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**COLLEGE OF LAW AND GOVERNANCE STUDIES**  
**SCHOOL OF LAW**  
**GRADUATE PROGRAM**

**Masters of Laws (LL.M) in Business Law**

**Reconsidering Ethiopia's Tax Incentive Policy on Hospitality Sector**

**A Thesis Submitted in Partial Fulfillment of the Requirements for the Award  
of Master of Laws (LL. M) in Business Law at School of Law, College of Law  
and Governance Studies, Addis Ababa University**

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**Advisor: Dr. Tadesse Lencho**

**September, 2020**

**Addis Ababa, Ethiopia**

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**By**

**Alemi Desta**

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**September, 2020**

## Declaration

I, **ALEMI DESTA**, hereby declare that the thesis titled ‘Reconsidering Ethiopia’s Tax Incentive Policy on Hospitality Sector’ is my original work and that it has not been submitted for any Degree or examination in any other University. I also pledge that all sources used in any form are duly acknowledged.

Alemi Desta

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## Abbreviations and Acronyms

Art.	Article
BoQ	Bill of Quantity
ETB	Ethiopian Birr
ESA	Ethiopian Standard Agency
FDI	Foreign Direct Investment
FY	Financial Year
GDP	Gross Domestic Product
GTP	Growth and Transformation Plan
IMF	International Monetary Fund
OECD	Organization for Economic Co-operation and Development
PASDEP	Plan for Accelerated and Sustained Development to End Poverty
Proc	Proclamation
Reg	Regulation
UNCTD	United Nation Conference on Trade and Development
VAT	Value Added Tax

## Abstract

*Hospitality sector as smokeless industry is becoming prior investment choice throughout the world. In order to attract potential investment in this sector, tax incentive has been widely in use by governments of different state to which Ethiopia is no exception. However it is subjected to wide abuse by beneficiaries and corrupted by involved granting authorities. Hence the main purpose of the thesis is to scrutinize whether Ethiopia's tax incentive Policy in hospitality sector is designed and implemented properly. It scrutinize applicable laws on tax incentive and assess the roles of enforcement authorities. After discussing design of the existing tax incentive laws vis-a-vis practical implementation, the writer argued that Ethiopia should reconsider the existing tax incentive Policy in hospitality sector. Finally, in order to control tax incentive abuse in this sector, the writer forwarded areas for recommendation including enactment of specific guidelines to regulate bill of quantity and establishment of designated institution.*

Key Terms: Hospitality Sector, Investment, Tax Incentive Abuse

## Chapter 1: Introduction

### 1.1. Background of the Study

Investment is the vital instrument for one country's economic and social development as it creates wide job opportunity, facilitate technology transfer, and contribute for one country's GDP growth. Tourism and hospitality sector is one of the fastest growing smokeless industry providing various socio economic advantages for a country. It offers abundant opportunities for poverty reduction by creating wide job opportunity, generating government revenues and increase foreign exchange.<sup>1</sup>

Cognizant of the sectors various socio-economic contributions, government of different states have been providing different means of encouragement and incentive to stimulate investment in the area. Different literatures define investment incentive as any economic advantages that government provides to certain business activity with an aim of influencing investment decision into favored areas.<sup>2</sup> Among different means of investment incentive, tax incentive has been used as one mechanism to attract both domestic and foreign investment.<sup>3</sup> Hence, tax in addition to raising revenue for government has the potential to determine investment decision in a particular sector.<sup>4</sup> Among various means of tax incentive the typical ones are, tax holiday, investment tax credit, loss carry forward and an exemption from customs duties.

Though tax incentive has been considered as one mechanism for investment attraction, its effectiveness is challenged by different scholars and subjected to various criticism and dialogue among academicians on the area. Richard Bird argues that an attempt to achieve various goals through tax incentive may result in inefficient tax collection system and widely open for

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<sup>1</sup> United Nation World Tourism Organization, *Annual Report (2015)* Available at:<https://www.e-unwto.org/doi/pdf/> 36 <accessed in February 13 2019>

<sup>2</sup> Sebastian James, 'Incentives and Investments: Evidence and Policy Implications' (2009) 1

<sup>3</sup> Bajracharya and Flatters, 'Ghana's Trade Policies: Exemptions from Import Duty' (2009) Available at: [http://qed.econ.queensu.ca/faculty/flatters/writings/ff\\_ghana\\_exemptions.pdf](http://qed.econ.queensu.ca/faculty/flatters/writings/ff_ghana_exemptions.pdf) 14 <accessed in January 20 2020>

<sup>4</sup> Organization for Economic Co-operation and Development, *Annual Report (2009)* Available at: <https://www.oecd.org/newsroom/43125523.pdf> 69 <accessed in February 2019>

corruption.<sup>5</sup> Regardless of the existing discourse, tax incentive has continued being employed in different country including USA, as one mechanism of investment attraction.

In cognizant of the various socio-economic benefit of hospitality sector, the Ethiopian government has been providing different means of encouragement for the sector including tax incentives.<sup>6</sup> Hence tax incentive for hospitality sector has been used by different Ethiopian Government at different times to transform the industry and to show potential investors the opportunities of investing in the industry.<sup>7</sup>

Though the advantage and disadvantage of tax incentive is subjected to continued discourse among different scholars, it is still employed as one mechanism of investment attraction in a particular sector.<sup>8</sup> The main issue is then how to design effective tax incentive Policy that has a potential to achieve the desired goal of attracting investment and contribute to the growth domestic product /GDP/ of the country.

Coming to the case of Ethiopia's hospitality sector, practical scenario shows that the tax incentive Policy is confronted by various challenges and subjected to wide abuse and create rampant tax evasion in the country.

Generally, in a situation where the existing law does not sufficiently govern tax incentive and strong institutional set-up is not in a place to supervise its implementation, Ethiopia is losing huge revenue each year that goes to the pocket of private individuals and drain governments coffer. Besides, it results in undesired consequence of negatively affecting individual tax payers who aren't eligible for the incentive package.

Hence this study was aimed at examining the existing legal and institutional loopholes contributing for abuse of tax incentive particularly in hospitality sector and devoted to come up with possible solutions against the bottlenecks.

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<sup>5</sup> Richard Bird, 'Tax Challenges Facing Developing Countries'(2008) Rotman Institute for International Business, Working Paper Series No 12, University of Toronto 10

<sup>6</sup> Investment Proclamation, 2020, Proc. No 1180, *Negarit Gazeta*, 26th Year, No.28, Preamble. (Herein after the Investment Proclamation)

<sup>7</sup> Ethiopia Investment Agency, 'Ethiopian Investment Guide', (2012, Addis Ababa Ethiopia) 29

<sup>8</sup> Investment Proclamation, Preamble

## 1.2.The Research Problem and Questions

Promoting hospitality sector and making it competitive in Africa so that it can contribute for the country's GDP is one of the plan recorded under the First Growth and Transformation Plan of Ethiopia.<sup>9</sup> To achieve this goal the government has taken different steps aimed at steering investment in the sector. Among the various activities, most of them were aimed at tourism attraction through promotion, awareness creation, tourism exhibitions, and enacting policies in favor of the investor.<sup>10</sup> At a policy level though agriculture has been considered as a primary source to reduce poverty, for the first time a Plan for Accelerated and Sustained Development to End Poverty (PASDEP) gave recognition for Tourism and Hospitality sector's contribution in eradicating poverty.<sup>11</sup>

Coming to the practical challenges, even if one of the Ethiopian Millennium Development Goal is to reach Tax to GDP ratio 20% by 2012/13 G.C. However, tax to GDP ratio in this Fiscal Year is only 14.6%, which shows 5.4% deficit. The second Growth and Transformation Plan (GTPII) of the country also aims at serving as a spring board towards realization of the national vision of becoming a low middle-income country by 2025.<sup>12</sup> In order to achieve this, it targeted at sustaining the rapid, broad based and inclusive economic growth, which accelerates economic transformation and the journey towards the country's Renaissance by increasing tax revenue contribution to GDP from 13.3% to 17.2% in 2019/20.<sup>13</sup> However, the results for 2017/18 showed unexpected trend that the total revenue contribution to GDP is declined from 4.4% in 2015/16 to 3.3% in 2017/18, showing negative difference of 1.1. %.<sup>14</sup>

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<sup>9</sup> Performance Evaluation of the First Five Years Development Plan (2006-2010) and the Growth and Transformation Plan (GTP) for the Next Five Years (2011-20015) 17

<sup>10</sup> Getnet Salew, 'Tourism Business and Corporate Social Responsibility: Analysis of the Legal and Institutional Framework in Ethiopia' (2018) (Unpublished, Thesis for Master's Degree, Addis Ababa University College of Law) 12

<sup>11</sup> Ministry of Culture and Tourism, 'Federal Democratic Republic of Ethiopia: Tourism Development Policy' (2009) 5

<sup>12</sup> Federal Democratic Republic of Ethiopia, *Growth and Transformation Plan II (GTP II (2015/16-2019/20)*

<sup>13</sup> *ibid*

<sup>14</sup> Gilles Montagnat, 'A Medium-Term Reform Strategy to Modernize Customs Administration' (International Monetary Fund Annual Report 2019) 13

During the 1996 and 2001 G.C, revenue forgone due to tax incentives was higher than the total tax revenue collected.<sup>15</sup> According to Ethiopian Ministry of Revenue statistical report, during the 2010-2018 G.C fiscal years, a total revenue forgone in the form of Customs Duty, Excise tax, Vat, Sur Tax and Withholding Tax amount to four hundred twenty million, four hundred twenty nine thousand and nine hundred forty birr (420,429,940.00) ETB.<sup>16</sup> From this revenue forgone, customs duty exemption take a lion share which amounts to eighty five million, fifty six thousand and five hundred thirty ETB (85, 056,530.00) in the mentioned fiscal years.<sup>17</sup>

The numerical data shows the alerting call to reconsider tax incentive Policy and assess whether it is designed properly to achieve specific goal. Moreover due to the large amount of revenue loss (forgone) from tax incentives, the country is not in a position to finance major Public expenditures such as Public Services and Infrastructures which are a key factor for economic development and growth.<sup>18</sup>

Most of investors make their investment decision by taking different factors in to account like, market demand, government Policy and security whereas, tax incentive is only one factor among them.<sup>19</sup> According to different studies conducted by Ethiopian researchers also, tax incentive given by the current government mainly customs duty exemption is found to be less significant in attracting foreign investment while other factors like, infrastructure, economic and political stability, security, etc. take a lion share.<sup>20</sup>

Regardless of losing huge revenue due to tax incentive, so far there is no study conducted by any of relevant authority to assess whether such loss is justified by its Socio-economic benefit.

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<sup>15</sup> Bereket Fetene, 'Tax Evasion and Avoidance in the Tax Incentive Policies in Ethiopia: The Law and Practice' in Taddese Lencho and Kyle Logue (eds), *The Ethiopian Tax System: Some Contemporary Issues and Problems* (VI Ethiopian Business Law Series 2014) 74

<sup>16</sup> Statistical Data from Ethiopian Ministry of Revenue, Research Directorate

<sup>17</sup> *ibid*

<sup>18</sup> Meron Elias 'Effect Of Tax Incentive on Domestic Investment in Ethiopia: A Case Study in The Manufacturing Sector' (Unpublished, Master's Thesis, Addis Ababa University Department of Accounting and Finance College of Business and Economics 2016) 56

<sup>19</sup> Paul Barbour, 'An assessment of South Africa's Investment Incentive Policy with a Focus on the Manufacturing Sector' (ESAU Working paper 2005) 49

<sup>20</sup> Samuel Kassahun, 'The Impacts Of Tax Incentives in Attracting Foreign Direct Investment In Ethiopia' (Unpublished Master's Thesis Addis Ababa University Department of Accounting and Finance College of Business and Economics 2015) 3

Coming to the hospitality sector it was purported for deep rooted abuse. For example, during the 2002 G.C fiscal year around two hundred fourteen million birr /214,000,000/ was provided as incentive to eighteen/18/ investors and among these, 80% of the incentive is abused by the developers using it for other activities i.e. re-selling at higher price and use it for another business not eligible for incentive.<sup>21</sup> Generally speaking, tax abuse in this sector was classified as duty free importation for fictitious business which does not really exist at the time of incentive grant and importing duty free capital goods and construction materials more than the quantity the said project demands.<sup>22</sup> According to one study, out of 6000 vehicles imported duty free, more than 5000 were illegally transferred to third parties which were not beneficiary of the exemption.<sup>23</sup>

This rampant tax incentive abuse is the contribution of various factors i.e. lax legal frame work, involvement of many government offices in the process of incentive grant, lack of institutional set-up to control the abuse and lack of co-operation among incentive granting authorities. Ethiopian Ministry of Revenue /EMR/ besides implementing incentive grant has a mandate of monitoring tax exemptions and incentives to make sure they are used for the intended purpose.<sup>24</sup> However the Ministry so far has been concerned only with validity issues, checking whether the application made by incentive beneficiary is valid or not and whether incentive is granted by appropriate organ. The Ministry disregarded the duty of monitoring by cross-checking the permission, bill of quantity and other related practical question that justify permission.<sup>25</sup> Moreover Art. 28/11 of Investment Proclamation which identifies the role of different investment authority impose up on each incentive granting authority to follow up and monitor whether the granted incentive is appropriately used for the intended purpose or not.<sup>26</sup> However none of the offices so far have taken a firm step to fulfill their duties of controlling the abuse and as a reason they mention the existence of extraneous challenges. As a result the

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<sup>21</sup> *Ethio channel gazette* no.243 ( Addis Ababa 2002), as cited by Breket Fetene, (n 15) 74

<sup>22</sup> Bereket Fetene (n15) 75

<sup>23</sup> Ibid.

<sup>24</sup> Ethiopian Revenue and Customs Authority Establishment Proclamation, 2008, Proc.No. 587, *Negarit Gazeta*, 14th Year, No.44. Art.6/2

<sup>25</sup> Bereket Fetene (n15) 85

<sup>26</sup> Investment Proclamation, 2004, Proc. No, 769/2004 *Negarit Gazeta*., 18th Year, No.63. Art 28/11

beneficiaries have been abusing the incentive and use it for other purpose rather than the one intended by Policy makers. Despite all this fact still tax incentive remain popular and widely used in the country, even without conducting a single review of its effectiveness.

Depending on the above stated problem statement, the paper posed a core research question ‘whether tax incentive Policy in general and hospitality sector in particular is well-designed’. Accordingly, the study was attempted to answer the following specific research questions:

**RQ1.** What are the major legal loopholes contributing for tax incentive abuse in Ethiopia’s Hospitality Sector?

**RQ2.** Is the existing Ethiopia’s tax administration system is well-organized to control tax incentive abuse?

**RQ3.** What are practical challenges contributing for tax incentive abuse in Ethiopia’s Hospitality Sector?

### **1.3.Objective and Significance of the Study**

#### **1.3.1. General Objective**

As discussed above, tax incentive provided for investors investing in the area of hospitality sector has been subjected to abuse by the developers and unfairly eroded revenue base of the government. Hence the general objective of this study is aimed at critically discussing basic factors that contributes for tax incentive abuse in Ethiopia’s hospitality sector.

#### **1.3.2. Specific Objectives**

In order to achieve the general objective, the following specific objectives were addressed;

- ✓ Appraisal of major legal loopholes that contribute for tax incentive abuse in Ethiopia’s Hospitality Sector.
- ✓ Examining whether Ethiopia has well-organized administrative mechanism in a place to control tax incentive abuse in Hospitality Sector and
- ✓ Scrutinizing how practical implementation contributed for tax incentive abuse in Hospitality Sector.

### **1.3.3. Significance of the study**

This research work is significant in a sense that it would help the law makers to make an informed decision of reconsidering the existing tax incentive laws particularly in hospitality sector. It's also helpful to the concerned implementing authority to beware of different mechanisms of tax incentive abuses in hospitality sector and take an informed steps to tackle the challenge. Moreover as this area is neglected and so far isn't researched by Ethiopian academicians, it will add to the existing literature and serve as a reference for further research and study.

### **1.4.Scope and Limitation of the Study**

Ethiopia has been providing tax incentive since 1949 for different business sectors<sup>27</sup> though hospitality sector got the privilege only after the enactment of the state special decree in 1990.<sup>28</sup> This study however focused on the hospitality sector which is volatile for abuse and tax evasion under the guise of tax incentive. Hence as can be understood from the title itself, other areas of investment eligible for tax incentive were not covered by this study. Secondly, from tax incentive concept the main focus is Customs duty Exemption as it's the only tax incentive grant for hospitality sector. Thirdly the focus is made on how such laws are designed and implemented in hospitality sector, and whether the existing administrative mechanism is appropriately functioning.

Regarding limitation of the study, as far as the knowledge of the researcher is concerned the area is not well explored by Ethiopian researchers and finding literature on the area become one challenge. Moreover since the concerned authority has not conducted a research on the implementation of tax incentive Policy, finding exact statistics information is the other basic challenge the researcher encountered during the study. Regardless of the various challenges the researcher made thorough study of different literature and by employing different research method, came up with the findings.

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<sup>27</sup> See Personal and Business Tax, 1949, Legal Notice No. 138, Negarit Gazeta, 9th year, No. 4

<sup>28</sup> See Council of State Special Decree, 1990, Decree No. 17, Negarit Gazeta, 49th year, No. 12

## 1.5. Research Method and Methodology

### i. Research Method

In legal research there are variety of methods that the researcher can employ. Considering the research problem and objective, along with different philosophy of research approach, the researcher employed mixed method of doctrinal and empirical research methods supported by both quantitative and qualitative data. As the study aims at understanding, criticizing, and analyzing the existing Ethiopian tax incentive laws, it adopted a **Doctrinal Legal Research**. Since it also goes beyond law in the text, to emphasis on examining revenue foregone due to tax incentive in each fiscal year and analyze practical implementation of tax incentive in hospitality sector, which is an aspect of **Empirical Legal Research**. Therefore, the researcher adopted a **Mixed Legal Research**. In this study qualitative research method is used to scrutinize the behavior, attitude and experience of selected study group<sup>29</sup>, hospitality sector investors and tax incentive administrating authorities. This research work is also not devoid of quantitative research that explains data numerically using mathematical applications.<sup>30</sup> Simple statistical tools like charts, table and graphics are used to explain the trend of tax incentive abuse in Ethiopia's hospitality sector.

### ii. Population and Sample

#### o Population

For the purpose of this study, the target population are hotel business registered by Ethiopian Ministry of Trade. Due to the fact that the applicable law consider star rated hotel for incentive eligibility,<sup>31</sup> the focus was made on star rated hotels operating in Addis Ababa. The other population category for this specific study are, Ministry of Culture and Tourism, Ministry of Revenue, Ethiopian Customs Commission, Ethiopian Investment Commission and other government offices involved either in making or implementing tax incentive Policy.

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<sup>29</sup> Yalew Endawok, 'Yemirmir Meseretawi Merhowochna Ategebaber' ( in Amharic 3<sup>rd</sup> ed. , Bahirdar University, 2017 ) 19

<sup>30</sup> Ibid. 17

<sup>31</sup> Council of Ministers Regulation on Investment Incentives and Investment Areas Reserved for Domestic Investors Reg.270/2012 Fed Negarit Gazete, 19year No.4, 2012 Art.13, as amended

### ○ **Sampling Technique**

In selecting the concerned participant (relevant authority and hospitality sector investor) in the survey, the researcher employed Simple Random sampling technique from hotel side and operating respectively in Addis Ababa city. In choosing selected research participants from government offices to acquire depth information, Purposive Sampling was used based on the participant's Policy enforcement role, expertise, and other attributes so as to acquire generalizable information capable of addressing the research questions.

### **iii. Data Type and Sources**

#### ○ **Primary Data**

In collecting the primary data the researcher used two tools namely questionnaire and interview. Questionnaire was used to collect data from Addis Ababa city star-rated hotel operator; and this was the dominant tool to collect the primary data from this groups. The other tool which was used to gather primary data is interview. This tool was employed to obtain the required data from experts of government offices mentioned above. Since legislations/laws are primary source in doctrinal research, the researcher also used different legislations applicable in the area as primary data.

#### ○ **Secondary Data**

In undertaking this study relevant documents from different sources were appraised. Thus, the main documents which were used in this research work are, court decisions, reports, different official records, books, articles and internet sources.

#### ○ **Data Collection Method**

To get relevant data from the study population, in this study the researcher employed different data collection methods, like semi-structured interviews, cases, questionnaires and document analysis.

### **Interview**

The researcher employed semi-structured interview. Since the members of the unit are experts and persons who know well about the practice, the researcher has worked out questions in advance and flow of the interview is modified in the way. Data from Ethiopian Investment

Commission, Ministry of Culture and Tourism, Ministry of Revenue and Ethiopian Customs Commission, were gathered through interview. To get the required information from the interviewees the researcher has taken on average an hour for each interviewee's. The researcher had taken intensive note during the interview. Additionally the researcher had used digital voice recording based on consent of the interviewee.

### **Questionnaires**

The researcher collected the required data through both open and close-ended questionnaires. These questionnaires are prepared for all the selected respondents from star-rated hotels in Addis Ababa city. It was prepared first in English language and then it translated in to the local language Amharic. This is a vital initiative to avoid certain inconveniences and communication barriers with regard to collecting the required data.

### **Documentary Review**

Secondary data were collected by using document review method. The documents that was covered are relevant government Policy and strategy document, court decision, reports, different publications and different books relevant to the study. Additionally, Internet sources were used in this work.

#### **iv. Data Analysis**

Data analysis involves working with data systematically; organizing interview, breaking them into units and synthesizing them. The researcher interpreted the collected data according to their type and nature. Moreover simple Statistical applications like, Percentage and Charts are thoroughly described in statements. For qualitative data obtained from close-ended questions which is categorized as **yes/no**, percentage was used. For qualitative data that are obtained from semi structured interview questions, **content analysis** was used.

#### **v. Ethical consideration**

While conducting interview and questionnaires the researcher has complied with ethical rules to ensure that the participants participated voluntarily and made informed decision. Moreover confidentiality and anonymity of the participants are ensured on the basis of their consents.

## **1.6. Organization of the Thesis**

This study attempts to discuss tax incentive regime in Ethiopia's hospitality sector. The work is divided into four Chapters.

Chapter one introduces the background of the study, research problem and research questions, objective and significance of the study, scope and limitation of the study and research methodology.

Chapter two briefly covers the conceptual framework of investment in hospitality sector and tax incentive. This Chapter consulted different literatures and views in favor and against of tax incentive and finally gave highlight on how to design effective tax incentive laws and parameters to be employed.

Chapter three deals with tax incentive regime in Ethiopian hospitality sector, the legal and institutional frame works. It also deals with practical challenges that contributes for tax incentive abuse in hospitality sector.

Finally, a section of conclusion and recommendations under chapter four is focused towards the end of the Paper. This section briefly summarizes the conclusions and come up with areas for recommendation to be considered by law makers and implementing authorities.

## **Chapter Two: General Over View of Investment in Hospitality Sector and the Role of Tax Incentive**

### **2.1. Conceptual Framework of Investment in Hospitality Sector**

#### **i. Meaning and Concept of Hospitality Sector**

Tourism sector is an industry which provides various services like food, beverages, tourist attraction and accommodation for tourists.<sup>32</sup> Among various tourism area, hospitality sector is the fastest growing industry with its many features.

Defining the word hospitality in a single word is not an easy task as it all depends up on the context one intends to explain. According to Lashley and others, the traditional definition of the term hospitality is more inclined towards economic activity which basically associated with hotel and catering services.<sup>33</sup> Hence they argue for more broaden and interdisciplinary definition which shows the real nature of the discipline.<sup>34</sup>

Broadly speaking, hospitality is the act of being kind to welcome and host guests to fulfill their basic needs i.e. food, drink, and accommodation.<sup>35</sup> A contemporary explanation of Hospitality refers to the relationship process between a guest and a host/companies or organizations which provide food and/or drink and/or accommodation to people who are away from their home.<sup>36</sup>

For the purpose of this study, hospitality sector is defined as, a business activity that renders hotel related service for those peoples who are away from their home for various personal reasons. Depending up on the foregoing discussion, hotel sector is to be mentioned as the primary sector of hospitality industry.

Hotel as one sector of hospitality industry can be defined as, any business oriented establishment which provides rooms, food, lodging and other service for peoples to stay in up on payment of service fee.<sup>37</sup>

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<sup>32</sup> Helen Atkinson, 'Finance and Accounting for Tourism', John Beech and Simon Chadwick (eds.), *The Business of Tourism Management*, (2006) Coventry Business School and Birkbeck College, University of London.

<sup>33</sup> Lashley and other, 'Theorizing Hospitality'(2011) I Hospitality and Society 4

<sup>34</sup> ibid

<sup>35</sup> Murray Mackenzie and others, *Manual on Module II Introduction to Hospitality sector*, (2009) 1

<sup>36</sup>ibid.

<sup>37</sup> Ethiopian Standard Agency, ' Hotels – Grading Requirements And Classification', (2014)

## **ii. Determining Factors of Investment Attraction in Hospitality Sector**

Though the relative importance of various factors are related to the nature of investment, there is a general consensus among scholars regarding the main factors having a potential to determine investment location decision and they can be classified as tax factor and no-tax factor.<sup>38</sup> Non-tax factor includes, market structure, access to natural resources, skilled labor, access to infrastructure, political stability etc. whereas tax factors includes, tax administration system, tax rates and tax incentive policies.<sup>39</sup> The following discussion will highlight how some of the factor determines investment decision in general and hospitality sector in particular.

### **i. Infrastructure**

According to IMF report, tax incentive Policy provided by developing countries is found to be unsuccessful in attracting the required number of investment due to the fact that it is not supported by other elements such as infrastructure.<sup>40</sup> In a situation where road infrastructure is so poor, the government should spent more on facilitating the road rather than providing tax incentive.<sup>41</sup> Hospitality industry by its nature is highly affected by infrastructure as investors consider suitability of transportation as the primary factor.

### **ii. Clarity of Taxation Policy**

Taxation Policy plays a prominent role in investment decision as investors are concerned about its consequence on their investment and it also determines the economic growth of one country as it is the primary source for government revenue.<sup>42</sup> Clarity of taxation Policy is one of the challenges encountered by many developing countries and inhibit flow of investors in a

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<sup>38</sup>Organization for Economic Co-Operation and Development, ‘Tax Incentives for Investment– A Global Perspective: Experiences in MENA and Non-MENA Countries’ Available at: <https://www.oecd-ilibrary.org/finance-and-investment/making-reforms-succeed/> <accessed in September,2019>

<sup>39</sup> *ibid*

<sup>40</sup> Jingqing Chai and Rishi Goyal, *Tax Concessions and Foreign Direct Investment in the Eastern Caribbean Currency Union* (2008) 9 available at <http://www.imf.org/external/pubs/ft/wp/2008/wp08257.pdf> <accessed in May 7, 2020>

<sup>41</sup> Sebastian (n2) 12

<sup>42</sup> *ibid* 11

particular sector.<sup>43</sup> In such scenario incentive can't play any role to mitigate the circumstances. Hence consideration should be made on enhancing taxation Policy to create smooth environment for investment.

### **iii. Market Security**

In a country where economic and political situation is not stable, mainly where property right is insecure, a rigid employment laws is applicable and poor justice machinery exist, tax incentive would play no role in attracting investments.<sup>44</sup>Hence it is necessary first to correct market security and other related factors before embarking up on tax incentives.<sup>45</sup>

Subsections of the next chapter will highlight how the existing Ethiopia tax incentive Policy fail to consider this and other determining factor.

## **2.2. Major Conceptual Frameworks of Tax Incentives**

### **2.2.1. Definition of Tax Incentive**

The term incentive can either be defined broadly covering virtually all assistance provided by government to attract an investor or narrowly as covering only specific types of encouragement offered by states.<sup>46</sup>

The operational definition of tax incentive is, a preferential treatment set up for certain member of tax payers provided in the form of tax exemption, tax holidays, tax credits, investment allowances, import tariffs etc.<sup>47</sup> The main justification to use tax incentive by countries is correction of market inefficiencies, to boost new industries and mobile investment which is

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<sup>43</sup> ibid

<sup>44</sup> Eric M. Zolt, 'Tax Incentives and Tax Base Protection Issues' (Draft Paper No.3, 2013) 6

<sup>45</sup> ibid

<sup>46</sup> United Nation Conference on Trade And Development, 'International Investment Agreements: Key Issues', (2004) Available at: [https://unctad.org/system/files/official-document/iteit200410\\_en.pdf](https://unctad.org/system/files/official-document/iteit200410_en.pdf) II 53 <accessed in September 2019> (Herein after UNCTAD)

<sup>47</sup> United Nations, 'Design And Assessment of Tax Incentives In Developing Countries',(2018) Available at: [https://www.ciat.org/Biblioteca/Estudios/2018\\_design\\_assessment\\_tax\\_incentives\\_UN\\_CIAT.pdf](https://www.ciat.org/Biblioteca/Estudios/2018_design_assessment_tax_incentives_UN_CIAT.pdf) iii <accessed in September 2019>

subject to tax competition, and to subsidize companies during their sector downturn.<sup>48</sup> Practically the objective of tax incentive may vary between developing and developed countries. Developed countries use tax incentive to promote research and development activities, and to support competitiveness of their product in the global market, whereas developing countries use tax incentive to attract foreign direct investment and encourage domestic industries.<sup>49</sup> Whatever the objective is, the definition determines the justification of providing the same and has a lot to do with abuse of the privilege.

Taxation as basic source of government revenue is becoming the main agenda in the current economic development discourse, as it facilitates different economic priorities i.e. infrastructure and smooth investment environment in one hand and reinforce investment if granted as incentive on the other hand.<sup>50</sup> However the remaining question is how to balance tax incentive Policy which is investment friendly and capable of raising adequate revenue to finance public service.<sup>51</sup> According to one study, currently tax incentive is highly employed in sub-Saharan Africa and tax holiday is offered by more than 2/3 in this country to attract investment.<sup>52</sup> Among the various means of incentives, financial and fiscal incentives are the common one whereas, fiscal incentive such as tax holiday, concessionary tax rates, customs duty exemption are used in developing countries.<sup>53</sup> Different study shows that in developing country the most widely used tax incentive are tax holiday and customs duty exemption.<sup>54</sup>

### **2.2.2. Design of Tax Incentive**

Historically speaking, investment incentive has been in use as one mechanism of investment attraction for a long period of time. At the end of 19<sup>th</sup> century, American Cities started providing

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<sup>48</sup> ibid

<sup>49</sup> ibid

<sup>50</sup> Mike Pfister ,‘Taxation for Investment and Development: An Overview of Policy Challenges in Africa’ (2009) Available at: <https://www.oecd.org/investment/investmentfordevelopment/43966821.pdf> 5 <accessed in February 2020>

<sup>51</sup> ibid

<sup>52</sup> ibid

<sup>53</sup> UNCTAD (n39) 51

<sup>54</sup> OECD (n 32) 8

money to railroads in order to have the railway pass through them.<sup>55</sup> But it was only at the end of the 20<sup>th</sup> century that governments around the world began providing formal direct grants, tax breaks and other encouragements to attract corporate investment.<sup>56</sup> During the last 20 years many countries in the world have been considering incentive as a vital Policy for various reasons, inter-alia; to boost investment flow, to compete with other countries offering incentive and attract potential investors.<sup>57</sup> However the most common factor is to cop up with other countries offering the incentive.<sup>58</sup> A properly designed and implemented tax incentive is a vital tool in attracting investments.<sup>59</sup> Though many scholars like Sebastian, agree that tax incentive is the best way to promote investment, there is an ongoing argument against their drawbacks. Among various argument against tax incentive the major ones are, that tax incentive will cause huge loss of government revenue, create inequality among those investment that are incentivized and not, entail huge administrative costs and results in rent seeking and corruption. Though it may seem not to affect current budget of the government, it results in long run costs such as huge revenue loss, low economic efficiency, excessive administrative and compliance costs, tax abuse and evasion.<sup>60</sup>

According to Bajracharya R. and Flatters F. in connection to tax incentive there are two main concerns. The first concern is related to creation of discrimination between incentivized and non-incentivized investment.<sup>61</sup> According to them, tax incentive beneficiaries have unequal market opportunity over those who import the same good according to the normal tariff rate.<sup>62</sup> Hence it

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<sup>55</sup> Albert M. Sbragia, 'Debt Wish: Entrepreneurial Cities, U.S. Federalism, and Economic Development', (University of Pittsburgh Press 1996) University of Pittsburgh Press

<sup>56</sup> Sebastian (n2) 2009

<sup>57</sup> OECD (n 32) 3

<sup>58</sup> International Monetary Fund country Reports No. 08/353 (2008) Available at <https://www.imf.org/external/pubs/ft/scr/2008/cr08353.pdf> 9 <accessed in June 2019>

<sup>59</sup> Alexander Trepelkov and Márcio Verdi, 'Design and Assessment of Tax Incentive in Developing Country :Selected Issues and Country Experience' (2018) 13

<sup>60</sup> *ibid.* iii

<sup>61</sup> Bajracharya R. and Flatters F. (1999). Ghana's Trade Policies: Exemptions from Import Duty. Available at: [http://qed.econ.queensu.ca/faculty/flatters/writings/ff\\_ghana\\_exemptions.pdf](http://qed.econ.queensu.ca/faculty/flatters/writings/ff_ghana_exemptions.pdf) <accessed in June 2019>

<sup>62</sup> *ibid*

promotes rent seeking and corruption.<sup>63</sup> Moreover it creates sense of appealing for exemptions other than undertaking productive economic activities.<sup>64</sup> The second concern according to them is, creation of ‘anomalies’ in countries tariff system as it tends to more protect the users of exempted products rather than producers of the product.<sup>65</sup> Generally, unregulated tax incentive is a cost for government in both situation.<sup>66</sup> Currently, tax incentives are less considered by investor in investment decision making and other factors like stability, Policy certainty, and transparency of tax policies are considered as the basis for investment decisions.<sup>67</sup> There are different countries in the world that avoid tax incentive and still become successful.<sup>68</sup> For example, Uganda in 1997, has taken a major tax reform which completely eliminate tax holidays in favor of 30% on company income, and set zero import duty on wide range of capital goods.<sup>69</sup> According to OECD report, the measure simplified investment licensing in Uganda and results in increment of 1% in the ratio of investment to GDP contribution and 70% increase in foreign investment inflows and 1% increase of tax revenue to GDP contribution.<sup>70</sup> Moreover the country has managed to attract high number of foreign direct investment higher than Kenya, a country which provides more generous tax incentive but failed to attract higher FDI.<sup>71</sup> Though many criticism is forwarded against tax incentive, still it remains the primary Policy to attract FDI and promote domestic sector both in developed and developing countries. As a result some scholars came up with different prepositions on how to implement effective tax Policy that will produce the desired goal. Sebastian come up with a proposition on how to balance the cost and benefit of tax incentive using a mechanism called **STAR**, so that governments can use it as a checklist to grant incentive and control its abuse. He explains the checklists as follows,

1. **Simplicity of Tax Incentive:** the first criteria according to Sebastian is simplicity of tax incentive administration and its accessibility for the beneficiary without incurring further

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<sup>63</sup> ibid

<sup>64</sup> ibid

<sup>65</sup> ibid

<sup>66</sup>ibid

<sup>67</sup> ibid. 14

<sup>68</sup> OECD (n32)11

<sup>69</sup> ibid

<sup>70</sup> ibid

<sup>71</sup> ibid

costs.<sup>72</sup>Tax incentive is simple if cost of its implementation is justifiable and the beneficiary can exercise such privilege without incurring extra-costs.

2. **Targeted:** secondly tax incentive Policy should be relied on a scientific research to make sure that they are the only means to achieve certain investment objectives which couldn't be achieved otherwise. Hence the end goal should be identified and be given to achieve national purpose that can't be successful using other methods. According to IMF report most of tax incentive granted in developing countries are loose in this aspect as they are not designed well in a way to achieve a particular purpose.<sup>73</sup>Hence Sebastian strongly argues that tax incentive should be well designed beforehand to achieve a clearly set goal.
3. **Affordable:** as a third requirement, he argue that though some cost is expected while giving incentive it shouldn't severely affect government's revenue. It should be economical and does not incur extra costs from government. Any tax incentive which unnecessarily erode revenue bases of the government shouldn't be implemented.
4. **Reviewed Periodically:** lastly he point out that the Policy should be subjected to continued review to assess whether they achieved the desired economic goal and their potential impact on the allocated budget.<sup>74</sup>

Though tax incentive is subjected to different argument, still it continues to be the preferable Policy by governments of developing countries.<sup>75</sup>

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<sup>72</sup> Sebastian (n 2)32

<sup>73</sup> ibid

<sup>74</sup> ibid

<sup>75</sup> OECD 2(n32) 5

## **Chapter Three: Ethiopian Tax Incentive Policy on Hospitality Sector: Legal and Institutional Frameworks**

### **3.1. Incentive Package for Promotion of Hospitality Industry in Ethiopia**

In Ethiopia, tax incentive has been provided under various laws i.e. Proclamations, Regulations, Directives, and internal letters mainly written by Ethiopian Ministry of Revenue and Ethiopian Ministry of Finance. Dispersion of tax incentive throughout various laws and amendment of Proclamation and Regulation by subsidiary law is the basic feature of the incentive which made the incentive Policy very complex and bureaucratic.<sup>76</sup> Customs duty exemption is one among the various means of tax incentive provided by Ethiopian government.

Investors investing in Ethiopia hospitality sector are eligible for customs duty exemption to import different capital goods and construction materials necessary for hotel construction and vehicles depending on number of star their hotel is labelled.<sup>77</sup> Hence customs duty exemption can be granted either in the form of tax reduction or total elimination from payment of such customs duty and tax.<sup>78</sup> Before embarking up on specific tax incentive given for hospitality sector it is of the researcher's view to highlight some historical background of tax incentive under different Ethiopian regimes. Hence the following discussion will give a bird's eyes view on how tax incentive Policy for hospitality sector is formally started and evolved under different regimes.

#### **i. During Imperial Era**

A formal tax incentive Policy in Ethiopia was started after the promulgation of the 1949 Income Tax Proclamation.<sup>79</sup> It was the first legal instrument that came up with tax exemptions to promote investment sector.<sup>80</sup> It introduced income tax exemption currently called a tax holiday

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<sup>76</sup> Bereket Fetene (n15) 62

<sup>77</sup> Investment Board Directives to Determine a Condition for Duty Free Importation of Vehicles for Investment Projects, Directive .No. 4, 2005,Art.7

<sup>78</sup> *ibid* 66.

<sup>79</sup> Personal and Business Tax, 1949, Legal Notice No. 138, Negarit Gazeta, 9th year, No. 4, as cited by Tadesse Lencho, 'Towards Legislative History of Modern Taxes in Ethiopia (1941-2008) (2012)' XXV JEL 117

<sup>80</sup> *ibid*

for long term investment in the specific sector such as: industry, transport, and mining enterprises which will stay for five consecutive fiscal years.<sup>81</sup> After short period of time a legal notice under a title ‘Statement of Policy’ was enacted in 1950 to provide a tax incentive for foreign capital investment.<sup>82</sup> The Notice provides a tax holiday for a period of five years to newly established investment and customs duty exemption to import necessary machines for the installation of new industries.<sup>83</sup>

The 1966 Proclamation which aims at encouraging capital investment in Ethiopia marked another historical significance in Ethiopian tax incentive Policy as it came up with tax and non-tax incentives.<sup>84</sup> Tax incentive, basically includes income tax relief currently called tax holiday and customs duty relief. The other hallmark of the Proclamation from its predecessor is that first, its sector specific as its limited at boosting agricultural and industrial enterprises and secondly, such benefit is justified if and only the goods to be imported are not produced and available in domestic market.<sup>85</sup> Coming to hospitality sector, the Proclamation ousted the sector from any type of incentive package.

## **ii. During Derg Era**

The Derg Policy has set up a command economy and all medium and large enterprises were nationalized. The Policy was very hostile to private sector investment as privatization and capitalization are ousted from its economic Policy. The 1978 income tax law which imposed up to 89% tax rate is an example of such hostile tax Policy towards private sector.<sup>86</sup> The system was relatively relaxed after the promulgation of the 1983 joint venture Proclamation which aims at

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<sup>81</sup> Proclamation to Provide for the Payment of Tax by All Individuals and Businesses, 1949, Proc. No. 107, *Negarit Gazeta*, Art.3

<sup>82</sup> Statement of Policy for the Encouragement of Foreign Capital Investment, 1950, Legal Notice No. 10, *Negarit Gazeta*

<sup>83</sup> *ibid* art 2.

<sup>84</sup> Proclamation to Provide for the Encouragement of Capital Investment in Ethiopia, 1966, Proc. No. 242, *Negarit Gazeta*, 26th year, No. 2.

<sup>85</sup> *ibid* Art.6/1

<sup>86</sup> Tadesse Lencho (n74) 151

encouraging the participation of domestic and foreign investor in joint venture investment.<sup>87</sup> It's only towards the end of the Policy in 1990 that the government issued a decree which grants customs duty exemption for investors investing in the area of agriculture, construction, **hotel service** and industrial sector to import necessary machineries to start or expand investment activities.<sup>88</sup> Hence tax incentive for hospitality sector for the first time was commenced during this Policy, and continued afterwards.

### **iii. During Transitional Period**

The transitional government of Ethiopia has taken a paradigm shift towards economic policies of the country. Among different decisions, the first one is promotion of private sector. A Proclamation which enacted to provide for the encouragement, expansion and co-ordination of investment was enacted in 1992 to provide tax exemptions on import duties up to 15% of the capital goods imported.<sup>89</sup> Since then different Proclamation and Regulation were enacted to regulate tax incentive given for various investment sectors.

After the Transitional period, the current government also provided different means of incentive for investors investing in various sectors. Since this study was focused on the currently existing tax incentive Policy, it was discussed thoroughly in subsequent sub topics.

## **3.2. Major Loopholes of Ethiopian Laws Pertaining to Tax Incentive in Hospitality Sector**

### **3.2.1. The Investment Proclamation NO. 1180/2020**

Even though the Proclamation is to be considered as governing laws of tax incentive under Ethiopia legal system, it nowhere defines tax incentive. Since taxation is a primary source for government revenue, any decision of exemption in this regard should firmly be justified through precise definition.<sup>90</sup> The degree of its specificity determine options of abuse in its

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<sup>87</sup> Joint Venture Proclamation, 1983, Proc. No. 235, *Negarit Gazeta*, 42nd Year, No. 6, as Cited in Tadesse Lencho (n74) 151

<sup>88</sup> See Council of State Special Decree 1990 Decree No.17 Art.11

<sup>89</sup> Proclamation to Provide for the Encouragement, Expansion and Coordination of Investment, 1992, Proc. No. 15, *Negarit Gazeta*, 51st year, No. 11

<sup>90</sup> Alvic Padilla and others, Use and Abuse of Tax Breaks: How Tax Incentive Becomes Harmful (2020) Available at <http://www.christianaid.org.uk> Accessed on May 15,2020

implementation.<sup>91</sup> The Proclamation, rather than defining tax incentive in line with specific national development strategy intended to be achieved, gave the mandate of determining incentive beneficiaries for Council of Ministers.<sup>92</sup> Regarding administration of tax incentive, according to article 4/1 of this Proclamation, Ethiopian Investment Commission has a mandate to administer investment activity to be undertaken by domestic investor investing in areas eligible for incentive.<sup>93</sup> According to this Proclamation the mandate to administer tax incentive is the jurisdiction of federal government, inter-alia: Ethiopian Investment Commission if and only the investor has obtained the business license from the federal government. The question is what if the investor obtained the license from regional government and invest in areas eligible for tax incentive. Silence of this legal provision and the practice shows, it is regional governments that administers tax incentive for investors obtaining license from regional investment bureaus and investing in areas eligible for incentive including hospitality sector. Practically, Regional and Zonal Tourism and Culture Bureaus write a letter to Ethiopian Ministry of Culture and Tourism to approve grant of tax incentive for investors investing in hospitality sector.<sup>94</sup> Note here that according to article 96/1 of the FDRE Constitution it is the jurisdiction of federal government to levy and collect customs duties on imported goods.<sup>95</sup> The word of the Proclamation regarding jurisdiction of tax incentive is then contradictory and open a way for its abuse. The other practical challenge is, Regional Investment Bureaus sends a letter to the concerned Federal authority to exempt particular investor from customs duty even without making impact

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<sup>91</sup> *ibid*

<sup>92</sup> The Investment Proclamation, 2020, Proc. No.1180, *Negarit Gazeta*, 26<sup>th</sup> Year No. 28, Art. 17(Herein after the investment Proclamation)

<sup>93</sup>*ibid* article 4/1/d

<sup>94</sup> Interview with Tedros Deribe, Tourism Related Service Rendering Institution, Competency and Accreditation Directorate, Ministry of Culture and Tourism, (Addis Ababa, May 26, 2020)

<sup>95</sup> Constitution of the Federal Democratic Republic of Ethiopia, 1995, Proc. No. 1, *Negarit Gazeta* 1<sup>st</sup> Year No.1, Art 96/1

assessment of the said project.<sup>96</sup> The enforcement authority make no further investigation as to the validity of such request and simply execute the order of State Investment Bureaus.<sup>97</sup>

Regarding administration of tax incentive, the preamble of the Proclamation provides that having a ‘system of supervision’ is essential to make sure that the granted incentive is appropriately used for the intended purpose.<sup>98</sup> In addition to this, Article 13/3 of the Proclamation provides revocation of investment license by appropriate investment organ whenever the granted incentive is abused by the investor.<sup>99</sup> However from the language of the Proclamation it is not clear which authority is specifically entrusted with such a duty. Since appropriate investment organ is defined to include both the Federal Investment Commission and Regional Executive Organs,<sup>100</sup> when it comes to tax incentive in hospitality sector, there is no specific organ duly mandated to enforce this provision. Moreover, the Proclamation is not well designed in specifying a condition to grant incentive and it all depends up on the discretion of incentive granting body.

### **3.2.2. Customs Amendment Proclamation No. 1160/2019**

The amendment Proclamation came up with some reforms on the Customs Proclamation No.859/2014. Art. 129 of the former Proclamation that provides for incentive granting body is one among the various reforms. The mandate of incentive grant by the law or international agreement to which Ethiopia is a party or by Directive issued by the Ministry<sup>101</sup> is conclusively given to Ministry of Finance.<sup>102</sup> Accordingly, any claim of duty free privilege is to be granted only by Ministry of Finance. The question here is then what is the fate of investment Proclamation that provides for administration of tax incentive. Does tax incentive administration mean only granting of the same or includes both deciding on the grant and administer the involved process? Because, granting tax incentive so far is concerned with the final decision on a

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<sup>96</sup> Interview with Habtamu Asfaw, Competency and Accreditation Service at Ministry of Culture and Tourism, (Addis Ababa, May 15, 2019)

<sup>97</sup> Interview with Ashenafi Bassa Lagebo, Head, Office Customss and Compliance Division, FDRE Customs Commission, (Addis Ababa, May 20,2019)

<sup>98</sup>Preamble of the Investment Proclamation

<sup>99</sup> *ibid* Art. 13/3

<sup>100</sup> *ibid* Art 16/2

<sup>101</sup> Customs Amendment Proclamation, Art.129

<sup>102</sup> *ibid*.

request letter produced by the beneficiary after passing through different process<sup>103</sup> and it used to be the role of Ethiopian Investment Commission. So does this specific provision gave the power of Ethiopian Investment Commission to Ministry of Finance or all the role of involved government office inter-alia; Ministry of Culture and Tourism and Zonal Investment Bureaus? Regardless of giving such a power to Ministry of Finance, still the Ministry has delegated its mandate to sector specific. Similarly, in the case of Hospitality sector Ethiopian Investment Commission and Zonal Investment Bureaus still has a mandate to execute such a duty. Regarding follow up measure, according to article 129/5 as provided in the amendment Proclamation, it is a mandate of Customs Commission. The Commission is required to keep data and record of duty free imported goods and follow up implementation of the same. In this latter case also there is a doubt whether other involved executing offices are relieved of supervising incentive grant to their specific sector. For example, in the case of hotel sector Ministry of Culture and Tourism has relative connection and information access than Customs Commission.

The other basic reform is regarding abuse of tax incentive. The customs Proclamation is revised three times within 10 years. The peculiar concern of the amendment is provisions that dealt with tax incentive abuse and available legal measures. The provisions are described as follows,

- ❖ Customs Proclamation No.622/2009, Art.98/1/b “..... Without prejudice to the forfeiture of the goods, be punishable with a **fine** equivalent to the amount of the customs duties and taxes payable when such good were imported and with **imprisonment** from 3 to 5 years.”
- ❖ Customs Proclamation No.859/2014, Art. 163/1/c  
“.... Without prejudice to settlement of the duty and tax payable assuming that the goods are imported at the time of seizure, be punishable with **fine** equivalent to 50% of the amount of such duty and tax.”

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<sup>103</sup> Interview with Zelalem Alemu, Investment Project Facilitation and Aftercare Expert, Ethiopian Investment Commission, (Addis Ababa, May 16, 2016). Before 2008, it is used to be the role of Zonal Investment Bureaus. After report of Aba’ala hotel project case, the then Ministry of Finance and Development ordered Zonal Investment Bureaus to cease grant of tax incentive and such power to be exercised only by Federal Government. Later on, such power is returned to Zonal Investment Bureaus due to work load at Federal Offices. Currently, the Amendment Customs Proclamation, gave back the mandate to Ministry of Finance whereas, practically the mandate is delegated to Regional and Zonal Investment Bureaus. Note her that, so far such order is given via letter written from Ministry of Finance to concerned Regional and Zonal Investment bureaus.

❖ Customs Amendment Proclamation No. 1160/2019, Art. 169/5

“..... Shall be punishable with **rigorous imprisonment** of five to seven years and a **fine** of birr 200,000. Without prejudice to the forfeiture of the goods”

As noted above the first Proclamation, in addition to administrative action criminalize misuse of duty free privilege. Whereas the second Proclamation provides only administrative action and reduced fine to 50%. Though different justifications are provided to validate the amendment,<sup>104</sup> nothing will validate how administrative action will be adequate to educate a perpetrator who misuse public property. There is a suspicion that it is driven by improper gain and corrupted motive of involved beneficiaries.<sup>105</sup> The criminal charge against Melaku Fenta et.al case is dropped and the suspects are set free following amendment of the proclamation. This scenario substantiates the suspicion that amendment of this particular proclamation is driven by individual interest rather than a particular economic objective needed to be achieved.<sup>106</sup>

The case was instituted in 2007 by the Federal Anti-Corruption Commission. Among twenty four individuals involved in this case, five of them were staff of the then ERCA.<sup>107</sup> Among many charges prepared by the Commission, the **second** charge involves Melaku Fenta Director of ERCA, G/Wahid W/Giorgis, ERCA Legal Director, Belachew Beyene ERCA Audit Directorate Director and Simachew Kebede owner of Intercontinental Hotel. In this second charge, the first and the second suspects were accused of having information of tax incentive abuse by intercontinental hotel owner since 2003 and it was later confirmed through the investigation undertaken by the authority’s intelligence office. However the suspects made an agreement with owner of the hotel and ordered termination of further investigation by authority’s intelligence office. The third suspect also after confirming that the hotel had improperly used duty free imported capital goods and construction materials which amounts to nine million, nine hundred

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<sup>104</sup> Preamble of Customs Proc. No.859/204

<sup>105</sup> Interview with Amdemichael Getachew, Vice Director of Tax Related Economic Crime Directorate, Attorney General (Addis Ababa, May15, 2020)

<sup>106</sup> *ibid*

<sup>107</sup> Currently the Authority is separated in to two as, Ministry of Revenue and Ethiopian Customs Commission. Among 24 individuals accused by the Commission, Melaku Fenta Director of ERCA, G/Wahid W/Giorgis ERCA Legal Director, Eshetu Giraf ERCA Kaliti Branch Legal Director and Asmelash W/Mariam ERCA Compliance Core Leader.

eighty one thousand and six hundred sixty one birr (9,981, 661.83 ETB) made an agreement with owner of the hotel so that the later would pay eight million seven hundred sixteen thousand and twelve birr (8,716, 012.84) and in return the investigation will terminate. Whereas Simachew Kebede owner of Intercontinental Hotel is accused of abusing different duty free imported capital goods for other purpose and made side agreement with the three individual mentioned above. After three years of court proceeding, the case was withdrawn by Attorney General and the suspects were set free of criminal charges.<sup>108</sup>

As can be noted, when the case was instituted in September 23, 2007 tax incentive abuse is punishable by both administrative and criminal punishment under Art.98/1/b of Customs Proc. No.622/2009. After institution of the case, the Proclamation was immediately amended in December, 2007. The fact that parties to the case are higher government official and renowned business person, pose a question of whether the amendment is intended or incidental one.<sup>109</sup> Following amendment of the Proclamation, undergoing investigations on different hotel owners, i.e. Crown Hotel and Capital Hotel is also aborted and the suspects are set free.<sup>110</sup> Though the case is withdrawn before final court decision, the process of its termination is influenced by political decision and shows how the sector is susceptible to intense abuse.<sup>111</sup> Considering revenue lost due to abuse by a single investor, i.e. nine million, nine hundred eighty one thousand and six hundred sixty one birr (9,981, 661, 83), it is simple to speculate how much it could be if the other suspects also investigated thoroughly.

### **3.2.3. The Investment Regulation**

The Investment Regulation for the Provision of Investment Incentives and Investment Areas Reserved for Domestic Investors, Regulation No. 270/2012 was repealed and replaced by the new Regulation No. 447/2020. However regarding tax incentive administration the new regulation has a transitory provision under art. 21 and the former Regulation is accordingly application in this area. Article 13 of the former Regulation specifies conditions needed to be fulfilled by investors of hotel sector to be eligible for customs duty exemption.

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<sup>108</sup> Melaku Fenta etal. Vs. Federal Anti-Corruption Commission (Federal High Court, Lideta, File No.141352)

<sup>109</sup> Interview with Amdemichael Getachew (n 105)

<sup>110</sup> *ibid*

<sup>111</sup> *ibid*

Pursuant to this provision the investor is allowed to import capital goods and construction materials which are necessary to establish new investment or upgrade the existing one. For the first time this Regulation come up with certain requirements that the beneficiary should comply with. This requirement is submission of the list of capital goods and construction materials to be imported and securing approval from the concerned local authorities.<sup>112</sup>

The Regulation also specifies a condition to transfer duty free imported goods. Accordingly the investor can only transfer such material for another investor beneficiary of the same package.<sup>113</sup> When the person to whom the property is transferred is not eligible for the incentive, such transfer can be effective only up on payment of customs duty that had to be paid at the time of importation.<sup>114</sup>

However the Regulation rather than requiring approval from the concerned authority does not specify conditions under which the request is to be held eligible or not. It gives wide discretion for concerned authorities to decide on the grant or deny, which open a way for corruption and abuse.

Regarding **quantity** of capital goods and construction materials to be imported by the beneficiary, it does not lay down any conditions. Lack of clarity in this regard results in inconsistent application and give concentrated power for a single deciding official.<sup>115</sup> This is a basic challenge in Ethiopia's hospitality sector as the investors import excess quantity than the hotel construction really demands.<sup>116</sup>

Moreover the definition given for construction material is too general and has its own contribution for tax incentive abuse. Art. 2/5 of the Regulation defines construction material as, "basic inputs necessary for the construction of investment project". The question here is what basic goods are and how to determine their necessity for certain investment. In the absence of

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<sup>112</sup> Regulation on Investment Incentive and Investment Areas Provided for Domestic Investors, 2012, Reg. No. 270, Art. 13/2

<sup>113</sup> *ibid.* Art 15/1

<sup>114</sup> *ibid*

<sup>115</sup> Alvic Padilla and others (n79) 11

<sup>116</sup> Interview with Sisay Gezu, Tax Fraud Investigation and Intelligence Directorate Director, Ministry of Revenue, (Addis Ababa, May 16, 2019)

expert group to determine this condition, many investors request importation of excess quantity than the project really demands and in some condition a totally different material than a certain project demand in the normal situation.<sup>117</sup> Due to this legal loophole Customs Commission relies only up on a single letter produced by local Investment Bureaus without crosschecking bill of quantity by experts. In this regard, the case of hotel construction in Afar region Aba'ala can be mentioned. The investors imported different capital goods that serve for delivery of service even before the commencement of hotel construction. This capital goods includes a very small material available in domestic market, like forks, spoon, knife, bed sheet, pillow...and other similar goods.<sup>118</sup>The broader definition gave a wide discretion for enforcing official and so as widen abuse of the privilege. Moreover unlike the 1960 Proclamation it does not specify whether the availability of necessary and the same material in domestic market serve as one condition to deny importation of such capital goods from abroad.<sup>119</sup> This in fact has its own negative impact on domestic market and encourage tax incentive abuse.

#### **3.2.4. Investment Board Directive No. 4/2005 to Determine Duty Free Importation of Vehicles for Investment Projects**

The Directive was enacted pursuant to article 14 of the Regulation to determine the conditions of duty free importation of vehicles that will be used for investment in particular sector. According to Art. 3 of the Directive, investment area eligible for tax incentive includes: Industries, agriculture, construction, star-rated hotels, Motels, Restaurants and Lodge, etc.

Regarding hospitality sector article 7 of the Directive specifies their incentive package depending on the classification already stipulated by Ministry of Culture and Tourism. Accordingly, 1-2 star hotel can import 1 pickup and for more than 3 star hotel they can import 2 pickups.

The Directive also for the first time specified eligibility conditions needed to be fulfilled by the investor. According to article 7/2 this requirements are:

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<sup>117</sup> ibid

<sup>118</sup> Interview with Addis Getachew and documents prepared by Customs Commission, Tax Abuse Control and Supervision Team

<sup>119</sup> Council of Ministers Regulations No. 84/2003 Council of Ministers Regulations on Investment Incentives and Investment Areas Reserved for Domestic Investor, Art.8/3

- ✓ evidence showing whether the investor has acquired a land for construction
- ✓ Producing an evidence from local investment bureau to Ethiopian Ministry of Revenue whether the said project is commenced, i.e. commencement of construction, readiness of store, etc.

The Directive by laying down this conditions tried to mitigate conditions for abuse at least in principle. However it is still subjected to different abuse since it gave wide discretion for Zonal Investment Bureaus to confirm the incentive.

### **3.3. Institutional Framework for the Administration of Tax Incentive in Ethiopia's Hospitality Sector**

When it comes to administration of tax incentive, many offices are involved starting from granting incentive permission and its implementation. The main actors in administration of tax incentive in hospitality sectors are, Ethiopian Ministry of Culture and Tourism, Ethiopian Investment Commission, Ethiopian Ministry of Revenue and Ethiopian Customs Commission. The following discussion will give highlight how this different offices are involved and whether they are fulfilling their duties in practice.

#### **3.3.1. Ethiopian Ministry of Culture and Tourism**

The Ministry was established by Proclamation No. 1097/2018, a Proclamation Enacted to Redefine the Powers and Duties of Federal Government Organ. According to article 30 of this Proclamation, the Ministry has a mandate of facilitating tourist attraction services and promotion of tourism sector. The Ministry had been working with Ethiopian Standard Agency /ESA/<sup>120</sup> to lay down hotel grading requirement and their star.<sup>121</sup> Besides, the Ministry had been actively involved in the process of granting incentive for those investors investing in the sector. For investors coming from regional state, after receiving request letter written by concerned regional

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<sup>120</sup> Ethiopian Standard Agency is established in 2010 by Regulation No. 193/2010. The agency is entrusted with duty of devising checking mechanism, whether goods and services are produced and rendered in line with the established standards.

<sup>121</sup> Accordingly the Agency prepared list of requirements each star hotel expected to fulfill. Accordingly, hotels can be classified as Five Star Grand Luxe, Five Star-Exceptional, Four Star-Excellent, Three Star-Very Good, Two Star-Good and One Star-Acceptable

investment organ they directly send such request letter to Ethiopian Investment Commission so that the later direct the request to Ministry of Revenue confirming that the said project is eligible to receive incentive.<sup>122</sup> However the Ministry does not have formally enacted guidelines and they for all purpose rely up on a single letter written from concerned local investment authorities. The Ministry does not have a team of expertise to assess whether the said project is really commenced or fictitious one. There is no mechanism to assess whether the requested amount of capital goods and construction material is reasonable in the normal situation.<sup>123</sup> A very surprising fact is that after confirming the request for incentive, they do not have any controlling mechanism in a place to follow up whether such investor have used the incentive appropriately for hotel construction.<sup>124</sup> They believe that such duty is entirely entrusted to implementing organ, inter-alia: Ministry of Revenue and Customs Commission.<sup>125</sup> Following amendment of Customs Proclamation, the mandate to grant tax incentive is duly conferred up on Ministry of Finance.<sup>126</sup> However still they exercise such a power since the Ministry delegated its mandate to sector specific and there is no practical change in this area.

### **3.3.2. Ethiopian Investment Commission**

Ethiopian Investment Commission formerly known as Ethiopian Investment Agency has been established by Council of Ministers and has been undertaking various tasks of investment allowance and incentive package grants.<sup>127</sup> Under the current Investment Proclamation, the Commission has been entrusted with enormous powers. It is mandated to serve as a ‘nucleus’ regarding all matters in relation to investment promotion and co-ordination.<sup>128</sup> Moreover it is responsible to monitor and follow up post investment activities including supervision of investment incentive whether they are appropriately used by the investor or not.<sup>129</sup> The

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<sup>122</sup> Interview with Habtamu Asfaw (n 92)

<sup>123</sup> Interview with Tedros Deribe, (n 90)

<sup>124</sup> *ibid*

<sup>125</sup> *ibid*

<sup>126</sup> Amendment of Customs Proclamation, Art.129

<sup>127</sup> Ethiopian Investment Board and the Ethiopian Investment Commission Establishment Council of Ministers Regulation, 2014, No. 313. Art. 7

<sup>128</sup> Investment Proclamation (n 76) Art.28/1

<sup>129</sup> *ibid*. Art 28/11

Commission has also a mandate to revoke investment license provided that the granted incentive is abused or misused by the beneficiary.<sup>130</sup> In relation to tax Incentive the Commission has two specific offices, Directorate of Incentive Implementation and Investment Project Continuity Monitoring Directorate. During the field research, the researcher noted that the Commission so far has not taken any action against incentive abuse, as their main focus is attracting huge number of investors as possible. Let alone taking a measure, the Commission believes that Ethiopia is at the stage of attracting investors rather than discouraging them.<sup>131</sup> Though when they come across tax incentive abuse, they solve such case amicably without a need to institute a legal proceeding.<sup>132</sup> Hence the Commission appears to be neglecting its duty of supervising and controlling tax incentive abuse.

### **3.3.3. Ethiopian Ministry of Revenue**

The former Ethiopian Revenue and Customs Authority is re-named by a Proclamation Enacted to Define the Power and Duties of the Executive Organs of Federal Government as Ministry of Revenue. The Ministry is entrusted with a mandate of enforcing duty free incentives given for investors.<sup>133</sup> Hence the Ministry has been entrusted with a broad based mandate to regulate and control tax incentive abuses. The Ministry has different offices entrusted with the duty of controlling tax related crimes and abuses. And most of this offices are concerned with assessing validity requirement whether the letter sent by granting authority is valid or not rather than controlling its abuse. Even there is no specific team organized within the Ministry specifically assigned to control tax incentive abuse. Regarding bill of quantity they directly accept the one produced by the beneficiary without affirming whether such quantity is required under the normal condition. Moreover there is no engineering expert in the Ministry to examine whether the requested material is necessary for the proposed project work. Accountants and legal experts (majority of the staff at the Ministry) are not expected to examine such issue. As a result the Ministry is not undertaking its mandate of controlling tax incentive abuse and even claim that it

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<sup>130</sup> *ibid* Art. 19/2/b

<sup>131</sup> Interview with Tedros Daribe (n 90)

<sup>132</sup> Interview with Zelalem Alemu (n102)

<sup>133</sup> Definition of Powers and Duties of the Executive Organs of the Federal Democratic Republic of Ethiopia 2018, Proc No. 1097, *Negarit Gazeta*, 25<sup>th</sup> Year, No.8

should be the duty of all involved offices in administration of tax incentive starting from granting authority.<sup>134</sup>

### **3.3.4. Ethiopian Customs Commission**

The other responsible organ to control and monitor tax incentive abuse is Ethiopian Customs Commission. The Commission is entrusted with various duties of implementation tasks as an ultimate body.<sup>135</sup> The Commission however rather than implementing the incentive does not have any mechanism in a place to crosscheck and confirm whether the bill of quantity produced by the investor and confirmed by other involved organ is accurate or not.<sup>136</sup> In order to control abuse practices the authority has currently established a team called Tax Incentive Control and Supervision Team. The Team come to existence one year ago and has been taking different measures to investigate and control tax abuses. However they face various challenges mainly when it comes to collecting information from different offices involved in the process of granting incentive.<sup>137</sup> Lack of information chain among tax incentive granting organ is the main challenge at national level and created a wide opportunity for the abusers. The team is currently investigating the case of Aba'ala Hotel Construction project and unable to proceed the case due to lack of co-operation from Afar Regional Investment Bureau.<sup>138</sup> The case was initially started in 2008, and the progress is inhibited by unavailability of information from the concerned regional bureaus.<sup>139</sup>

### **3.4. Practical Assessment of Tax Incentive Abuse in Ethiopia's Hospitality Sector**

Though there is no internationally recognized means of reporting incentive abuse, some countries have certain means of doing so by implementing different mechanisms. For example Morocco has an experience of reporting tax incentive abuse whereby tax expenditure report due to incentive is elaborated and integrated in government's budget process report of 2006.<sup>140</sup> In

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<sup>134</sup> Interview with Sisay Gezu (n115)

<sup>135</sup> Amendment of Customs Proclamation 1160/2019, Art.129/5

<sup>136</sup> Interview with Sisay Gezu (n115)

<sup>137</sup> Interview with Addis Getachew (n117)

<sup>138</sup> *ibid*

<sup>139</sup> Interview with Habtamu Asfaw (n 92)

<sup>140</sup> OECD (n 4) 11

order to ensure transparency and effectiveness of tax incentive, the government should among others, record beneficiaries of the incentive, duration of the incentive, costs of revenue forgone, and make an assessment whether it achieved the intended objective or not.<sup>141</sup>

In Ethiopia, so far there is no firm practice of keeping record of tax incentive beneficiaries and reporting the abuse to the public. For the last five years of its First Growth and Transformation Plan (2003-2007) the country has lost a total of one hundred ninety one billion birr /191 000,000, 000/ in the form of tax incentive.<sup>142</sup>

According to IMF study, revenue forgone on imports exceeds the total revenue collected from imports which counted sixty five point five billion birr /65.5,000,000,000/ in 2014/15, seventy one point one Billion birr /71.1,000,000,000/ in 2015/16 and seventy one point three billion birr /71.3,000,000,000/ in 2016/17.<sup>143</sup> According to this report such exemption is widely abused due to magnitude of the exemption and lack of sufficient control by Customs Commission.<sup>144</sup> Hence the IMF study, recommends establishment of central exemption monitoring and control unit to control abuse of incentive, to strength compliance and guarantee end use of such incentive.<sup>145</sup>

The country is losing huge amount of money due to tax incentive each year. Most surprisingly in 1996 and 2001, the revenue lost due to incentives was higher than the total tax revenue collected.<sup>146</sup> The trickiest fact is then though the country has decided to let off this huge amount of revenue, there is no research conducted by any authority so far to assess its viability. The following table shows revenue lost due to import duty forgone in different fiscal years.

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<sup>141</sup> United Nations(n 40) 32

<sup>142</sup> IMF Study (n 50) 26

<sup>143</sup> *ibid*

<sup>144</sup> *ibid*

<sup>145</sup> *ibid*

<sup>146</sup> Bereket (15) 74

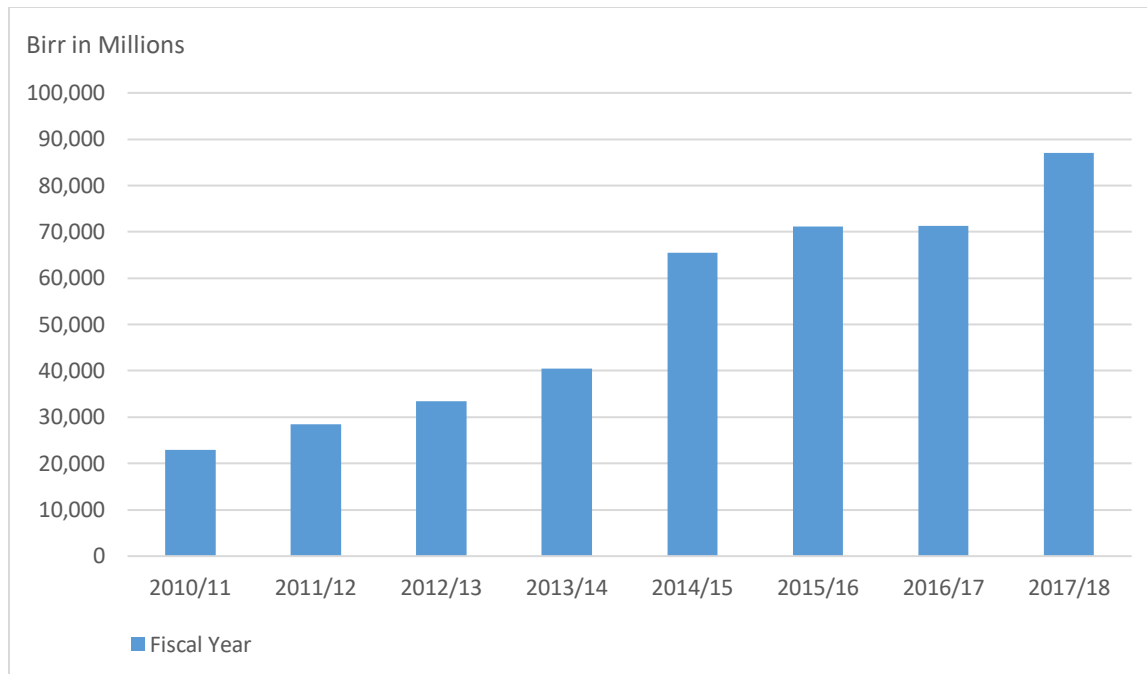


Chart 3.1. Revenue Forgone Due to Tax Incentive during the Last Eight Years

Source: Ethiopian Ministry of Revenue Research and Development Directorate

Assessing and tracking revenue lost due to tax incentive and monitoring the abuse is basically the mandate of the then ERCA<sup>147</sup> and currently Ethiopian Customs Commission.<sup>148</sup> Monitoring includes preparation of tax expenditure statement which shows revenue cost incurred by the government due to tax incentive and continuous review of incentive policies whether they achieve the intended goal or not.<sup>149</sup> However the Ministry so far has been concerned only with validity issues, checking whether the application is valid or not and disregarding the duty of monitoring.<sup>150</sup> Due to this the above shown revenue forgone is not well studied by the concerned authority and one can't find specific record of how many percent is exactly used for the intended purpose and how much is abused. This in one hand has its own contribution for the wide range abuse of tax incentive in Ethiopia.

<sup>147</sup> Ethiopian Revenue and Customs Authority Establishment Proclamation, 2008, Proc. No. 587, *Negarit Gazeta* Art.6/2

<sup>148</sup> Amendment Customs Proclamation 116/2019. Art.129/5

<sup>149</sup> Sebastian (n2) 4

<sup>150</sup> *ibid* 85

One study showed that in tourism sector, mainly in a country which is endowed with unique natural resource, incentives is considered as redundant since the investor in such environment would have invested anyway.<sup>151</sup> Hence it needs further study whether tax incentive in this sector achieved the intended goal and need for paradigm shift.

In Ethiopian Hospitality sector, during 2002 FY around two hundred fourteen million /214,000 000/ birr was provided as incentive to 18 investors investing in the hospitality sector whereas 80% of these incentive is abused by the investors using it for another activities not eligible for the incentive.<sup>152</sup> And in each financial year the country is losing sixty to seventy billion birr in the form of tax incentive for hotel sector.<sup>153</sup> Basically tax incentive abuse in this sector is practiced in different forms.

The **first** scenario is duty free importation of construction materials and capital goods for fictitious business, a project which does not really exist. In this case the investor import duty free capital goods for construction of hotels when in fact such business does not exist.<sup>154</sup>

The current case of hotel construction in Afar region, specific area called Aba'ala is one practical scenario justifying how the investors are abusing tax incentive for construction of hotel in this place. The following table demonstrates revenue forgone for different construction materials and capital goods for hotel construction in Aba'ala.

N	Building Materials and House Equipment	Total Tax to be Paid	Total forgone	Total forgone in %
1	Steel Bars	107,269,316.00	107,269,316.00	88.8%
2	Finishing Equipment	660,711.00	660,711.00	0.56%
3	Furniture and Hotel Utensils	12,911,018.00	12,911,018.00	10.64%
4	Total	120,841,045.00	120,841,045.00	100%

Table 3.1. Revenue foregone for Hotel Projects in Aba'ala, Afar Regional state

<sup>151</sup> Sebastian (n 2)13

<sup>152</sup> Ethio Channel Gazette No.243 2002, as Cited in Bereket Fetene (n15)75

<sup>153</sup> Interview with Fikir Tamiru, Documentation Team Leader, Ethiopian Customs Commission, Kaliti Branch, May22, 2020

<sup>154</sup> Interview with Addis Getachew (n117).

As the table (3.1.) shows, 42 investors had imported construction materials which costs One hundred seven million, two hundred sixty nine thousand and three hundred sixteen (107,269,316.00) Birr for steel bars. It is constituted 88.8% of the total imported items, which is an important input for the substructure of the hotel’s construction. Having completed the substructure, the next work is to install the finishing equipment which ranges from wall painting to the installation of electricity and water pipes. For this, duty free imported items cost around six hundred sixty thousand and seven hundred eleven (660,711.00) birr. The imported finishing materials is constituted less than 1%. In the normal course of the business this finishing materials compared with steel bars have less market demand if one intends to resell them in the market. Since the investment is in hotel sector, it is necessary to equip and furnish the hotel with different materials so as to deliver services to customers. Any hotel required to be furnished with furniture’s, kitchen utensils, technological equipment –security cameras, bedroom accessories and other pertinent apparatuses. In fact, these all will be in place next to the completion of substructure and superstructures. Even though the stage of construction of hotels in Aba’ala are at substructure level, that means they only erect the beams and slabs, and some of them were not started at all (See the following Picture), the beneficiaries imported goods which costs more than 10 million birr worth for furniture’s and hotel utensils. This is comprised 10.64% of the total duty free goods imported by the investors. The main question here is how a responsible government official allow importation of all this furniture and hotel utensil without cross checking the status of hotel construction.



<b>PROJECT</b>	<b>2*HOTEL</b>
<b>DESCRIPTION</b>	<b>G+3</b>
<b>PROJECT STATUS</b>	<b>ONLY COLON</b>



<b>Project Description</b>	<b>Motel</b>
	<b>G+3</b>
<b>Project Status</b>	<b>No Work And Any Kind</b>

Picture 3.1. Status of Hotel Construction in Aba’ala, Afar Region

*Source: ECC, Tax Incentive Supervision and Controlling Team*

The **second** scenario is importation of duty free capital goods more than the business really requires.<sup>155</sup> In a situation where the implementing authority does not have any structure to cross check bill of quantity, most of the time the beneficiary import double time of capital goods than the said business demands. For single hotel project, some hotel owners request importation of steel bars that can be used for three or more hotel construction.<sup>156</sup> The **third** scenario is resell of duty free imported goods in the market. This is widely practiced and become a common form of abuse extensively taken place in Ethiopia. According to one report, out of 6000 vehicles imported duty free by investors, more than 5000 were illegally transferred to third party not beneficiary of the exemption.<sup>157</sup> Steel bars are commonly sold in Markato, after imported by the investor for the purpose of hotel construction.<sup>158</sup> During the 2009-2011, one hundred forty seven (147) case in relation to this abuse were investigated, and forty seven 47 of them were proved guilty and they paid one hundred seventeen million, eight hundred fifty five thousand and seven hundred sixty seven (117,855,767.00) birr.<sup>159</sup> The **fourth** scenario is, duty free importation of construction material and capital goods repeatedly for a single project. There are some scenarios whereby a single investor import duty free capital goods at different times for single hotel

<sup>155</sup> Bereket Fetene (n15) 75

<sup>156</sup> Interview with Fenes Ayalew, Government Offered Privileges Supervision Co-coordinator, Ethiopian Customs Commission Kaliti Branch, (Addis Ababa, May 22,2020)

<sup>157</sup> Bereket Fetene (n 15)

<sup>158</sup> Interview with Fikir Tamiru (n1154)

<sup>159</sup> ibid

construction.<sup>160</sup> In this case using the name of the same hotel the investor import different materials at a different time and there is no enforcing authority to detect and penalize such activity. The **fifth** scenario is importing construction material for hotel construction and using the project for other purposes. In this case the investor after finishing hotel construction use it totally for different purpose not eligible of tax incentive.<sup>161</sup> The case of Yordanos Hotel around Haya Hulet, Addis Ababa, is one scenario, whereby the hotel it is used for rental purpose.<sup>162</sup> Moreover there is a practical case whereby an investment license revoked by one enforcement organ is permitted by the other due to lack of co-operation among them, and hence opening a loophole for abuse of incentive.<sup>163</sup> In some situation, the investors import duty free capital goods by stating initially construction of five or four star rated hotel and later on the constructed hotel is sub-standard. In this case Ministry of Culture and Tourism identified 104 hotels that imported duty free construction materials to construct five and four star rated hotel, whereas their hotel is leveled as three and two star after construction.<sup>164</sup> They reported the case to Investment Commission so that the later take an action.<sup>165</sup> However, the Investment Commission believes that such duty is to be undertaken by Ministry of Revenue and as a result they didn't proceed with the case. This shows that when number of incentive granting authority is many so as increased challenges of supervision among this offices. There also is a scenario whereby investment license granting authority make a report after a long period of time, even after the investor used revoked license to import duty free goods.<sup>166</sup>

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<sup>160</sup> Interview with Sisay Gezu (n 115)

<sup>161</sup> Interview with Fenes Ayalew (n159)

<sup>162</sup> *ibid.* Customs Commission Kaliti Branch is investigating the case after the hotel is red handed by the branch officials. Moreover there is an investor used duty free imported material for hotel construction and used it for Real-estate investment. After investigation is undertaken by the Commission, the investor requested to pay due tax so that the case will terminated in his favor.

<sup>163</sup> Interview with Ashenafi Lagebo (n93)

<sup>164</sup> Interview with Tedros Deribe (n90)

<sup>165</sup> *ibid*

<sup>166</sup> *ibid*

### **3.5. Factors Contributing for Tax Incentive Abuse in Ethiopia’s Hospitality Sector**

#### **i. Lack of Appropriate Guidelines Regarding Quantity of Capital Goods to be Imported**

Enforcement authority like Ethiopian Customs Commission and Ministry of Revenue, execute the incentive without proper assessment of bill of quantity produced by beneficiary. In both offices there is no expert to assess whether the requested list of capital goods and construction materials are really necessary to undertake the said investment. They just permit duty free importation depending on a single letter either written by Ministry of Culture and Tourism or Regional Investment Bureaus. It widens the loophole for abuse and weaken means of control. According to information gathered from customs Commission intelligence office, the quantity ordered by an investor is prepared by private engineers and they are beyond the quantity required to build the said type of hotel.<sup>167</sup> There is no mechanism in a place to cross check bill of quantity and whether they are prepared by proper experts. From the beginning they are prepared by private individuals and aren’t subject to detection by enforcement authority. They are also not subjected to any legal accountability for producing inappropriate BQ.<sup>168</sup> Hence it paves a way for wide-ranging tax incentive abuse, by generating illegitimate benefit for individuals and drain government coffer.

#### **ii. Lack of Strong Controlling Mechanism**

Lack of strong institution to control the abuse is one of the basic factor contributing for wide range tax incentive abuse in hospitality sector. The Customs Commission somehow has sort of controlling mechanism which was undertaken by two of its staffs; Post Clearance Audit and Intelligence and Investigation Audit. This two offices serve as first hand source of information currently used by the Commission to investigate incentive related abuses.<sup>169</sup> The second source of information is Federal Police, and Security and Intelligence offices which investigate any

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<sup>167</sup> *ibid*

<sup>168</sup> Interview with Addis Getachew (n117)

<sup>169</sup> Interview with Ashenafi Legebo (n93)

abuses of public resources by its inherent power.<sup>170</sup> Thirdly, there are group of individuals working in this area professionally. They have an agreement with the Commission to follow up any suspicion in relation to tax incentive abuses.<sup>171</sup> If they get to know that a particular investor abused the incentive, they immediately inform Customs Commission so that the latter will follow up. If found true and confirmed through investigation they will get payment in the form of reward.<sup>172</sup> Currently there are more than one hundred ten (110) informants actively engaging in this work.<sup>173</sup> Though it is a good means to get information, there is a possibility of hiding the information by siding with the investors and get more payment from the suspects.<sup>174</sup> Since they are individual seeking a profit, they will incline towards the one who pays more. The other challenges in relation to this individual is they report against someone with whom they have other personal issue or conflict of interest. Hence it is better to formally establish the information channel through legal instrument and create the sense of accountability.

Coming to the role of other stake holders, i.e. Ministry of Culture and Tourism and Ethiopian Investment Commission, so far they didn't play a firm role to oversee whether the incentive they grant, in one way or another is appropriately used for the intended purpose or not.

Among hotel sector participated in questionnaires, 95% of the respondent has replied that during construction of their hotels none of the involved granting authority made any supervision. They replied that once they import necessary construction materials and capital goods they don't have any contact with neither Ministry of Revenue nor Ministry of Culture and Tourism. Their contact is when they request to import other capital goods for hotel service and its only for this purpose that the authority order them to produce evidence of whether the construction is finished and ready for service. Only 5% of the respondent has a contact with staff of Ministry of Revenue and Customs Commission specific branch, due to prolonged construction or delay of service provision. This shows how the responsible enforcement organ is far from follow up measure and

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<sup>170</sup> Interview with Sentayehu Reta, Intelligence and Contraband Supervision Core Leader Coordinator, Ethiopian Customs Commission, Kaliti Branch, , (Addis Ababa, May 22,2020)

<sup>171</sup> *ibid*

<sup>172</sup> *ibid*

<sup>173</sup> *ibid*

<sup>174</sup> *ibid*

control of tax incentive abuses. They react only if information is provided by either of the aforementioned three ways, and in all other cases they do not have appropriate record of who used the incentive appropriately or misused it. Once the beneficiary imports duty free capital goods and construction materials the end use is up to them.

Generally the country is losing huge amount of revenue which goes to individual pocket and drains government coffers.

iii. **Lack of Information Chain:**

In the era of technology where the world is moving towards a single neighborhood through the chain of globalization, still information exchange among concerned authority regarding tax incentive grant and its abuse is not well recorded. The other fact is that Ethiopian Investment Commission after revoking license of a particular investor has no customs of notifying Customs Commission of the same fact.<sup>175</sup> As a result investors holding revoked license continue importing goods duty free appearing as eligible investor.<sup>176</sup> Involved Investment Bureaus in the process of granting tax incentive does not have record of number of investor benefited from incentive so far and up-date of their condition.<sup>177</sup> So far investment granting authority for revocation purpose does not require a clearance from implementing authority, Customs Commission.<sup>178</sup> It means that investors holding revoked license continue importing goods duty free. In relation to information chain, the other noted problem is lack of recording system in each Customs Transits operating in the country. Currently, there are twenty Five (25) Customs Transits functioning in Ethiopia. However, among them only Kaliti Branch does have a department that keeps and follow up appropriate usage of duty free imported goods.<sup>179</sup> The other Customs Transits operating throughout the country does not have such a mechanism in a place.<sup>180</sup> Hence chain of information should be created among all Customs Transits and recording system should be digitalized so that the process will become transparent and easily accessible to different offices.

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<sup>175</sup> Interview with Siay Gezu (n115)

<sup>176</sup> *ibid*

<sup>177</sup> *ibid*

<sup>178</sup> *ibid*

<sup>179</sup> Interview with Amdemichael Getachew (n105)

<sup>180</sup> *ibid*. see also Interview with Addis Getachew (117)

#### iv. Corrupted Working Chain

The other basic challenge contributing for tax incentive abuse in hospitality sector is involvement of personal interest from government officials. Amendment of Customs Proclamation No.622/2009 by Proc. No.859/2014, is not a mere incident and pose a question ‘how robbery of public property could be compromised under the guise of investment promotion?’<sup>181</sup> There is one prominent case substantiating this scenario, the case of Melaku Fenta et al, which involves higher governmental officials like, Gebrewahid Welde Giorgis, Belachew Beyene and Simachew Kebede (owner of Intercontinental Hotel).They were accused of improperly using public resources.<sup>182</sup> Following their accusation, the Customs Proclamation No.622/2009, was amended and specifically a provision that criminalize tax incentive abuse is replaced by administrative action. The amendment was taken place immediately within three months after institution of the case in Federal High Court. Given the fact that the parties to the case are higher government official, and the charge is basically instituted on a provision that criminalize tax incentive abuse, there is high tendency of influence from other decision making organ.<sup>183</sup> Following amendment of the Proclamation in addition to the case of Melaku et al, more than ninety (90) file were terminated by the order of government officials.<sup>184</sup> Among these file, the case of Crown Hotel and Capital Hotel are the primary one.<sup>185</sup> During that time, only a single case was decided <sup>186</sup>and the defendant is subjected to payment of sixty seven million birr and seven years of imprisonment.<sup>187</sup>

After amendment of the proclamation, intensity of tax incentive abuse is dramatically increased. Only in a single Customs Transit (Kalliti branch) one hundred forty seven (147) cases in hotel

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<sup>181</sup> *ibid*

<sup>182</sup> *Melaku Fenta et al. Vs. Federal Anti-Corruption Commission* (Federal High Court, Lideta, File No.141352)

<sup>183</sup> Interview with Amdemichael Getachew (n 105)

<sup>184</sup> *ibid*

<sup>185</sup> *ibid*

<sup>186</sup> *Ibrahim Mohammed Seid Vs Ethiopia Revenue and Customs Authority*, File No.522/404/27, Available at Attorney General

<sup>187</sup> *ibid*

sector is reported and through investigation forty seven of them proved misusing the incentive.<sup>188</sup> As a result, one hundred seventeen million, eight hundred fifty five thousand and seven hundred sixty seven birr (117,855,767.00) ETB was collected.<sup>189</sup> Hence, replacement of criminal action by administrative measure has its own impact on the range of reported tax incentive abuse in hospitality sector. The case of five star hotel construction in Sheno town is also another phenomenon to be mentioned in this regard. Sheno is a small town and its relative approach to the Capital City, Addis Ababa is only 83 km. However Zonal Investment Bureau sent a request letter in support of the investor, so that the latter can import different capital goods and construction materials for construction of Five Star Hotels.<sup>190</sup> Given the fact that Sheno is small town and very close to the Capital City, ‘how responsible government organ can give permission for the construction of Five Star Hotel in such area’ is a very keen question. According to Mr. Sisay Gezu, so far there is no construction under taken in the area<sup>191</sup> and since the case is in court proceeding the researcher is refrained from discussing the detail. Generally, the wide discretion given for a number of government offices paved a way for its abuses.

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<sup>188</sup> Interview with Dereje Tilahun,, Customser Compliance Deputy Manager, Ethiopian Customs Commission Kaliti Branch, Addis Ababa, Interviewed on May 22, 2020

<sup>189</sup> *ibid.*

<sup>190</sup> Interview with Sisay Gezu (n115)

<sup>191</sup> *ibid*

## **Chapter Four: Conclusion and Areas for Recommendation**

### **4.1. Conclusion**

Tax incentive as one mechanism of investment attraction is widely used by different countries in the world to which Ethiopia is no exception. Tax incentive for hospitality sector in Ethiopia is formally started during Derg Policy after the enactment of Council of State Special Decree No.17 in 1990. Since then investors investing in the area of hospitality sector were granted customs duty exemption for importation of capital goods and construction materials. Due to this the government is losing huge amount of revenue in each fiscal year. Regardless of huge forgone revenue, it is subjected to abuse by the beneficiaries and corrupted by involved granting authorities. Having this problem at hand, the introductory part of this thesis posed three research questions which are answered thoroughly by subsequent chapters and sub-sections.

The first research question is, what are the major legal loopholes contributing for tax incentive abuse in Ethiopian hospitality sector? To find an answer for this first question the thesis scrutinized the existing laws on the area. The first legal document was Investment Proclamation No. 1097/2018. This Proclamation has many loopholes that contribute for tax incentive abuses. The first loophole is, it nowhere defines tax incentive in line with specific objectives needed to be achieved. Different scholars argue that this is the main challenge that contribute for tax incentive abuses, as implementing authority are left with wide discretion to determine the conditions. The second gap is related to jurisdiction of granting and administration of tax incentives. According to Art. 96/1 of the FDRE Constitution, it is the federal government that is entitled with levying and collecting customs duties on imported materials. However the Proclamation under Art. 4/1/d limited the duty of federal government to administer tax incentive granted for investors who obtain their investment license from the concerned federal government. Practically, Zonal Investment Bureaus write a letter to Ministry of Culture and Tourism, and Ministry of Revenue to exempt a particular investor from customs duties. This however is against the Constitution and open way for corruption and abuses. Though the amendment Customs Proclamation No. 1160/209, gives the mandate of granting tax incentive to Ministry of Finance, practically such power is delegated to sector specific. The second legal instrument is Regulation No. 270/2012 as amended by Regulation No. 474/2020. Though it attempt to regulate some issues of incentive grant, it fails to specify conditions needed to be

fulfilled for eligibility requirement. Among other thing it does not clearly define construction materials and capital goods. As a result it creates a loopholes for investors to import excess quantity than the business really demand. The third legal document discussed in this thesis is Investment Board Directive No. 4/2005. The Directive for the first time came up with some conditions needed to be fulfilled by investor claiming duty free importation of vehicles, inter-alia, proof of commencement of project and approval from concerned licensing authority. The last one is Council of Ministers Draft Regulation on Investment Incentive. Though the drafting committee tried to deal with some issues which aren't addressed by the existing laws, it repeats the same problems of broadly defining capital goods and construction materials and does not define the term incentive.

The second research question posed by this thesis is, Does the existing Ethiopian tax administration system is strong enough to control tax incentive abuse? In order to answer this question the researcher attempted to assess the role of tax incentive administering authorities. Accordingly the first involved office is Ethiopian Ministry of Culture and Tourism. The Ministry rather than directing a letter to Investment Commission for approval, so far has not taken any step to oversee and supervise whether the investor appropriately used such incentive for the intended project. Moreover they believe that such duty is conclusively to be undertaken by implementing authority, inter-alia; Ministry of Revenue. The second involved government office is Ethiopian Investment Commission. According to Art. 28/1 of the Investment Proclamation the Commission has to serve as a nucleus on any investment matters. Like Ministry of Culture and Tourism, the Commission so far is concerned with promoting investment and attracting potential investors as much as possible by disregarding the issue of incentive abuse. The third enforcement organ involved with tax incentive administration is Ministry of Revenue. The Ministry has different offices to control tax related crimes and abuses. However regarding tax incentive so far the Ministry hasn't taken any firm step. They are basically concerned with validity issue, whether a letter produced by a particular investor is written by the said incentive granting authorities. Moreover they don't have any means to cross check bill of quantity produced by the beneficiary as most of the staff are accountant and legal expert. The last enforcement offices discussed by the researcher is Ethiopian Customs Commission. The Commission, relatively speaking has taken some steps to control abuse of tax incentive in Ethiopia. Currently it established a team called 'Tax Incentive Control and Supervision team'. However they face a

challenge in tracking record of tax incentive beneficiary in the past ten years. Lastly the role of Ethiopian Ministry of Finance is highlighted. According to Art.129 of the Customs Amendment Proclamation No.1160/2019, the Ministry has a mandate to grant tax incentive. In this case two problem is identified by the researcher, the first thing is that it didn't deal with the role of other offices, like Ministry of Culture and Tourism in the process of granting tax incentive and whether 'granting' includes the last decision or administration of the same. Secondly, even if the law duly gives such power for the Ministry, the mandate is delegated to sector specific and nothing changed except Nomination.

The third research question is, how does practical implementation of tax incentive in hospitality sector contributed for its abuse? In order to answer this question the thesis consulted different scenarios whereby tax incentive is hugely abused by the beneficiaries. In this part of the discussion the researcher identified forms of tax incentive abuse by the beneficiaries. The first way is importation of capital goods and construction materials for fictitious project. In this case the investor import the materials duty free even without commencement of any kind of project. The researcher discussed the case of Aba'ala hotel construction project in Afar region and demonstrated how the country lost huge revenue for non-existent project. The second way is importation of capital goods and construction materials more than the project really demands. Due to lack of appropriate specific guideline to determine bill of quantity the beneficiary request excess quantity than a certain project demands in the normal course of the thing. Thirdly most of the time after importing duty free construction materials the beneficiary resell them in a market. Since the Regulation does not qualify availability of same product in domestic market as one condition to deny importation, the beneficiary import the material duty free and resell them at lower price in domestic market. According to data gathered from Customs Commission and Ministry of Revenue, this practice is widely visible in hospitality sector, and the country is losing 60-70 billion birr each year. This in one hand creates imbalanced market competition and affect other tax paying citizen engaged in the same business. The last means of tax incentive abuse identified by this thesis is importation of different capital goods for the same business at different time. Due to lack of information chain among enforcing institution the same investor import capital goods under the name of single business at different time.

The paper attempted to identify major practical challenges contributed for rampant tax incentive abuse in hospitality sector. Accordingly, lack of appropriate guideline to evaluate bill of quantity,

lack of strong administrative mechanism, corrupted working chain, and gaps in the law are mentioned as the leading one.

## **4.2. Recommendations**

In the preceding discussion, major causes of tax incentive abuse in hospitality sector is broadly discussed and in order to make sure the huge foregone revenue is properly used for the intended purpose, reconsidering the existing tax incentive Policy is underlined as a matter of necessity not of choice. Basically, the governing laws of tax incentive should be amended in a way that clear definition for the term incentive and capital goods is provided, and specific guideline to regulate bill of quantity should be enacted.

Hence the following recommendations are forwarded to be considered by Policy makers and other concerned government institutions.

- The existing Investment Proclamation should be amended to clearly define the term Tax Incentive and how it specifically achieve certain economic objective. Moreover the word capital goods and construction material, under investment Regulation should narrowly and specifically defined in a way of limiting wide discretionary power of enforcement organ.
- Grant of tax incentive should be made conditional on the fact that importation of capital goods and construction material will be allowed if and only such material isn't available in domestic market. This solution will have multi direction benefits. First it helps to reduce expenditure of foreign exchange which the country is currently fighting for, Secondly, it will help to encourage domestic producers and thirdly, will reduce abuse of incentive as the local authority will have an updated information regarding the price and quantity of goods.
- A very specific guideline should be enacted to determine and regulate bill of quantity. The guideline will determine whether the request of a particular investor is reasonable in the normal situation of constructing the said hotel.
- A team of experts should be established within each enforcement sector and Customs Transit to follow up tax incentive grant from the first step up to its final stage. The team among other things will make impact assessment of granting incentive for specific sector, make record of duty free imported material and follow up whether the said project is undertaken and used for the intended purposes.

- Revenue forgone due to tax incentive should be disclosed to the public and it should be subjected to continuous review by the Policy makers.

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