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PRIVATE INVESTMENT IN ETHIOPIA: THE AFRICAN CONTEXT, REGULATORY FRAMEWORKS, AND ACHIEVEMENTS

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INTRODUCTION

Ethiopia, with a population of 61 million and land area of 1.14 million square kilometres, is quite a large country. Ethiopia has considerable potentials for investment and trade. The country has the largest livestock population in Africa. The country's domestic raw materials and mineral reserves of the country can create investment opportunities in a wide range of areas. The historical monuments of the wild life diversity and the contrasting features of the country provide potential sources of the tourism industry. Lying within 15 degrees north of the equator, with moderating influence of high altitude, Ethiopia enjoys a pleasant climate, especially in the central highlands, where more than 80 percent of the economic activities take place. On the sparsely populated lowlands, a typically sub-tropical and tropical climate prevails. Of the potentially irrigable land, (about 3.5 million hectares) only 3% is currently irrigated. Ethiopia has an abundant, assiduous, cheap but disciplined workforce. The minimum wage for unskilled labour is Birr 6.6 (less than 1 USD) a day. The cost of labour in the country is most likely low by any standards.

In spite of such potentials, Ethiopia has remained among the poorest countries in the world. Only an insignificant proportion of the potential resources has been exploited for commercial purposes.

Why Ethiopia failed to exploit its resources through increased trade and investment activities has been largely ascribed to distorted macroeconomic policies that prevailed in early 1970s and 1980s. The reform measures that have been implemented since 1992 are aimed at removing distortions created by the previous regime. Investment policy reforms are among such measures undertaken by the current government.

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The undergoing policy reforms are designed and implemented in the context of the globalisation process. They are meant to enhance Ethiopia's integration into the global economy, mainly through increased openness as envisaged by major donors and international agreements (e.g. WTO). The assumption underlying a strategy of an open economy is that the globalisation process provides Ethiopia with opportunities to be exploited. But whether for Africa, globalisation is more of an opportunity rather than then a challenge has not yet been settled Evidently, Africa is being marginalized in world trade activities and investment flows. Besides, African economies are characterised by institutional and structural constraints in addition to natural disasters, civil strives and HIV/AIDS epidemics that adversely affected the most productive section of the society and created pressure on the already scarce financial resources. Moreover, recent international developments are for from improving Africa's capability to take advantage of the globalisation process. The global economic and financial crisis of recent years tends to enhance Africa's marginalisation in the world economy.

Whether Africa is capable of taking the full advantage of the globalisation process can be investigated on the basis of concrete evidence generated through case studies. Accordingly, this study investigates the extent to which investment reforms are undertaken in Ethiopia and examines how these reforms have impacted investment flows and growth. The Ethiopian case demonstrates the argument that policy reforms alone do not improve a country's ability to adjust to the rapid winds of changes that are taking place in the world economy. The data for this study have come mainly from National Bank of Ethiopia and Ethiopian Investment Authority.

DETERMINANTS OF FOREIGN DIRECT INVESTMENT

The role of foreign direct investment (FDI) in the growth process of developing countries has remained controversial. In the neo-classical approach, FDI is seen as being conducive for sustainable growth. Accordingly, FDI, in addition to providing finance is expected to help promote growth in developing economies by facilitating the transfer of technology, increasing labour force skills, promoting competition, and increasing exports. These "spill over effects" are expected to be translated into greater productivity growth in the economy as a whole [World Bank, 1999b].

More formally, host country determinants of FDI flows to Africa can be classified into three categories [UNCTAD, 1998]: 1) policy frameworks for FDI, 2) economic determinants, and 3) business facilitation.

Policy framework for FDI includes factors such as political and social stability, rules regarding entry and operations, international agreements, privatisation policy, trade policy (e.g. tariffs), tax policy, etc. Africa has perhaps gone considerable way in putting in place the required policy frameworks except the first one, i.e. political stability. However, it should be noted that as FDI policies in many countries become similar, "the value of these policies as tools to influence locational decisions become less pronounced" (UNCTAD 1998:98). Hence, other factors (e.g. business facilitation and economic determinants) become important in determining FDI flows into the region.

Economic determinants can be classified into three categories depending on the motives of trans national corporations (TNCs) interested in the host country, where the TNCs motives can be market-seeking, resource/asset-seeking or efficiency-seeking. These categories are, therefore, 1) market-related factors (e.g. market size and per capita income, market growth, access to regional and global markets, country-specific consumer preferences, and structure of market); 2) resource/asset-related factors (e.g. raw materials, low-cost unskilled labour, skilled labour, physical infrastructure, and technological, and other assets); 3) efficiency-related factors (e.g. costs of assets like raw materials and labour, transport, intermediate goods, etc.,) and membership of regional integration agreement conducive to the establishment of regional corporate networks) [UNCTAD, 1998].

Business facilitation efforts include factors such as investment promotion efforts (including image-building and investment-generating activities and investment facilitation services), investment incentives, hassle costs (related to the reduction or elimination of corruption, improving administrative efficiency, etc.), procedures for getting licenses, contract enforcement mechanisms, access to land, social amenities (e.g. availability of high standard schools, quality of life, etc.), and after-investment services.

In Africa, market-related factors are not encouraging in attracting FDI as market size is small and per capita income is low. The size of the market in the entire continent (excluding South Africa) is less than that of South Korea (UNCTAD 1998). In addition, consumer preference in Africa is highly biased in favour of basic necessities such as food and the demand for high tech products is low. Also, Africa (except North Africa) does not provide locational advantage in terms of access to global markets.

Historically, Africa's most important determinant of FDI has been the availability of human (during the era of slave trade) and natural resources. Since then, however, the relative importance of natural resources has been reduced in an increasingly globalised

world. Though declining in relative importance, the availability of natural resources is still an important determinant of FDI and continues to offer possibilities for inward investment in resource-rich countries (UNCTAD 1998: 107).

In Africa, efficiency-related factors, too, are not encouraging in light of efficiency levels already attained in other regions competing for FDI. Costs are unnecessarily inflated because of high transaction costs of doing business. Transportation costs alone are very prohibitive in Africa.

One lesson we can draw from Africa's experience in attracting FDI is that "there is no single determinant that could explain by itself the recent relative success of the forerunners" (UNCTAD 1998: 189). Neither availability of natural resources nor liberalisation alone is enough to attract adequate and growing FDI into Africa. Perhaps, the flows of FDI into the region depend on the combination of the following factors:

1. A stable and predictable macroeconomic environment and good governance;
2. Political stability and intense investment promotion activity;
3. Business facilitation environment including conducive regulatory frameworks, efficient and corruption-free administration, and institutional reforms (including reforms of bank laws, contract enforcement mechanisms, properly defined property rights);
4. Increased regional integration efforts to overcome small market size and achieve economies of scale; and
5. Availability of human and natural resource reserves and large markets.

However, these factors alone are not enough to improve investment conditions in Africa. Additional measures include initiatives to be undertaken by the international community. These initiatives may include the provision of quota-free and duty-free status for Africa's exports, as being considered under the planned United States-Africa Growth and Opportunities Act. Debt relief is also another measure that could improve investment conditions in Africa.

INVESTMENT POLICY OF ETHIOPIA*

Ethiopia has achieved substantial progress in stabilising the economy and deregulating economic activities that had been previously subjected to a Soviet-style central planning. Policy measures have been undertaken aimed at correcting price distortions, removing restrictions earlier imposed on the private sector, reducing macroeconomic imbalances, realigning the exchange rate, deregulating the labour market and liberalising trade.

In addition, some institutional reforms were undertaken (e.g. decentralisation of government structure and the devolution of power to the regional states, fiscal decentralisation, streamlining of the licensing procedures, reform of the civil service, etc.).

The Ethiopian tax system has also become more favourable to the private sector since the liberalisation process was initiated in 1992. Several maximum tax rates have been reduced. For example, the maximum rate for business income. and profit has been reduced from 89% to 40% in 1994 for unincorporated firms and a flat rate of 35% was set for corporate bodies. Also, the tax regime has become simpler to administer. For example, the number of tax rate brackets has been reduced for business income tax and for import tariffs.

To promote private investment, the Government has undertaken specific measures that have resulted in some increases in the rate of domestic private investment. The private sector is encouraged to invest in most areas of the economy. A foreign investor may be engaged in joint ventures or may set up a wholly foreign-owned enterprise.

However, some restrictions are imposed on foreign investors. These are: 1) a minimum equity capital of USD 300, 000 is required from any foreign investor who intends to inter into a joint venture with a domestic investor; 2) the share of the domestic partner cannot be less than 27% in a joint investment; 3) a foreign investor, who intends to invest on his own, except in engineering and other technical constancy services (which is a minimum of USD 100,000), is required to invest not less than USD 500,000; 4) a foreign investor is not allowed to invest in areas reserved for Ethiopian nationals or the Government (e.g. banking and insurance business, generation and supply of electrical energy, rail transport

* The first part of this section draws from a report of Ethiopian Investment Authority (1998) and Proclamations No.37 /1996 and No.116 /1998, and Council of Ministers Regulations NO. 7/1996.

services, air transport services); and 5) investors shall be allowed to invest in defence industries and telecommunication services only in partnership with the government.

Ethiopia provides different guarantees and benefits to attract FDI. These include repatriation of capital and profits, guarantees against expropriation, and adequate compensation in case of expropriation in the interest of the public and in compliance with the requirements of the law. Also, Ethiopia is a member of the World Bank-affiliated Multilateral Investment Guarantee Agency (MIGA).

To encourage private investment and promote the flows of FDI and technology, Ethiopia provides different incentives. These are fiscal incentives, R & D incentives, and concession regarding loss carried forward. Fiscal incentives have included a 100% exemption from the payment of import duties for capital goods; exemption from customs duties or from other taxes levied on imports of raw materials necessary for the production of export goods; tax holidays differentiated by type of investment and location; and deduction of expenses incurred for research and training.

In addition, vigorous investment promotion activities are being undertaken by the Ethiopian Investment Authority (EIA) and by similar organisations. The EIA provides, among other things, a one-stop shop for investors in order to reduce cumbersome bureaucratic Procedures.

The policy response of investment can be summarised as follows. Regarding private investment, FDI has responded poorly; the initial increase in private investment (which is dominated by domestic investors) has not been sustained; 71% of approved projects are not yet implemented; the Government's objective of encouraging investment in the disadvantaged regions was not successful. Western MNCs have shown little interest in investment opportunities in Ethiopia; Asia (Saudi Arabia, in particular) has dominated FDI flows to Ethiopia; and private investment has contributed little to easing the country's unemployment problems.

To what extent has the performance of investment contributed to the growth of the economy? This is a difficult question to answer. Nonetheless, the performance of the overall economy in the post-reform period is as follows.

The Ethiopian economy has exhibited noticeable improvements in the 1990s as compared to the 1980s. Real GDP growth has increased from 1.9% in the 1980s to 4.7% in the 1990s. Similarly, the growth rate of per capita GDP increased from -1.2% in the 1980s to 1.6% in the 1990s. A considerable degree of macroeconomic stability has been achieved

by maintaining the rate of inflation at around 6.7% as estimated on the basis of the Addis Ababa consumer price index.

Regarding the foreign exchange market, considerable achievements have been registered since October 1992 when the Ethiopian Birr was devalued by 59 percent. The difference between the official and the parallel rates has been progressively narrowed from about 6 Birr during the pre-devaluation period to Birr 2.50 in 1992/93 and then to 0.37 Birr in 1996/97 in the post-devaluation period. In fact, at one time it was reported that the parallel market rate fell below the official rate.

In the weekly auction market, the demand for the U.S. Dollar has exceeded the supply of the Dollar. During the period 1992/93-1997/98, total supply of the U.S. Dollar in the auction market has met only 75% of the total demand. The excess demand has contributed to progressive depreciation of the Birr. The average marginal rate increased from Birr 4.27 in 1992/93 to Birr 6.88 in 1997/98.

Though improvements are observed, the growth of the economy has failed to keep pace with population growth (which is around 3%). GNP per capita dropped from $ 164 in late 1980s to $ 119 in the 1990s. Similarly, total consumption per capita dropped from $ 151 to $ 101 between the two periods.

Gross domestic savings, as percent of the GDP, have remained not only low by any standards, but also dropped from about 7% in the 1980s to about 6% in the 1990s. The still widening gap between gross domestic capital formation and the gross domestic savings shows that an increasing proportion of the gross domestic capital formation is being financed by external sources.

On the other hand, gross domestic investment increased at an annual average rate of 15.4% during 1990-1998 compared to only 4.2% Sub- Saharan Africa. Such a growth rate can be partly explained by the extremely low level of initial conditions of private investment in the country and by the abrupt rise in investment in mid-1990s following the liberalisation of the economy.

The private sector has assumed increased importance in the economy since the downfall of the old regime as discussed above. Credit to the private sector has been increasing at annual average rate of 29% in recent years as compared to 9% in late 1980s. Net private capital flows increased from –45 million dollars in 1990 to 28 million dollars in 1997.

Improvements in macroeconomic variables have been associated with increased inflows of official financial resources and consequent increases in the debt burden. The country's total external debt increased from an annual average of 6,850 million dollars in late 1980s to 9,607 million dollars in the 1990s. The debt to GNP ratio increased from 41% in late 1980s to 77% in mid-1990s, while the debt to export ratio rose from 374% to 607% over the same period.

CONCLUDING REMARKS

From the above, we can conclude that Ethiopia has not fully succeeded to boost investment activities required for growth of the economy in spite of important reforms undertaken in the area of policy and regulatory frameworks since 1992. Perhaps, this confirms the argument that African economies cannot grow by focusing on the problem of "getting prices right" alone. To grow, an African country should address structural and institutional constraints prevailing in the domestic economy, in addition to manipulating policy variables and regulatory frameworks. Moreover, the international environment, which is today a challenge for Africa, must be a conducive one, though unlikely.

Ethiopia has to do more in the area of business facilitation than in the area of policy reform. In particular, increased institutional innovations are required to further promote private investment in the country. These observations are in line with another study under taken in Ethiopia [Workie, 1996]:

> *The encouragement of private investment is not only a question of relatively liberal investment laws, establishment of investment institutions which facilitate investor needs, but also is a question of making resources available particularly land, finance and infrastructure. Bureaucratic procedures in these institutions have to be improved in order to activate private investment.*

Similarly, the conclusion of this study is more or less in line with the one reached for Africa as a whole: "It is obvious that the trade reforms and investment incentives yielded results that are unsatisfactory by any standards" [ECA, 1997: 59].

Further research is required to more deeply investigate the problems and prospects of promoting investment in Ethiopia. For example, the following issues need to be

investigated: What concrete factors explain the fact that 71% of approved projects are not implemented? Why are some projects successfully implemented while others are not? What concrete factors explain the low level of implementation of approved investment projects?

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