideration in making a decision to invest, will probably not be enough to persuade a hesitant investor to go forward if the primary reason for his hesitation is other cost factors.

Perhaps the strongest argument in favour of income tax exemption is that it "may engender a nonrational response from the potential grantee because it serves as an advertising lure which stimulates interest in the potentialities of an area."[52] However, the cost of this form of advertising may be more than the advertising is worth.

There is no great harm in an unsuccessful tax policy if it costs nothing. In the case of income tax exemption, however, the costs can be substantial. Most developing countries have few revenue sources to begin with, and to forgo taxation of a part of the industrial sector may seriously reduce government reveenues. The granting of income tax exemptions to industrial enterprises "increases the gap between basic development and the only reliable source of financing the annual costs of the development."[53] In view of the considerable cost of granting exemptions, it may seem fair to place the burden of proof on their proponents. If it cannot be demonstrated clearly that an income tax exemption policy is fulfilling its purpose in attracting capital which would not otherwise have come, then perhaps the policy should be abandoned since the costs are so high.[54]

IV. Alternatives to Income Tax Exemptions

Assuming that income tax exemption is not an effective measure for attracting new capital, what are some alternatives? Direct subsidies have been suggested by some writers.[55] One form of direct subsidy might be a government guarantee of a certain percentage return on invested capital for a period of time.[56] If six percent were guaranteed, for example, someone investing E$ 200,000 would be assured of an annual return of E$ 12,000. If profits fell short of this during the period of time, the government would make up the difference. This would have the advantage of granting a benefit to all new investors and not just those who make a profit as is the

51. Taylor, p. 5.
52. Kauffman, p. 24.
53. A.H. Smith, *op.cit. Supra* note 8, at, p. 367.
54. Taylor comments that "the aggregate cost of exemption ... has been inordinately high. Much of the burden is in the nature of indirect effects and disguised social costs ... The principal disadvantages of tax exemption are: (1) The direct revenue loss of tax exemption is sizeable but is largely concealed and indeterminate. (2) Tax exemption lacks selectivity to a marked degree. (3) Tax exemption tends to become permanent and to proliferate to other taxable areas of the economy, as well as to other political areas. (4) The administration of tax exemption is difficult and burdensome. (5) Tax exemption frustrates the achievement of a fair distribution of the tax burden." Taylor, p. 152.
55. *Supra*, note 32.
56. Some sort of limitation as to the reasonableness of the investment in relation to the business activity would have to be made to prevent inflated investments for the purpose of taking advantage of the subsidy.

case under the income tax exemption.[57] The subsidy a company receives would be limited to this percentage return instead of extending to the total amount of profits and, since the income tax would be retained, the government would not lose revenue from this source. Under this scheme, however, the government would also have to subsidize losses which might be quite high, and a company which should go out of business might be kept needlessly in existence for the period of the subsidy. This objection might be met by subsidizing only a percentage of a company's losses; for example, up to 20% of invested capital each year for no more than three years in a row, for five years from the date of commencement of the enterprise. Taylor mentions a similar proposal which would tax "profitable firms and (underwrite) 50 percent of the losses of unprofitable units. (This) would have cost only about one-half of the amount expended on the present (Puerto Rican income tax) subsidy. In fact, it would have been possible to guarantee all new firms either a 15 percent return on intended investment in machinery and equipment, at a lower cost than the income tax subsidy."[58] Since many enterprises do not plan to make much of a profit in the first few years of operation anyway, income tax exemption is not a very great inducement to them. This kind of enterprise would find a guaranteed percentage return on invested capital more attractive than exemption from income tax.

Another proposal would retain the income tax exemption, but argues that "the relief should be tied to the amount of the capital investment *without any* limitation of the period of time (during which an exemption is allowed) at all." A company would not be taxed on income until an amount equal to its initial investment had been recouped. This would help the enterprise which has no profits in its early years. An enterprise which never makes a profit would not be taxed at all; neither would it receive a benefit, but "possibly there is no reason why such a business should be subsidized."

Conclusion

It is doubtful that the income tax exemption provision of the Investment Proclamation of 1966 will be very effective in attracting foreign investment to Ethiopia. The exemption provision may even have an adverse effect if government officials consider it to be an important element in a program to encourage foreign investment, because it could divert attention from other efforts which may be less spectacular but more productive. In addition, the cost of the exemption may be higher than the benefits derived, and yet costs are very easy to overlook because they involve no direct expenditure by the government.

The appeal of income tax exemption as an inducement to foreign investment in developing countries, however, is strong. As long as other developing countries continue to grant such an exemption, the pressure on Ethiopia to do so will remain great.

57. Since the income tax is levied on profits, only a firm that begins to operate at a profit before the end of the exemption period would receive any benefits from an income tax exemption.

58. Taylor, p. 118.