AN ANALYSIS OF FOREIGN DIRECT INVESTMENT PATTERN AND ITS IMPLICATIONS IN ETHIOPIA

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ABSTRACT

This study investigates the sectoral and geographical distribution of the approved foreign direct investment (FDI) in Ethiopia between 1992 – 2000. It is observed that, sectorally, FDI is mainly concentrated in consumer goods manufacturing and processing. Agriculture, real estates, construction, and hotels and tourism have also claimed substantial proportions of the approved FDI, in that order. Fishing, and mining and quarrying attracted the least amount of FDI. The relative shares of health and education were also low. The present Investment Code is argued to have a strong influence in causing this sectoral pattern as the Code maintains such entry restrictions as high minimum capital requirements and a list of several areas reserved for domestic investors.

Regional considerations show that FDI is predominantly situated in Addis Ababa. The Oromia, Amhara and Afar regional states have also taken sizable proportions of the approved FDI. No foreign private company expressed its interests to invest in Benishangul-Gumuz and Somali regional states during the period under reference. The study argues that the regional distributions of FDI are largely determined by the level of economic development of the regions (in relative terms) such that the better the availability of infrastructural facilities the larger the flow of FDI, other things being constant.

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CHAPTER ONE

INTRODUCTION

1.1. Background to the Study

The decisive role for sustainable and equitable development of a country must primarily be played by the country itself through coordinated efforts of both the private enterprises and the public organizations. However, a considerable role can also be played by foreign direct investment (FDI)[1] specially, as the world economy becomes more global and new technology is ever more essential to growth[2].

There is no consensus as to the role of FDI in development endeavours of economies. There are two diametrically opposing views in this respect. One of these classes of thought asserts that FDI fills different resource gaps in developing countries, such as savings, foreign exchange, and local revenue. In addition, it is argued that FDI provides a package of highly needed resources including managerial, entrepreneurial, and technological skills. The other view counter argues that the benefits from FDI are outweighed by its adverse effects on the domestic economy in a number of ways. In this regard, the major ones include: stifling of the infant industry, failure by the

1 "FDI is defined as an investment involving a long term relationship and reflecting a lasting interest and control of a resident entity in one economy in an enterprise resident in an economy other than that of the foreign direct investor. FDI implies that the investor exerts a significant degree of influence on the management of the enterprise in the other economy" (UNCTAD, *World Investment Report* 1999: 465).

2 UNCTAD, *World Investment Report 1999*:iii.

transnational corporations (TNCs)[3] to reinvest much of their profits, reduction in tax revenue due to exclusive agreements with host governments, and inhibition of the growth of indigenous entrepreneurship as a result of TNCs' dominance over local markets (Todaro, 1992:396-7). Thus, policy recommendations regarding the role of FDI vary accordingly.

Nevertheless, presently, because of the changes in both perceptions of developing countries and the ways TNCs are operating, the policy that favours FDI has taken the upper hand[4].

Some time has passed now since Ethiopia has taken measures congruent with this new global context. In this respect, a market oriented economic policy has been adopted; consequently, a new investment code with generous incentives has been issued; the exorbitant import tax has considerably been reduced as a step towards trade liberalisation; and the privatisation of state-owned enterprises has been going on progressively.

Pursuant to the favourable environment thus created for the private investment in the country, a number of foreign investors have expressed their desire to invest in Ethiopia. To this effect, the investors have been granted the necessary permits that enable them to carry out their envisaged investment projects[5]. In fact, some of them, such as the

3 TNCs, also referred to as multinational corporations (MNCs), are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates (UNCTAD, *World Investment Report* 1999: 465).

4 See, for example, UNCTAD, *World Investment Report* 1999: 313 and Yohannes, 1999:296.

5 See the Ethiopian Investment Authority (1998), *Statistics on Investment in Ethiopia*, No .1.

conglomerate MIDROC Ethiopia, the Ethiopian Steel (engaged in production of corrugated iron), the Golden Rose Agro Farm (engaged in flower plantation), and BGI Ethiopia, have already started actual production/ services[6]. The purpose of this study is therefore to examine the sectoral and regional distribution of foreign investment projects in post-1991 Ethiopia with the aim of deriving relevant policy implications.

1.2. Statement of the Problem

Ethiopia has adopted a market oriented economic policy since 1991. In line with this policy, a new investment code was promulgated, and successively amended with the aim of inducing expansion of the private investment in the country. The local capital in the country is not adequate to let the economy embark on a sustainable development. The main reason for the weakness of the domestic capital is the fact that the development of private ventures was highly suppressed by the previous regime, to the extent that most of them were confiscated by the regime.

In 1991, a new government came into power in Ethiopia and subsequently introduced an economic policy that is market friendly. The new government, realising the inadequacy of the domestic capital to stimulate a sustainable economic development in the country, has been encouraging foreign private investment by means of tax holidays (1-5 years), low corporate income tax (35%), duty free importation in areas eligible for incentives, customs concessions in the import of specified units, deduction of expenses

6 Interview information with EIA official, November 2000.

incurred on research and development, etc[7]. In response to this favourable policy environment, a considerable amount of FDI has been attracted to the country[8].

It is important to investigate in detail the behaviour of the foreign private investment projects in the country to see whether they are concentrated in few or evenly distributed across regions and/or sectors of the economy. This is imperative because a concentration of investments in only few regions implies an imbalanced regional growth whereby the citizens of the country cannot be able to equitably appropriate the gains from economic growth. Sectorally, an undiversified investment can result in neglecting of some sectors (for example, education and health) that are essential to the growth of the other sectors. When such phenomena occur, there will be a clear need for appropriate policy interventions.

This study seeks to investigate the sectoral and regional distribution of approved foreign investment projects in post-1991 Ethiopia in order to get insights relevant for policy conclusions.

1.3. Objectives of the Study

The study attempts to achieve the following objectives:

(a) To investigate and document the sectoral and regional distribution of FDI projects in Ethiopia;

7 Federal Democratic Republic of Ethiopia (FDRE), Proclamation No.37/1996 and Council of Ministers Regulation No.7/1996.

8 See EIA (1999), *Statistics on Investment in Ethiopia*, No.1.

(b) To identify sectors and/or regions which have not yet attracted the interests of foreign private investors;

(c) To explore the reasons for the observed pattern of FDI; and

(d) To draw policy recommendations.

1.4. Data and Methodology

Data sources for this study are the Ethiopian Investment Authority (EIA), the Central Statistical Authority and the *World Investment Report* published yearly by the UNCTAD. Secondary data on relevant variables will be collected from these sources since the country adopted a market oriented economic policy, from 1992 to 2000. This is indeed a short period. As a result, conclusions based on these data may not be firm enough to suggest strong policy implications. However, they are believed to be indicative of the trend of the distribution of foreign private investment in the country. In addition, this study cannot supplement the analysis by a survey concerning why each foreign private investor has chosen a particular sector and/or region to undertake his/her project. This is beyond the scope of the study due to the limited time and other resource constraints under which the study will be conducted. Moreover, the study cannot apply any econometric model due to lack of sufficient data on relevant variables. Instead, the analysis of the study will be based on theoretical reasoning and on such statistical tools as percentages and ratios.

1.5. Significance of the Study

This study is intended to investigate the sectoral and geographical distributions of approved FDI in Ethiopia following the adoption of the new economic policy in 1991. The study also aims at exploring possible explanations for the observed patterns and tries to draw policy implications. It is therefore hoped that the study will make a modest contribution to the growing body of literature in this area in the country, and accordingly, it can be a useful reference for policy-makers, future researchers, and others interested in the subject.

1.6. Scope of the Study

This study is confined mainly to the analysis of the distribution of FDI projects across regions and sectors of the economy for the period 1992 to 2000. Thus, the analysis of the behaviour of domestic private investment and public investment are not the focuses of this study.

1.7. Organization of the Study

The study is organized as follows:

Following the introduction chapter, a review of the literature will be provided in chapter two. In this chapter, the theories of FDI, views concerning FDI, FDI in Africa, and problems in attracting FDI to Ethiopia have been reviewed. Chapter three presents a

brief survey of the current state of the Ethiopian economy, with some details on the Ethiopian agriculture, foreign trade, and the private investment environment. Chapter four treats FDI patterns in Ethiopia. This chapter presents the trends, volume, and the sectoral and regional distributions of FDI in post-1991 Ethiopia. Finally, the policy implications, summary and conclusions are presented in chapter five.

CHAPTER TWO

REVIEW OF THE LITERATURE

2.1. The Theoretical Framework

In today's world economy, there are huge flows of investment capital across countries every year. Various theoretical explanations have been forwarded for these phenomena. All of them, however, agree with the fundamental principle: that is, investment capital moves from one place to another with an expectation of a higher rate of return in the new location than it earned in the old. In other words, whether capital moves across countries, or between regions of a country or between industries, the basic principle is a higher rate of return, and FDI is no exception to this rule (Field, 1998). However, one also finds theories that are specific to FDI. The next section will provide a brief review of the popular ones that are common in the literature.

2.1.1. Industrial Organization Theory of Foreign Direct Investment

This theory began with works of Stephen Hymer (1960)[9] on multinational enterprises. According to this theory, firms possess certain ownership-specific advantages that can be better exploited abroad by establishing subsidiaries instead of exporting their products or licensing their technology. The ownership specific advantages that motivate

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9 See Chen, K.Y. Edward, 1983:20.

a firm to invest in a foreign country include superior technology, economies of scale, an exclusive control over certain natural resources, access to inexpensive labour, finance and information.

It is, however, noteworthy that a possession of firm-specific advantages, such as superior technology, per se, cannot fully explain why firms engage in direct foreign investment as superior technology can also be exploited through licensing agreements and exporting of products, which embody the superior technology. It can also be argued that an exclusive control over inputs is only a necessary condition for foreign direct investment. Thus, one still has to explain why foreign direct investment is a more viable strategy than exporting and licensing (Chen, K.Y. 1983:22). This puzzle was resolved by internalisation theory of foreign direct investment discussed in the next section.

2.1.2. Internalisation Theory of Foreign Direct Investment

The internalisation theory of foreign direct investment is in fact an extension of the industrial organization theory. The former, developed by Williamson (1975)[10], asserts that possession of ownership-specific factors will make it profitable for a firm to engage in foreign direct investment to avoid risks and uncertainties that arise from exporting and/or licensing[11].

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10 See Helleiner, 1989: 1452.

11 It should be noted that exporting has potential risks for a firm because some knowledge may flow from one country to another due to intentional actions of would-be imitators. Similarly, licensing also involves risks. For instance, an innovative firm may be unable to prevent some opportunistic behaviour of a licensee after its technology has been transferred. The licensee might use the technology in markets different from one specified in the agreement as a springboard to develop a different or better technology of its own.

The internalisation of markets across national boundaries depends on location-specific advantages. If a foreign country does not possess location–specific advantages, a firm internalises the home market and exploits the foreign market by exporting. On the other hand, if a foreign country possesses location-specific advantages (e.g., lower factor costs), the firm prefers internalisation of the foreign market (the factor market in this case). Furthermore, it is important to note that according to this theory, it is not the ownership–specific advantage per se that leads to FDI, but the fact that the advantage can be beneficially appropriated through internalising the market of this advantage across national boundaries. In the absence of such benefits to be obtained from internalisation, firms may exploit the advantages through export and/or licensing (Chen, K. Y., 1983:31).

It is argued that this theory explains only the Japanese type of FDI. That is, Japanese firms tend to transfer labour-intensive technologies to developing countries as these countries have a comparative advantage with respect to labour endowment. But, the theory fails to explain the American type of FDI in developing countries that is usually capital-intensive as these countries have a comparative disadvantage with respect to capital endowment (Chen, K.Y., 1983:24-25).

Thus, if internalisation (i.e., direct foreign investment), by alleviating costs of these risks, is thought of resulting in a net benefit to the firm, FDI will be a viable option (For this and more such examples, see Grossman and Helpman, 1995:1332-1333).

2.1.3. Location Theory of Foreign Direct Investment

This theory, developed by Dunning (1973)[12], asserts that for a country to be attractive to FDI, it should possess certain location–specific advantages. These location-specific factors are:

1. **Availability and Cost of Inputs**: It is suggested that a firm investing abroad may be attracted by the availability of some inputs, which are very expensive at home, or by a lower cost of inputs abroad (e.g., lower labour costs in developing countries) (Field, 1998:229).
2. **Marketing Factors**: It is asserted that TNCs invest in a foreign country in which there is a large and rapidly growing market for their products. In so doing, they will be able to better exploit the local market, avoid tariff and non-tariff barriers, and reduce transportation costs[13].
3. **Factors Related to Government Policies**: It is suggested that a firm is often attracted to invest in a foreign country because the country offers advantages such as lower tax rates, better infrastructure, greater political stability, and greater scope for expansion and the pursuance of corporate goals (Chen, K.Y., 1983:26).

It can be noted that this theory provides a good list of host-country determinants of foreign direct investment. However, it fails to incorporate other factors, such as firm-specific advantages indicated above under industrial organization theory as motivations behind undertaking foreign direct investment.

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12 See Chen, K.Y.,1983:25.

13 See UNCTAD, *World Investment Report 1998*:89 and Meier, 1995:5.

2.1.4. The Product Life Cycle Theory of Foreign Direct Investment

This is one of the popular theories of foreign direct investment, developed by Vernon (1966)[14]. The theory attempts to explain the causes of international investment as follows: In the early stage of the life of a product, the production of the good usually takes place in the country where it was invented, and initial access to foreign markets is by means of exports. However, in the long run, as competing products emerge, the firm may decide to move toward locations where it finds lower costs of production along with new markets. In addition, the firm may also be attracted to new locations due to economies of scale that might result from allocating component production and assembly to different plants (Sodersten and Reed, 1994:85, 471).

The product life cycle theory of foreign direct investment takes into account both ownership-and location- specific factors in explaining FDI. It is also a dynamic theory in the sense that it deals with changes over time. However, it also has some shortcomings. The theory predicts the sequence of events, but does not really deal with the rate of change or the time involved in each stage. Moreover, since 1970s this theory has increasingly failed to explain many of the phenomena of FDI. In particular, it is observed that the production of a new product begins simultaneously at home and abroad. This means that the product life cycle has become very short or even non-existing (Chen, K.Y., 1983:28).

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14 See Grossman and Helpman, 1995:1334.

2.1.5. An Eclectic Theory of Foreign Direct Investment

This theory, developed by Dunning (1981), is a synthesis of all the existing theories (Helleiner, 1989:1453). In a sense, an eclectic theory is an elaborated version of the internalisation theory. According to this theory, there are three determinants of foreign direct investment. First, ownership-specific advantages of firms, such as superior technology, monopoly power, better resource capacity and usage, etc. Second, internalisation advantages, implying that FDI occurs only if the ownership-specific advantages can profitably be internalised. This is made possible when FDI enables the firm to avoid risks and uncertainties that stem from exporting and/or licensing[15]. Third, location-specific factors of the home and host countries. These factors have been discussed above under location theory of FDI.

What is new about the eclectic theory is that it provides a link that connects the various theories of FDI. The theory asserts that if a firm possesses only ownership–specific advantages, it will consider FDI, exporting and licensing equally viable strategies. But, if the ownership–specific advantages can profitably be internalised across national boundaries due to location–specific factors, then the firm will prefer FDI to both exporting and licensing (Chen, K.Y., 1983:33).

15 See footnote no.11.

It is indicated that, in a sense, the eclectic theory is no theory. The reason is that, although the theory has a strong explanatory power, it derives this power simply from the fact that it synthesises almost all the other existing theories of FDI. Thus, it is argued that the eclectic theory is just a framework from which specific theories can be derived. Nevertheless, given the fact that the determinants of FDI are so complex, the eclectic theory remains popular in the analyses of determinants of FDI (Chen, K.Y., 1983:35).

The theories reviewed above are the major theoretical explanations as to why firms engage in direct foreign investment. It is, however, important to note that different reasons will apply to different industries, periods, and investors. Moreover, there is no single grand theory that completely explains the reasons for foreign direct investment[16].

2.2. Views Concerning FDI

There are two opposing and yet unsettled views as to the role of TNCs in a developing economy. In this section, the main arguments of both views will briefly be reviewed[17].

2.2.1. Economic Arguments in Favour of FDI

This view mainly comes from the traditional neoclassical analysis of the determinants of economic growth. According to this view, FDI is required by least developed countries

16 See Field (1998:31) and Chen, K.Y. (1983:16).

17 Unless otherwise indicated, this section largely draws on Todaro, 1992:396-398.

(LDCs) to fill in the gaps between domestic savings, foreign exchange, government revenue, and management skills and the level of these resources needed to achieve growth targets. Brief comments are made on each of them below.

1. **Filling Investment–Saving Gap**: This is the first and most often cited contribution of FDI to national development. The basic premise here is that since in LDCs the domestically available saving generally falls short of investment that is needed to generate a growth rate targeted by the countries, FDI is claimed to fill this resource gap. Here, obviously, saving is assumed to be a key factor for economic development.
2. **Filling Foreign Exchange Gap**: This is analogous to filling investment-savings gap. FDI is claimed to contribute in filling the gap between targeted foreign exchange requirements and those obtained from export earnings plus net public foreign aid. The argument maintains that an inflow of FDI not only reduces part or all of the deficit on the balance-of-payments current account but it also serves to remove that deficit overtime assuming that the foreign firms can generate a net positive export earnings.
3. **Filling Government Revenue Gap**: This refers to the gap between targeted tax revenue of the government and locally collected taxes. Governments of developing countries are thought of being better able to mobilize financial resources for development projects by taxing profits of TNCs.
4. **Filling Management, Entrepreneurship, Technology and Skill Gap**: According to this argument, TNCs bring in not only financial resources and new factories to

developing countries, but they also provide a number of critically needed resources, such as managerial experience, entrepreneurial abilities and technological skills that can be transferred to domestic enterprises through training programmes and the process of learning-by-doing. Moreover, TNCs can bring in with them the most sophisticated modern technologies, some of which not available without FDI, and adapt these technologies to local conditions, drawing upon their experiences in other developing countries[18].

2.2.2. Economic Arguments against FDI

Each of the above pro-FDI argument is strongly counter argued, in the above respective order, as follows:

1. Even if TNCs provide capital, they may decrease local savings and investment by stifling competition by means of exclusive agreements they enter into with host governments. It is argued that these problems take place when TNCs fail to reinvest much of their profits, generate local incomes for those groups with lower savings propensities, hamper the expansion of domestic enterprises that might supply them with intermediate goods by instead importing these products from affiliates abroad, and charge high interests on capital borrowed by host governments.

18 See UNCTAD, *World Investment Report* 1999: 317.

2. Although investments by TNCs, initially, may improve the host country's foreign exchange position, in the long run it may result in reduction of foreign exchange earnings on both current and capital accounts. The current account may deteriorate due to a substantial importation of intermediate and capital goods. The capital account may worsen because of repatriation of profits, interest, royalties, management fees, etc.
3. It is true that TNCs do contribute to government revenue in the form of corporate taxes. However, their contribution is substantially lower than it should be because of liberal tax concessions, excessive investment allowances and tariff protection provided by the recipient nation.
4. The managerial, entrepreneurial skills, and technology brought in by TNCs may have insignificant impact on developing indigenous potentials of these resources and may in fact inhibit their development as a result of TNCs' dominance over domestic markets.

In addition to the above economic arguments against FDI, there are other criticisms of TNCs that were particularly raised by LDCs in the past. In this regard, the following objections have been raised[19]:

1. The impact of TNCs on development is very uneven and in many cases their activities result in dualistic economic structures and worsen income inequalities. They tend to promote the interests of the small number of well paid modern sector

19 See Todaro, 1982:332-333.

workers against the interests of the majority of the local population by widening wage differentials. They divert resources away from highly needed food production to the production of sophisticated goods catering mainly for the demands of local elites. Moreover, they tend to aggravate the imbalance between rural and urban economic opportunities, as they are usually located in urban areas, thus contributing to the accelerated flow of rural-urban migration.

2. TNCs often produce improper products (that is, those demanded by a small rich minority of the local population), encourage inappropriate consumption patterns through advertising and their monopolistic market power, and do these all with unfitting (that is, capital-intensive) technologies of production.
3. As a result of (1) and (2) above, domestic resources tend to be allocated towards socially unsuitable projects. These in turn tend to aggravate the already existing income disparity between the rich and the poor and the severe difference between urban and rural economic opportunities.
4. TNCs use their economic power to have an influence on host government policies in direction unfavourable for development. They are able to extract sizeable economic and political concessions from LDCs' governments in the form of exclusive protection, tax discount, investment allowances and the cheap provision of factory sites and essential social services. As a result, the private profits of TNCs may surpass social benefits. In some cases, these social returns to host countries may even be negative. In addition, a TNC can avoid much local taxation by means of artificially inflated prices it pays for intermediate products purchased from abroad affiliates in order to understate its local profit levels. This phenomenon, known as

"transfer pricing", is the most common practice of TNCs over which host governments do not have any effective mechanism of controlling.

5. TNCs may be harmful to host economies by stifling domestic private enterprises using their superior knowledge, worldwide contacts, advertising skills, and range of essential support services to drive out local competitors and inhibit the emergence of small-scale local ventures.
6. At the political arena, anxiety is often expressed that powerful multinational corporations can have the ability to control local assets and jobs, and then exert significant effects on political decisions at all levels. In extreme cases, they may even challenge the very political process of host nations.

The criticisms of TNCs raised by developing countries grew out of inherent differences in the interest of host governments and those of the TNCs, creating much suspicion of FDI on the part of the host countries. However, one of recent global reports has come up with a different conclusion:

> *... [P]erceptions have changed greatly in recent years. So have the ways in which TNCs operate and organize themselves globally. Both are in response to the new global context: rapid technical progress, shrinking of economic space, improved communication, intensification of competition, new forms of market rivalry, increasingly mobile capital, widespread policy liberalization and more vocal (and influential) stakeholders*[20].

20 UNCTAD, *World Investment Report* 1999: 313.

2.3. FDI Flows into Africa

The relevance of the criticisms of TNCs raised by LDCs (discussed in section 2.2.2. above) cannot be fully refuted. Nevertheless, from the literature one can safely deduce that they have become less important issues. In addition, regardless of the unsettled controversy concerning the role of FDI, its demand by developing countries is increasing very rapidly. For instance, Yohannes (1999:313) noted that the absolute level of FDI flows into Africa is rising from an annual average of $800 million during 1975 – 80 to annual average of $3.9 billion during 1990-96. Although rising from a small base, FDI inflows into Africa grew by five folds between 1975-80 and 1990-96, compared to 4.7 times for Latin America and seven folds for developing countries as a whole.

The latest *World Investment Report*[21] has also documented that inflows of FDI to Africa rose nearly by 28 percent, from $8 billion in 1998 to $10 billion in 1999. This growth rate is higher than that of other developing countries. However, in absolute terms these figures are very small compared to dramatic rises in FDI flows to the rest of the world in 1998-1999. For instance, developing countries as a whole attracted $208 billion in 1999, which is 16 percent higher than the 1998 level. On the other hand, developed countries attracted $636 billion of FDI inflows in 1999, $156 billion more than in 1999, accounting for nearly 75 percent of the world's total.

21 This section heavily draws upon UNCTAD, *World Investment Report* 2000.

As indicated above, because of the limited amounts of FDI flows to Africa, most African countries receive small FDI flows in absolute terms. In recent years, however, Angola, Egypt, Morocco, Nigeria, South Africa and Tunisia have attracted considerable amounts of FDI. In Angola, the foreign investment capital went mainly to petroleum. Egypt managed to attract such increasing amounts of FDI mainly because of deregulations and privatisation. Consequently, these two countries became the leading recipients of FDI flows to the continent in 1999, overtaking Nigeria, which had been traditionally the largest recipient in Africa. However, compared with FDI flows to these countries, Ethiopia's position is not that much impressive[22].

Evidences on sectoral distribution of FDI in African countries show a varying interest by different sources. FDI originating from the United States, for example, is mainly interested in natural resources, particularly focusing on petroleum investment. French FDI also shows a rising interest in natural resources extraction, while FDI from Germany, the Netherlands, and Switzerland has gone mainly to manufacturing. FDI from the United Kingdom has shown an increasing interest in service sectors[23].

22 For details, see UNCTAD, *World Investment Report 2000*:283-288.

23 UNCTAD, *World Investment Report* 2000: 42.

2.4. Problems and Prospects of FDI in Africa

As pointed out in the previous section, Africa's share in the global flow of FDI is very small. Several reasons have been forwarded for this less attractiveness of the continent to FDI. The major ones in this respect are briefly outlined below[24].

1. Prolonged civil conflicts, political crises, and natural disasters, especially drought, which renders the investment environment highly risky.
2. Relatively small markets. In 1993, most African countries in Sub-Saharan Africa had an average GDP of $3.4 billion (or $311 per capita), and the North African economies an average GDP of $30 billion (or $116 per capita). Attempts to alleviate this problem through regional integration have either failed or proved ineffective in terms of creating larger economic areas and increasing intra-regional trade.
3. Lower economic growth relative to other least developed countries: For instance, Collier and Gunning (1999) noted that in the 1980s Africa's per capita GDP declined by 1.3 percent, 5 percent below the average for all low income countries, while in 1990-94 the decline increased to 1.8 percent and the gap widened to 6.2 percent.
4. Poor and deteriorating physical infrastructure, particularly telecommunication and transportation, and the lack of capital to improve it. In addition to these are often

24 See, for evidence, UNCTAD (1995), *Foreign Direct Investment in Africa*, pp.37-39 and UNCTAD (2000), *The Least Developed Countries 2000 Report*.

weak institutional and especially financial infrastructures, such as banking and financial institutions.

5. The high degree of indebtedness of many African countries. The debt problem is worsened by balance-of-payments difficulties often caused by the sharp decline of commodity prices. As a result, many African countries chronically suffer from shortage of foreign exchange. This makes it very difficult to ensure repatriation of FDI profits, which is a key aspect of favourable climate for FDI.
6. Lack or low level of skills and technological capabilities, and high production costs. By the mid 1980s, costs of production in Sub Saharan Africa were as twice as those in low-income Asian countries. For example, the cost of rail transport was 2.8 times higher, and wages of unskilled workers in the construction sector 1.4 times higher in Sub-Saharan Africa. Since productivity levels in Africa are generally poorer than in low-income Asian countries, high relative production costs further worsen the attractiveness of the continent as an investment site[25].

A wide-ranging survey was recently conducted jointly by UNCTAD and the International Chamber of Commerce (ICC) as to the prospects of FDI flows to Africa[26]. At the beginning of 2000, 296 of the world's largest TNCs were contacted. Results of the survey suggest that a rise in FDI inflows to Africa in recent years might continue in the future. About the 33 percent of the companies responded indicated that they intended to increase investment in the next three to five years, while more than 50 per cent expected their investment levels to be unchanging. In addition, more than 43

25 UNCTAD (1995), *Foreign Direct Investment in Africa*, p.39.

26 For details, see UNCTAD, *World Investment Report* 2000, pp.42-49.

percent of the respondents expressed their view that Africa's overall prospects for attracting FDI would improve in the next three to five years, compared with the past three years. On the other hand, slightly more (46%) did not expect the prospects to improve. The majority of the respondents (73%) indicated the overall potential for FDI in Africa to be "limited", and only 12 percent assessed it as "there is potential" for FDI in Africa although that is not easily seen.

Moreover, it is indicated that only 6 percent of the companies that responded were considering reducing their investment from present levels or pulling out completely, showing encouraging prospects of FDI in the continent. According to this survey, countries with a high level of development or large domestic markets dominate the list of most attractive ones. Thus, South Africa is on the top of the list of the most attractive countries to FDI in the continent, followed by Egypt. Morocco and Nigeria, ranked third and fourth in the list, respectively. Furthermore, similar preference has been reflected in the ranking of countries with respect to creation of a more business-friendly environment in the near future.

2.5. FDI in Ethiopia: an Overview

The history of endeavours to industrialize Ethiopia dates back to the beginning of the 20th century, when foreign nationals who had settled in urban areas realised Ethiopia's demand for manufactured goods, and began to establish manufacturing firms in Ethiopia (Yohannes, 1999:305). Befekadu (1983:100), however, noted that until 1957 there had

been no documented strategy for industrialization of Ethiopia except the declaration of the Ten-Year Industrial Development Programme of 1945, which consisted of only the general guidelines.

From 1957 onwards, formal industrialisation policies were issued and successive five-year plans were designed. These policies included exemptions from income tax, access to foreign exchange, loans for buying real estates, and tariff protections (Ministry of Industry, 1986:33). As a result, foreign nationals resident in Ethiopia responded by bringing in capital and technology. However, it is argued that the policy was totally outward oriented and the domestic factors of development were put at a secondary position and, as a result, a modern sector that is totally dependent on the external world and completely divorced from the traditional sector was set up (Befekadu, 1983:100).

During the era of the Derg (1974-1991), because of the socialist ideology that is alien to the private sector, the regime not only confiscated the flourishing private enterprises, but also, viewing the private capital as dangerous to the well being of the society, deliberately sterilized the private capital formation efforts in the country[27].

Post-1991 Ethiopia is characterized by fundamental political and economic reforms that are deemed to revitalize the economy in the short run and expedite long run development. In this respect, the major policy changes include:

27 For a brief discussion of the policy followed by the Derg towards the private sector, see Yohannes (1999:305).

1. The exorbitant import tariffs have been reduced, and trade liberalization measures have also been introduced;
2. Markets and prices have been liberalized;
3. The Birr has been devalued so that distortions in the exchange rate have almost been eliminated;
4. A new investment code has been promulgated, and successively amended;
5. The privatisation of the state-owned enterprises is being carried out step by step.

As these policy measures have created a conducive environment for the smooth operations of the private capital, the private sector is resurrecting after two decades of deliberate stifling by the previous regime.

2.6. Problems in Attracting FDI to Ethiopia

In response to the above listed policy changes, some foreign private investors have started their investment activities in the country. However, the response by foreign investors is so far below expectations[28]. Although there are no comprehensive studies regarding the problems inhibiting entry, operation and expansion of foreign private investment in the country, a brief assessment by Berhanu (1999:7-12) is, however, worth reviewing here.

28 EIA (1999:11), *Statistics on Investment in Ethiopia, No.1.*

The writer identified the following six major factors that foreign investors consider and are in short supply or not in favour of them in Ethiopia.

1. **Resources:** He argued that from what is so far known, Ethiopia's natural resource base is not strong enough to clamour foreign investors to Ethiopia.
2. **Cost Conditions:** The author also argued that the costs of land, labour, and raw materials are relatively higher in Ethiopia than other countries in similar level of economic development, and hence cause foreign investors not to choose Ethiopia as their priority country for their investment.
3. **Demand Conditions:** In this regard, he identified two impediments to the inflow of FDI to Ethiopia. The first is a very low effective demand of the population implied from its very low per capita income. The second is difficulty in protecting the local market because of increased pressure by multilateral institutions and donor countries to liberalize the trade sector.
4. **Macroeconomic Conditions:** It is also pointed out that the fact that the Ethiopian economy is highly dependent on agriculture, which itself is dependent on climatic conditions, makes the economy unstable, implying that foreign investors will be less willing to invest in Ethiopia because of the risk they may face.
5. **The Inefficiency of the Bureaucracy and the Legal System:** He noted that the amount of time it takes to secure land for investment is so high, and the judicial process for enforcement of contracts is also too slow. Thus, foreign investors, who have ample opportunities to enjoy better services in other countries competing for their resources, may not be attracted to Ethiopia.

6. **Security and Property Rights:** Finally, the writer indicated that the weakness of the legal system of the country can be another important factor for lack of confidence by some foreign investors to invest in Ethiopia.

It is difficult to disprove the validity of these arguments. As Ethiopia is one of the least developed countries in the world, such problems are so prevalent in the country. But one can argue that Ethiopia's natural resource base is not so weak. Some surveys and assessments by investors show that Ethiopia is endowed with a wide-range of natural resources. In particular, it is documented that the country has several rivers that can be used for both irrigation and hydroelectric power generation[29].

Surveys also show that Ethiopia has good prospects for mineral extraction, including petroleum oil. For example, a Canadian company, named Pinewood Resources Ltd, recently reported that it had been engaged in petroleum exploration in the Gambella area of the country during the last few years. In an interview with *The Reporter*, a weekly newspaper, the president of the company said that the prospects for oil extraction were so encouraging that he was convinced at least 50,000 barrels a day would be extracted, which is believed to surpass the current domestic demand for oil[30].

A large coal deposit has also been recently discovered in Yayu district (Wollega). County reports claim that an annual output of 3000,000 tonnes is possible, and would

29 Ministry of Information and Culture (1998), *Investment Opportunities in Ethiopia.*

30 For details, see *The Reporter*, February 7, 2001.

last for about 40 years[31]. In addition, it is also reported that more than 500 metric tonnes of gold reserves have been identified by the government's exploration efforts[32].

It is argued that a high degree of indebtedness of a country coupled with balance-of-payments difficulties often caused by a sharp decline of commodity prices result in a severe shortage of foreign exchange, which makes it difficult to ensure a repatriation of FDI profits—an essential aspect of favourable climate for FDI[33]. Ethiopia is one of highly indebted poor countries in the world and also suffers a deterioration of its trade balance[34]. Thus, the poor attractiveness of the country for FDI can also be related to the problem of high foreign debt-burden and the deteriorating terms of trade, both making the country less attractive for foreign private investment.

It is also argued that reservation of several areas to domestic investors by the Investment Code has created some degree of suspicion on the part of the investors that the government is not fully committed to open up the economy for foreign investors (FIAS,1997). One can also add to the arguments that the inadequacy of the domestic infrastructure, shortage of skilled labour force and, perhaps most importantly, the negative image of the country due to recurrent drought and prolonged civil war the country went through for decades as other critical factors constraining the inflow of FDI into the country.

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31 The Economist Intelligence Unit (2000), *Country Report*, December 2000.

32 EIA (1998), *Invest in Ethiopia*, p.18.

33 See UNCTAD (1995), *Foreign Direct Investment in Africa*, p.38.

34 See the Ethiopian Economic Association, EEA, (2000:65, 281).

CHAPTER THREE

AN OVERVIEW OF THE CURRENT STATE OF THE ETHIOPIAN ECONOMY

3.1. General

Reports on the Ethiopian economy reveal several staggering facts and figures. According to the recent *World Development Report (1999/2000)* by the World Bank, in GNP per capita terms measured by the Purchasing Power Party (PPP), Ethiopia ranks last out of the total of 210 countries. A similar ranking has been reported by the United Nations Development Program (UNDP), which indicated that, in terms of human development indices, Ethiopia stands at 172nd out of 174 countries[35].

In 1998, Ethiopia's real per capita GNP, calculated in terms of dollars, was $100, which was far below the year's average figure for the low-income countries ($480). In terms of PPP, which is more indicative of the individuals' purchasing power in their own countries, Ethiopia's real GDP per capita for 1998 was $500, third lowest figure in Africa, exceeding only those of Tanzania ($490) and Sierra Leon ($390)[36].

35 UNDP, *Human Development Report*, 1999:171.

36 The Ethiopian Economic Association (EEA), 2000:1.

Staggering figures have also been reported with respect to the living condition of the people in the country. About half of the population live on a meagre income that is below absolute poverty level[37]. Ethiopia's average life expectancy at birth is only 48.7 years, and the infant mortality rate is so high that 109 out of 1000 live births do not celebrate their first birth date. Astonishingly, it is observed that the main cause for the deaths is easily controllable diseases. In addition, only 27% of the population have access to safe water while only 10% have access to sanitation. Moreover, the adult literacy rate for Ethiopia stands at 35.5%. These figures are very low compared to those of other developing countries. For instance, life expectancy at birth for low-income countries stands at 62.2 years while the figures for infant mortality rate per 1000 live births is 80. For these countries the average figures for access to safe water, access to sanitation and adult literacy rate stand at 71%, 30% and 49.2%, respectively. For Kenya, for example, life expectancy stands at 53.8 years while the figures for infant mortality rate per 1000 live-birth, adult literacy rate, access to safe water and sanitation stand at 57%, 78.1%, 53%, and 77%, respectively (Berhanu Nega, 1977:7).

The statistical evidences listed above show that Ethiopia is one of the poorest countries in the world. Nevertheless, recent assessments of the performance of the economy have indicated some promising figures with respect to the growth rate of the economy. Between 1991/92 and 1997/98, the real GDP of Ethiopia grew at an average rate of

37 EEA, 2000:1.

4.7%. Excluding the year 1991/92, which was the year of highest political instability in the country, the average growth rate was registered at 6.1%, with a per capita GDP growth rate exceeding 3.1% on average. This performance of the economy favourably compares with 1.9% GDP growth rate for the last decade of the previous regime. In 1992/93, the highest GDP growth rate of 12% was registered, although it started from a very low level of -3.7% in 1991/92. An impressive growth rate of 10.7% was also achieved in 1995/96 (Berhanu Nega and Said Nuru, 1999:30-31). With this general background, next sections will present brief assessments of some specific aspects of the economy relevant to the research theme pursued.

3.2. The Ethiopian Agriculture

Agriculture is the dominant sector in the Ethiopian economy, with its contributions to the GDP ranging between 46% and 58% over the period 1980 to 1998. About 85% of the country's population live in rural areas, being principally dependent on agricultural activities as sources of their livelihood (Mulat Demeke, 1999). In addition, about 70% of the country's labour force is employed in the agricultural sector (EEA, 2000:83). Moreover, nearly 85% of the country's foreign exchange earnings are derived from exports of few primary commodities—coffee alone contributing to over 60%, followed by hides and skins, 14.1% (Alemayehu Geda, 1999).

The Ethiopian agriculture is predominantly characterized by traditional methods of farming with no considerable advances in the farming technology over centuries. It is

principally rain-fed and hence vulnerable to severe fluctuations following changes in the rainfall. As agriculture is the dominant sector in the economy, it is noted that the overall performance of the economy is highly associated with the performance of the sector (EEA, 2000:155).

Development theory asserts that growth in the agricultural sector that alleviates the poverty of the majority of the population residing in rural areas of developing countries is vital for attainment of rapid industrialization. This assertion is based upon a number of persuasive arguments. The following ones include the most important ones in this respect[38]:

1. A higher agricultural productivity implies a rise in income of the rural population, which then can generate increased demand for industrial products—both consumer goods and agricultural inputs—allowing manufacturers to operate at large scales enjoying efficiency gains from economies of scale.
2. A higher income of the rural population implies that there will be a high potential for rural savings which, assuming availability of adequate financial institutions there, can be used for expansion of the industrial sector that is constrained by lack of financial resources.
3. A highly productive agriculture implies adequate food supply to the urban population at low prices, decreasing the upward pressure on wages in urban areas.

38 For more details, see Meier, 1995:395-452.

This situation results in higher profits and thus in higher savings and investments in the industrial sector.

4. A rise in agricultural labour productivity would imply a fall in marginal productivity of labour in the excess labour force living in the rural areas, thus resulting in migration to cities. This increases the supply of labour to the industrial sector, reducing the upward pressure on wages in urban areas (EEA, 2000:154).

It is this general belief about the role of agriculture that is supported by the successful experiences of the East Asian countries, coupled with the immediate concern of alleviating rural poverty, where the majority of the population are residing, that has become the basis for the government's development strategy known as Agriculture Development Led Industrialization, ADLI[39].

3.3. Ethiopia's External Trade

3.3.1. Ethiopia's External Trade Policy

Ethiopia has introduced the Structural Adjustment Programme (SAP) since 1992. In accordance with this program, the country has implemented a number of policy changes, particularly with respect to the foreign trade sector. The following include the most prominent ones in this regard[40]:

39 See EPRDF's Five- Year Development Program, EPRDF Publication, 1995.

40 See Alemayehu Geda (1999) and EEA (2000).

1. Liberalization of the foreign exchange market by applying the auction system to allocate the foreign exchange to those who are duly licensed.
2. The drastic reduction of customs duties from an average maximum of 230% during the previous regime to an average maximum of 50%.
3. Significantly simplifying of import/export licensing procedure.
4. Providing supportive services to the private exporters in areas such as transport, package training, and overseas market research.
5. Elimination of export duty on all exportables except coffee, on which three different taxes were imposed: customs duty of Birr 15 per 100kg, a 2% transaction tax and a cess tax of Birr 5 per 100kg.
6. Introduction of foreign exchange retention scheme such that exporters are required to sell 90% of their export earnings to the commercial bank within 30 days while they are allowed to retain the balance for the exporters' uses of import of goods and services, export promotion and any other payment approved by the National Bank of Ethiopia. Failure to sell the specified percentage within 30 days will entail surrendering of the foreign exchange to the National Bank at the prevailing rate of exchange.

In general, based upon the above listed series of foreign trade related reforms undertaken by the government, one can conclude that post-1991 Ethiopia is characterized by a major policy shift from the controlled regime of the previous government towards a more liberalized trade policy regime.

It is, however, argued that customs procedures are still slow, cumbersome and unpredictable—something many investors described as "nightmares"[41]. This points to a need for the government to consider adopting streamlined clearance procedures that avoid unnecessary costs of efforts, time and money, and facilitate the smooth operations of the import-export activities.

It is also argued that the present foreign exchange system of the country is another major concern to foreign investors as the National Bank is reluctant to register any private foreign loans, although the Investment Code provides both for the registration of foreign loans and a guarantee of foreign exchange to service such loans (FIAS, 1997).

3.3.2. Ethiopia's Exports and Imports

3.3.2.1. Exports

Ethiopia's foreign trade is characterized by exports of few primary commodities and imports of manufactured goods. Studies on the structure of Ethiopia's exports between 1987 and 1998 documented that five products—coffee, hides and skins (including leather and leather products), oil seeds, pulses, fruits and vegetables—accounted for over 75% of the export revenue. Coffee alone averaged nearly two-thirds of the export earnings during the same period. See Table 3.1 below.

41 Foreign Investment Advisory Service (FIAS), 1997.

Table 3.1

Ethiopia's Major Exports for Selected Years
(As a % of total value of exports)

Year	Coffee	Hides and Skins	Oil Seeds	Pulses	Fruits and Vegetables	Total of	Industrial Products
1987/88	56.8	16.0	2.9	2.1	1.5	79.3	7.4
1988/89	69.4	13.7	1.2	1.8	1.0	87.1	3.5
1991/92	60.3	21.0	0.1	0.1	2.3	83.8	7.4
1994/95	65.9	13.7	2.1	3.8	-	85.5	3.6
1996/97	63.8	10.3	2.1	1.9	1.3	79.4	3.1

Source: EEA, 2000:259.

The sample data in Table 3.1 above further show that exports of industrial products were insignificant, contributing no more than 7.4% to the total exports. These statistics indicate that Ethiopia's exports are concentrated on only few primary products. A study by Alemayehu Geda (1999) also indicated that during the decade between 1987 and 19997 the share of GDP exported ranged between 3-8%. This shows that, measured against domestic output, the share of exports is very small, suggesting that the country mainly produces for home consumption rather than for exports.

In addition, there were considerable fluctuations in Ethiopia's foreign exchange earnings from exports, causing export-earnings instability, which, in turn, results in instability on the country's capital formation endeavours. It is noted that the major

reasons for such fluctuations in the country's foreign exchange earnings from exports are inadequate and variable rainfall, declining in the prices of primary commodities in the world market, low productivity due to the backward production technology, weak infrastructure facilities, particularly transport network, and underdeveloped rural financial markets[42].

Furthermore, it is argued that the Ethiopian farmer is tenure insecure because the Constitution of the Federal Democratic Republic of Ethiopia (FDRE) proclaims that land remains vested in the State:

> *The right to ownership of rural and urban land, as well as of all natural resources, is exclusively vested in the State and in the Peoples of Ethiopia. Land is a common property of the Nations, Nationalities and Peoples of Ethiopia and shall not be subject to sale or to other means of exchange* (Article 40).

The opponents of the land ownership system enshrined in the Constitution of FDRE argue that the law puts the farmers in the anxiety of being evicted from the land they have put every effort to make it more productive as they have no right to own it[43]. Consequently, the farmers will be reluctant to improve the land and undertake medium- and long-term investments on it, thus reducing agricultural production, which is the main source of the country's export earnings.

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42 EEA (2000) and Alemayehu Geda (1999).

43 Dessalegn Rahmato (1999).

3.3.2.2. Imports

Data on Ethiopia's imports by end use as percent of total imports, and total imports as percent of GDP for the period between 1987/88 and 1997/98 are presented in Table 3.2 below.

Table 3.2

Ethiopia's Imports by End Use
(As a % of total Imports and GDP)

Imports	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98
Raw materials	2.4	2.6	3.2	2.7	1.6	2.0	1.8	2.0	2.3	2.2	2.4
Semi-finished materials	14.4	16.9	17.6	11.1	8.8	9.0	16.3	17.0	16.4	19.2	18.6
Fertilizers	3.2	3.7	5.7	1.4	1.4	3.4	4.1	3.3	1.6	7.8	7.6
Fuel	9.5	10.1	12.3	9.9	13.8	22.7	15.3	15.2	12.1	16.5	17.6
Capital goods	47.1	39.0	38.6	45.3	25.8	36.0	29.2	39.1	33.7	36.7	32.2
Transport	20.8	16.8	8.1	21.3	18.6	23.3	13.4	13.4	16.8	16.7	14.3
Agriculture	2.5	0.7	1.0	0.7	0.1	0.3	0.7	1.9	1.0	2.3	2.2
Industrial	23.7	21.5	29.5	23.3	7.1	11.4	15.1	16.5	16.6	11.8	15.7
Consumer Goods	26.3	30.8	28.1	30.2	29.8	31.3	35.1	32.5	31.6	23.0	27.1
Durable	8.6	9.5	13.1	10.0	7.6	7.2	10.0	8.7	9.3	9.5	8.2
Non-durable	17.8	21.3	16.1	20.2	22.1	24.1	25.4	23.8	22.3	14.5	18.8
Cereals	8.0	10.0	4.3	9.8	10.7	11.8	11.0	13.1	7.2	4.9	9.2
Imports as a % GDP	15.2	13.4	10.9	11.1	8.7	13.6	16.7	19.3	20.4	22.7	22.1

Source: EEA, 2000: 261.

From the data in Table 3.2 above, it is evident that capital goods and consumer goods constitute the principal imports of Ethiopia, their combined share ranging between the maximum of 75.5% in 1990/91 and the minimum of 55.6 in 1991/92. It is also interesting to note from Table 3.2 that splitting the capital goods item into its constituents reveals a bias against agriculture (compare transport and industrial imports against agriculture). Moreover, semi-finished and fuel accounted for nearly a third of total imports while the relative share of raw materials was very small.

Another important point to note from Table 3.2 is that imports of cereals (excluding aid) on average constituted about 10% of the value of total imports, indicating insufficiency of domestic food production to meet the local demand. Furthermore, the data in the table also show that the share of fertilizers in total imports was very small, though it showed some tendency to increase in the recent two crop years of 1996/97 and 1997/98. Yet in per capita terms, fertilizer use has been estimated at 50 to 60 kg per farming household or less than 10kg per farmer, which is too small to have a significant impact on the agricultural yield (EEA, 2000:262).

3.4. Private Investment and Business Environment in Ethiopia

In recent years, a broad consensus has emerged on the importance of promoting the private sector and increasing its share of total investment for long-term growth[44]. It has

44 See Oshikoya, 1994.

been emphasized by researchers and policy-makers that private investment could play a significant role in economic development. This swing in growth strategy towards according the private sector a leading role while allowing the state to concentrate on improving the availability and the quality of infrastructure, and poverty alleviation goals is predicated on two main reasons. First, there have been increasing empirical evidences showing that private investments are more efficient than public investments in the productive sectors. Second, there is physical complementarily between the private investment and the public infrastructural investments[45].

In recognition of this growing consensus on development strategy, the current government in Ethiopia has been promoting expansion of the private sector since it came to power in 1991. In this respect, the then Transitional Government proclaimed as its economic policy that it would:

1. Create enabling conditions for the participation of both domestic and foreign capital in economic activities without any capital limitation.
2. Remove all existing bureaucratic procedures and red-tape, introduce new laws and regulations, and enforce them to enhance domestic and foreign capital participation.
3. Provide incentives, and encouragement to promote domestic capital participation and encourage a wider participation of private capital.

45 See, for example, World Bank, *World Development Report 1991* and Khan and Reinhart (1990).

4. The State will work out a comprehensive package of incentives for domestic and foreign private capital participation[46].

Subsequent to the issuance of the economic policy, Proclamation No. 15/1992 was promulgated in order to materialize the policy of encouraging the private sector. The proclamation opened vast areas of investment, particularly for domestic investors, including air transport, hydroelectric power production and distribution, banking and insurance. The proclamation nevertheless denied investment incentives (customs duty exemptions) to investors engaged in such activities as hotels and tourism, education, and health services. It also lacked clarity in a number of issues. Thus, Proclamation No.37/1996, referred to as Investment Proclamation of the Federal Democratic Republic of Ethiopia, was issued in July 1996 in order to rectify weaknesses of Proclamation No.15/1992. Accordingly, the following amendments, among others, were made in the new proclamation.

1. Areas reserved for only Ethiopians and the government, foreign investors, and joint ventures between foreign and domestic investors were clarified (Article 5-8).
2. Projects eligible for investment incentives and investments that do not need investment permits were clarified[47].

46 *Ethiopia's Economic Policy during the Transition Period*, November 1991:18.

47 Ethiopian investors in activities not qualified for incentives, such as developing office/apartment building and land transport, can undertake their investments without applying for investment permits (EIA, *Statistics on Investment in Ethiopia*, 1999:12).

3. Domestic investors, for selected projects, were allowed to benefit from import duty exemptions even if their capital is less than the minimum requirement of Birr 250,000.
4. Proclamation No.37/1996 extended investment activities eligible for incentives to services such as education, health, hotel and tourism.

The main purpose of the national investment policy enshrined in Proclamation No. 37/1996 (and subsequent Investment Incentives Council of Ministers Regulation No. 7/1996) was to further facilitate favorable conditions to attract and guide the distribution of both domestic and foreign private investment in the country. With regard to attracting investment, the policy provides various incentives based on regional and sectoral priorities. The major investment incentives include: exemption from customs duty, income tax holidays, R&D incentives (in the form of deduction of expenses for research, improvement studies or training, from taxable income), and exemption from the payment of taxes on remittance of capital.

According to the investment policy, sectors are classified as pioneer and promoted activities. The former are granted tax exemptions ranging from 3-5 years while the latter are granted tax exemptions from 1-3 years. A hundred percent exemptions from the payment of customs duty and other taxes levied on imports is granted to all investment capital goods, such as plant, machinery, equipment, etc, as well as spare parts worth up to 15% of the value of the imported investment capital goods, provided

that the goods are not produced and/or not available locally in comparable quantity, quality, and price.

With regard to guiding the distribution of investment, the policy proclaims that its objectives are to promote balanced regional growth and integrated economic activity among the regions of the country. To this effect, spatial discrimination is made in the provision of incentives, especially tax exemptions. For promoted activities, the geographical criteria are stated as:

> *Where the investment is in Addis Ababa, Nazareth or in locality within a radius of 15kms of the main highway connecting the two cities, the period of tax exemption shall be for one year. Where the investment is in relatively underdeveloped regions such as Gambella, Benishangul and Gumuz, South Omo, certain zones in Afar, Somali and other regions to be determined by the Board, the period of exemption shall be for 3 years*[48].

However, for Addis Ababa and its environs, the tax holidays for pioneer activities are 3 years. For underdeveloped regions, the tax holiday is as high as 5 years while for other locations it is given to be 4 years. Tax holidays by locations are summarized in Table 3.3 below.

48 FDRE, Council of Ministers Regulation No.7/1996.

Table 3.3

Tax Holidays by Locations

Location	Type of Investment Activity	The Tax Holidays (in years)
Addis Ababa, Nazareth and in locations within 15Kms of the main highway connecting the two cities	Pioneer	3
	Promoted	1
Relatively underdeveloped locations, such as Benisshangul-Gumuz, Gambella, South Omo, certain zones in Afar, Somali and other regions which are determined by the Investment Board	Pioneer	5
	Promoted	3
All other locations	Pioneer	4
	Promoted	2

Source: Ethiopian Investment Authority, *Invest in Ethiopia,* 1998:12.

Following the adoption of the above policy measures, a large number of private investors have applied to invest in Ethiopia. Accordingly, between July 1992 and July 2000, 5676 investment projects with estimated capital of Birr 50.41 billion were issued investment permits. Out of these projects, 544 with estimated capital of Birr 38.4 billion were domestic while the remaining 232 (4%) with capital of Birr 12.01 billion (31.3%) were foreign[49].

49 EIA, unpublished.

The sectoral distribution of the approved number of investment projects shows that 44.6%, with a total capital share of 34%, are in the secondary sector (manufacturing and processing) while the tertiary sector (services) and the primary sector (agricultural and mining activities) constitute 30.4% and 25% with total capital share of 52% and 14%, respectively. On the other hand, the regional distribution shows that 39%, 23%, 12.3%, 8%, 8% and 10% of the total number of investment projects approved are located in Addis Ababa, Oromia, SNNR[50], Amhara, Tigray and the remaining regions (i.e.,Afar, Dire Dawa,Harrari and Gambella), in that order. In terms of the total estimated investment capital 47%, 18%, 4%, 7%, 9% and 15% are located in Addis Ababa, Oromia, SNNR, Amhara, Tigray and the remaining regions, respectively[51].

With regard to implementation, 2870 (51%) projects, consisting of 2757 domestic and 113 (4%) foreign, with capital of Birr24.83 billion and Birr4.1billion, respectively, were in their implementation phase as of July 2000. More specifically, 1832 (32%) of the total approved projects, comprising 1781 domestic and 51 (0.9%) foreign, with respective capital of Birr11.77 billion (23%) and Birr 3.7 billion (0.8%), started production/service as of July 2000[52].

Despite considerable efforts on the part of the government to remove macroeconomic constraints to the private investment, the proportion of the actually fully implemented projects has been very low. It is argued that this low ratio of implementation is due to

50 An abbreviation for Southern Nations, Nationalities, and Peoples' Region.

51 EIA, unpublished.

52 EIA, unpublished.

bureaucratic red tape, which discourages investors in the process of implementing their projects. Particular mention has been made concerning the slow process of land allocation and the high price charged of it by the City Government of Addis Ababa as a major constraint to private investment in recent years (Berhanu Nega and Seid Nuru, 1999:34).

Another important point to note about private investment in Ethiopia is the low level of foreign investment in the country in spite of considerable efforts made by the government through provision of attractive incentives. More detailed discussions on foreign private investment will be provided in the next chapter.

CHAPTER FOUR

FDI PATTERN IN ETHIOPIA

4.1. General

Very large and powerful transnational companies (TNCs) with considerable impacts on the global economy are emerging in the world today. Transnational companies have become central actors in the world economy, and in linking FDI, trade technology and finance, they have become a driving force of economic growth. Their role on the economic and social welfare of both developed and developing countries is widespread and well recognized that, today, TNCs account for above 25% of global output and 20% of employment in non-agricultural activities in developed and some developing countries[53].

It is also noted that, in addition to direct employment, a number of employment opportunities are indirectly generated by TNCs through various linkages with subcontractors, suppliers and other enterprises in home and host countries. Moreover, it is indicated that workers in TNCs typically belong to the core work force in technologically advanced activities, contributing to the development of human resource

53 UNCTAD, *World Investment Report 1999*:xviii-xix.

and the spread of technological, managerial and organizational advances that stimulate economic growth[54].

To further appreciate the significance of the resources of TNCs, it may be helpful to consider the value of annual sales of few TNCs in comparison with Ethiopia's exports, imports and GDP. This is provided in Table 4.1 below.

Table 4.1

Ethiopia and Few Global Companies
(A comparison in 1998)

Sales of	(1) Billions of USD	Ethiopia			
		Value of Exports ($0.56 billion as a % of (1))	Value of Imports ($1.33 as a % of (1))	Total Trade (exports+imports as a % of (1))	GDP, ($6 billion as a % of (1))
General Motors	155.5	0.36	0.86	1.2	3.9
Ford Motor Company	144.4	0.39	0.92	1.3	4.2
Mitsubishi Corporation	116.1	0.48	1.15	1.6	5.2
IBM	81.7	0.69	1.63	2.3	7.3
Hitachi	63.8	0.88	2.08	3.0	9.4
Sony	56.6	0.99	2.35	3.3	10.6

Source: Author's calculations based on data in UNCTAD, *World Investment Report 2000*, pp.283-288 and IMF, *Financial Statistics Year Book 2000*, various pages.

54 UNCTAD, *World Investment Report* 1994:163-164.

From Table 4.1 above, it can be noted that Ethiopia's annual GDP is about 11% of the annual sales of Sony (Japanese electronics company), while Ethiopia's total trade is a mere 3.3% of Sony's annual revenue. Compared to General Motors, the annual value of goods and services produced in Ethiopia is only about 4% of its annual sales, while Ethiopia's total foreign trade is a minute 1.2% of the annual sales of this giant American company. Comparisons with the other companies also tell similar histories[55].

Although these companies are driven by profits maximizing motive, developing countries like Ethiopia can be beneficiaries of both the tangible and intangible assets (capital, marketing and R&D capabilities, technology, organizational and managerial practices, trade links) of these companies by devising policies that meet the mutual interests of the companies and their own.

It can be shown, however, that Ethiopia has so far benefited only limited amount of resources of TNCs through FDI. To this end, data for inflow of FDI to Ethiopia and comparable African countries (i.e., countries that have recently introduced the Structural Adjustment Program, SAP) are given in Table 4.2 below.

55 For similar comparisons with other global companies, see EEA, 2000:270.

Table 4.2

FDI Inflows to Ethiopia and Comparable Countries
(1993-1999)

Country	FDI Inflows (Millions of USD)							Per Capita FDI Inflows (USD)						
	1993	1994	1995	1996	1997	1998	1999	1993	1994	1995	1996	1997	1998	1999
Ethiopia	4	21	32	13	68	178	90	0.08	0.38	0.59	0.23	1.17	2.97	1.46
Ghana	125	233	107	120	83	56	115	7.52	13.6	6.06	6.61	4.45	2.92	5.84
Kenya	1.6	4	32	13	40	42	136	0.06	0.14	1.05	0.41	1.21	1.45	4.6
Uganda	54.6	88	125	120	175	210	180	3.05	4.57	6.3	5.87	8.32	9.99	6.76

Sources: FDI inflows: UNCTAD, *World Investment Report 2000*, pp.283-288. Per capita FDI inflows: Author's calculations based on population data in IMF, *Financial Statistics Year Book 2000*, various pages.

As shown in Table 4.2 above, in 1999, Ethiopia attracted $90 million, while Ghana, Kenya and Uganda attracted $115 million, $136 million, and $180 million, respectively, indicating that Ethiopia received the least amount of FDI relative to comparable African countries. Nevertheless, in 1998, FDI worth $178 million was attracted to Ethiopia, which is the second largest amount, exceeded only by $210 that went to Uganda.

In terms of per capita FDI inflows as well, Ethiopia attracted the least amount of $1.46 million FDI in 1999, while Ghana, Kenya, and Uganda attracted $5.84, $4.6 and $6.76 in that year, respectively. In 1998, however, attracting $2.97 per capita FDI, Ethiopia ranked the second highest recipient of FDI in this group of countries. Uganda again

stood first among these countries by attracting $9.99 per capita FDI. In the rest of the years, Ethiopia's position with regard to FDI inflows per capita is one of the lowest, suggesting that Ethiopia should consider undertaking further measures in creating a conducive business environment that can induce more foreign capital to flow into the country.

To see a more accurate picture of the magnitude of FDI attracted to Ethiopia, data on FDI flows into Ethiopia in recent years as a percent of GDP and gross fixed capital formation are given in Table 4.3 below. For comparison purposes, the corresponding set of data is presented in the same table for Ghana, Kenya and Uganda.

Table 4.3

FDI Inflows to Ethiopia and Comparable Countries
(As a % of GDP and Gross Fixed Capital Formation (G.F.C.F.), 1993-1998)

Country	FDI Inflows as a % GDP						FDI Inflows as a % G.F.C.F					
	1993	1994	1995	1996	1997	1998	1993	1994	1995	1996	1997	1998
Ethiopia	0.3	0.5	0.6	0.2	1.13	3.0	0.53	2.7	3.5	1.2	6.5	16.0
Ghana	2.6	4.8	2.0	18	1.3	-	24.0	19.0	7.8	8.4	5.1	3.4
Kenya	0.03	0.04	0.38	0.14	0.4	0.37	0.2	0.3	1.7	0.7	2.1	2.2
Uganda	1.53	0.17	0.21	0.17	-	-	9.5	11.7	12.2	12.4	17.1	20.4

Source: Calculated form data in UNCTAD, *World Investment Report 2000*, pp.283-288, and IMF, *Financial Statistics Year Book 2000*, various pages.

From data in Table 4.3 above, it can be noted that between 1993 and 1998, FDI flows to Ethiopia as a percent of GDP increased tenfold, ranging between 0.3 and 3%, while FDI inflows as a percent of gross fixed capital formation rose dramatically from 0.53% in 1993 to 16% in 1998. These figures favorably compare with those of Kenya. But compared to those of Uganda, particularly with respect to FDI inflows as a percent of G.F.C.F., Ethiopia's position is not that much impressive. Nevertheless, the general trend of FDI inflows to Ethiopia shows that the importance of FDI in the economy has been rising in recent years.

4.2. Trends of FDI Inflows

As indicated in the previous section, FDI inflows to Ethiopia have been growing following the adoption of the market oriented economic policy in 1991. To see this trend more clearly, data on registered FDI between July 1992 and July 2000 are provided in Table 4.4 below.

Table 4.4

Pledged FDI and the Expected Job Creation
(July 1992 – July 2000)

Year	Approved		Accumulated FDI Approved (Millions of Birr)	Expected Job Creation	
	Number of Projects	Investment Capital (Millions of Birr)		Permanent	Temporary
1992/93	4	1250.51	1250.51	1579	-
1993/94	4	437.60	1680.11	770	4
1994/95	7	504.94	2193.05	2674	-
1995/96	10	434.45	2627.5	1498	-
1996/97	42	2267.70	4895.2	5450	40666
1997/98	81	4106.32	9001.52	10986	3716
1998/99	30	1379.92	10381.44	2312	-
1999/2000	54	1626.83	12008.27	27040	12231
Total	232	12008.27		52309	56617

Source: Adapted from EIA (1999), *Statistics on Investment in Ethiopia*, No,2, various pages and unpublished documents of EIA.

As shown in Table 4.4 above, the trend of approved FDI over the past eight years seems encouraging. Particularly, starting from the fiscal year 1996/97, a substantial rise in both the number approved projects and investment capital was registered. Until 1995/96, only 25 projects with investment capital of Birr 2627.50 million were registered. However, in 1996/97 alone, 42 projects with investment capital of Birr 2267.70 million were approved. It is also interesting to note that up to 1996/97 only 65 projects with investment capital of Birr 4895.20 million were approved, while in

1997/98 alone, 81 projects with investment capital of Birr 4106.32 million were approved.

According to the Ethiopian Investment Authority, the considerable growth in the approved foreign private investment since 1996/97 is mainly due to the revision of the Investment Code in 1996 that opened additional investment opportunities for both domestic and foreign private investors and that created a more favorable business environment in the country[56]. The newly opened areas, which had previously been exclusively reserved for the government, are defense industries, hydropower generation and telecommunication services[57].

It can also be noted from the data in Table 4.4 that, if the projects be fully operational, they would open 52309 permanent and 56617 temporary employment opportunities. This is, if realized as envisaged, quite a significant benefit to a country whose millions of citizens are suffering from lack of employment and are living in abject poverty. One can also imagine the amount of employment that can indirectly be generated by such investments through various linkages with other economic agents in the country. Furthermore, it is argued that workers in multinational companies belong to the typical workforce in technologically advanced activities that stimulate economic growth[58]. It is therefore very important to encourage these projects, by removing any impediments in the implementation phase, that they successfully achieve their goals and that the society may be beneficiary of the fruits of the investments.

56 EIA (1999), *Statistics on Investment in Ethiopia*, No.1, p.49.

57 EIA (1998), *Invest in Ethiopia*, p.8.

58 UNCTAD, *World Investment Report* 1994:163-164.

In fact, a considerable proportion of the projects have already started production/ service, while some of them are in implementation phase, (that is, started practical activities, such as clearing of sites, construction of factory buildings, and purchasing of machinery and equipment)[59]. Table 4.5 and Figures 4.1 and 4.2 below show the status of these projects as of July 2000.

Table 4.5

The Status of the Approved FDI
(As of July 2000)

Project Status	(1) Number of Projects	(1) As a % of Approved Total	(2) Investment Capital (millions of Birr)	(2) As a % of Approved Total	Estimated Job Creation			
					(3) Permannt	(3) As a % of Approved Total	(4) Temporary	(4) As a % of Approved Total
Operational	51	22	3708.17	31	8808	17	35127	62
Under Implementation	62	27	4135.78	34	2593	5	9557	17
Pre-implementation	119	51	4164.32	35	40908	78	11923	21
Total	232	100	12008.27	100	52309	100	56617	100

Source: Adapted from EIA (1999), *Statistics on Investment in Ethiopia*, No.2, various pages, and unpublished documents of EIA.

59 EIA (1999), *Statistics on Investment in Ethiopia*, No. 2, p.20.

Fig. 4.1. Status of FDI
(In terms of the number of projects)

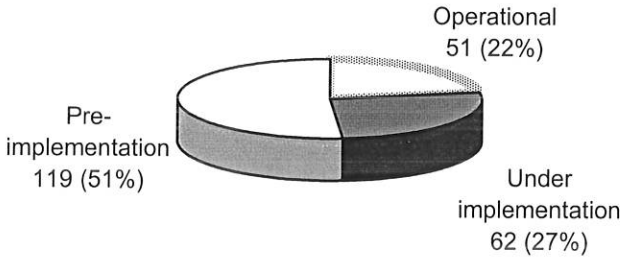
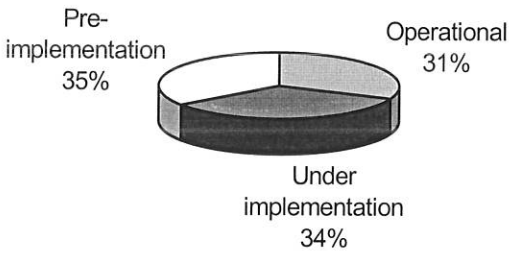


Fig. 4.2. Status of FDI
(In terms of investment capital)



As can be seen from Table 4.5 and Figures 4.1 and 4.2 above, out of the approved 232 projects 51 of them, 31% in terms of approved investment capital, have started production or service, while 62 projects, 34% in terms of approved investment capital, are under implementation phase, as of July 2000. This shows that about two-thirds of the approved capital and half of the approved number of investment projects have actually advanced up to the practical investment activities. According to the Ethiopian Investment Authority, the remaining 119 projects are also reported to be active.

It is, however, argued that the rate of implementation of the investment projects is lower than it should be. Some critics of the government indicate that this is due mainly to the inefficiency of the bureaucracy in general and a slow process of land allocation as well as the price charged of it by the City Government of Addis Ababa in particular, where the investment projects are highly concentrated in (Berhanu Nega and Seid Nuru, 1999:34).

The criticisms seem not unfounded when one considers the case of Huda Real Estate, a sister company of MIDROC Ethiopia. The company said that although it signed a lease agreement three years ago to build 48 and 39 storeys twin-skyscrapers (with additional buildings of up to 6 storeys) in Piassa, at the center of the capital, with a capital outlay of 3 billion Birr, the company could not start the construction as the city administration has not yet cleared of the water, telephone, and other infrastructures existing in the site[60].

This is, however, just one example. To make a balanced judgment it may be important to solicit feedback from several investors (including potential investors who never progressed beyond simple inquiry), requesting their views of Ethiopia's investment climate, including EIA's procedures. Such information will help the government understand how much potential investment is deterred by specific aspects of the present investment environment[61].

60 See, *The Ethiopian Herald*, 7 March 2001 and *Addis Tribune*, March 9, 2001.

61 For more such suggestions, see FIAS (1997).

It appears nevertheless reasonable to expect that the majority of these projects, if not all of them, can be put into implementation. This is because it is highly unlikely that investors, having spent a lot of time, effort and money in studying the country and the people, and preparing their project documents, which in some cases can take several months, and then gone through the "old-fashioned, complex and cumbersome" investment approval procedures of Ethiopia, (as FIAS, 1997:vi, described them) would be discouraged from advancing to their business adventures due to some hurdles on their ways.

It is important to note here that apart from the above 232 projects approved by the Ethiopian Investment Authority, there are 7 others registered by the Ministry of Mines and Energy and are engaged in mineral prospecting/exploration, as of July 1999. These consist of 2 American, 1 British, 1 Saudi Arabian, 1 joint venture of Canadian and Ethiopian, 1 Norwegian and Ethiopian, and 1 South African and Ethiopian[62].

4.3. Sectoral Distribution of FDI

Investigating investment patterns across various sectors of an economy is important to identify areas that need interventions so as to direct resources in line with long term growth objectives (e.g. developing infrastructure), and short term concerns, such as ensuring food security in the economy. For instance, it is argued that growth in the

62 EIA (1999), *Statistics on Investment in Ethiopia* No.2, p. 22.

agricultural sector that alleviates poverty in the rural areas of developing countries, where the majority of the population resides, is crucial for attaining industrialization[63].

Similarly, it is noted that the success of most East Asian countries is largely a result of these countries' enormous investments in human capital (See Stiglitz, 1996). Thus, in order to explore relevant policy suggestions in the case of Ethiopia, data on sectoral distribution of approved FDI are given in Table 4.6 below.

63 For details, see Meier, 1995:395-452.

Table 4.6

Sectoral Distribution of Approved FDI
(July 1992 - July 2000)

Sector	Number of Projects		Investment Capital (Millions of Birr)	
	Approved	As a % of Total	Approved	As a % of Total
Agriculture	25	10.8	2381.43	19.8
Fishing	1	0.4	12.57	0.1
Mining and Quarrying	2	0.9	60.21	0.5
Manufacturing and Processing	107	46.1	4007.34	33.4
Construction	30	12.9	1345.01	11.2
Real Estate development	9	3.9	1946.60	16.2
Distributive trade and maintenance services	4	1.7	113.83	1.0
Hotel and tourism	8	3.4	1253.32	10.4
Education	12	5.2	371.66	3.1
Health	12	5.2	261.80	2.2
Other businesses[64]	22	9.5	254.50	2.1
Total	232	1000	12008.27	100

Source: Adapted from EIA (1999), *Statistics on Investment in Ethiopia*, No.2, and unpublished documents of EIA.

As can be seen from the above table, the total of Birr 12008.27 million approved FDI during the period under consideration is distributed across a wide-range of sectors. However, a concentration in only few sectors can also be observed. Manufacturing and processing claimed the highest share of 33.4%, agriculture following by a far distance,

64 Include sport or recreation centers development, consultancy services, machinery leasing, liquid waste disposals and others not included elsewhere, EIA (1999), *Statistics on Investment in Ethiopia*, No. 2, P.6.

19.8%, and real estate development ranked third by attracting 16.2%. These three sectors alone claimed 69.4% of the total approved FDI. Two other sectors—construction (11.2%), and hotels and tourism (10.4%) have also attracted a considerable proportion of the approved FDI. This shows that the approved FDI is mainly concentrated in these five sectors only, they together claiming 91% of the total registered FDI. A similar situation can also be observed in terms of the number of approved projects; these top five recipient sectors alone consist of 77% or 179 out of the total of 232 projects. The rest of the sectors share the mere 9%, the least recipients being fishing (0.1%), and mining and quarrying (0.5%).

According to the Ministry of Mines and Energy "Ethiopia's green stone belts are one of the finest prospects for gold mineralization anywhere in the world"[65]. However, no considerable progress has been attained in its exploitation due to lack of information on the mineral endowments of the country, shortage of skilled manpower and more generally, as a result of the underdevelopment of the economy (Leulseged, 2000:17).

Another important point to be made from Table 4.6 is that the shares of education (3.1%) and health (2.2%) are also low relative to the percentage share went to the top recipients—mainly manufacturing and processing.

Disaggregating the approved FDI into sub-sectors brings interesting points to consideration (see Annex 1). Of the total of Birr 2454.21 million approved in the

65 Cited in Leulseged, 2000:17.

agricultural sector, Birr 1193.76 million (49%) goes to food crops farming, while Birr 757.61 million (31%) goes to mixed food and cash crops farming. That is, about 80% of the approved FDI in agriculture goes mainly to food crops production. This is perhaps due to the private capital's response to a large domestic market for food crops that is reflected by the chronic shortage of foodstuffs in the country.

Considering manufacturing and processing in a sub-sectoral level also reveals interesting points. Out of the total of Birr 4007.34 million registered in the manufacturing and processing sector, Birr 1718.01 million (43%) goes to beverages, while Birr 396.13 million (10%) goes to food products processing, both constituting 53% of the approved FDI in this sector. Further, it can be noted that the share of other sub-sectors in manufacturing and processing is relatively insignificant.

It appears that the concentration of the approved foreign private investment in such areas as foodstuffs, beverages, real estate, construction, and hotels and tourism is due to the availability of large domestic markets for these products and services. Nevertheless, the influence of the investment policy can also be significant in causing this sectoral pattern, as banking, insurance, commercial road transport and several small-scale investments are not yet opened to foreign private investment. (See Annex 2 for a list of areas reserved for domestic investors).

The Investment Code also maintains a very high minimum capital requirement. Specifically, except for engineering and other consultancy services, wholly-owned

foreign investments are required a minimum of 500,000USD in cash and/or in kind as an initial investment capital to start a business. For engineering and other consultancy services the minimum capital requirement is 100,000USD, while for joint ventures with domestic partner(s) a minimum equity capital of 300,000USD are required, the domestic partners' share being not less than 27%. In other African countries, e.g., in Ghana, the minimum capital requirement is as low as 10,000USD. Therefore, it is argued that these restrictions have discouraged foreign investors, who often prefer to "test the waters" with small investments before committing to larger ones (FIAS,1997).

Overall, the observed trend of concentration of the inflow of FDI in the manufacturing and processing sector seems promising in the sense that it may contribute to the industrialization of the economy by bringing some modern technology into the country. This should therefore be further encouraged by the policy makers by identifying and removing any possible impediments that may occur in the implementation phase.

Moreover, the interest expressed by some foreign investors to invest in the agricultural sector, if implemented as envisaged, can have some contribution to the economy by alleviating the long persistent problem of shortage of foodstuffs in the country. Moreover, as real estate development and construction activities are at a very low stage of development in the country, the inflow of FDI into these sectors can play a considerable role by contributing to the long-term growth of the economy.

However, despite the above-mentioned positive aspects of the observed sectoral distribution of FDI inflows, some weaknesses can also be identified. In this regard, from Table 4.6, it is evident that manufacturing and processing claims the largest proportion of the approved FDI. It should be nevertheless noted that these manufacturing and processing enterprises are principally engaged in production of consumer goods, which may not have a strategic importance in the industrialization drive of the country.

In addition, given the high potential of the country's agricultural sector and the government's objective of encouraging private investment in this sector, one would expect relatively highest investment flows into this sector. However, this is not the case with respect to the flows of FDI as shown in the above table. This trend may imply poor attractiveness of the country for foreign investors, even towards the pioneer sector to which a wide range of investment incentives are accorded in the investment policy document of the country.

Further, it can be noted from Table 4.6 that the (percentage) shares of education and health in the total foreign investment capital approved are low. As a sound education is the basis for any innovation that stimulates growth in all other activities and hence the growth of the economy at large, neglecting or paying less attention to this sector results in a failure to achieve the long term growth objectives. Similarly, weak and sick citizens cannot be effectively productive and innovative. But, a private investor, being guided by his/her motives of profit maximization, is little concerned (if at all he/she is)

about the long-term development of a country. Therefore, it remains for the government to identify and then increase its interventions in the areas (such as education and health in this case) where the private investors are not interested in and/or fail to bring about the desired outcome.

4.4. Regional Distribution of FDI

An attainment of a comparable and competitive economic growth by all regions of a country is imperative for balanced regional development whereby the citizens of the country will enjoy equitable shares of the fruits of economic growth, such as education, health services, access to safe water, etc. Moreover, a balanced regional growth brings about economic dynamism within the country that would improve the overall economic performance of the country by strengthening regional integration, its resource base, capacity to produce, and expand its markets, first domestically and then across national borders.

With the objective of promoting a balanced regional growth, the Ethiopian investment policy offers generous investment incentives, especial treatments being accorded to those investors who want to invest in the least developed areas of the country. It is important, therefore, to carry out investigations whether this policy has achieved this desired goals or not, so that appropriate policy adjustments may be considered timely. To this end, data on the regional distribution of approved FDI, both in terms of the number of projects and the investment capital, are provided in Table 4.7 below.

Table 4.7

Regional Distribution of Approved FDI

(July 1992 - July 2000)

Region	Number of Projects Approved	Investment Capital (Million Birr)		Population (Million persons)	Approved Per Capita FDI inflows (Birr)
		Approved	As a % of Approved Total		
Tigray	5	508.75	4.2	3.49	145.8
Afar	6	667.94	5.6	1.16	575.8
Amhara	6	1503.53	12.5	15.41	97.6
Oromia	47	1710.41	14.2	21.05	81.3
SNNPR	8	270.69	2.3	11.75	23.0
Gambella	1	24.90	0.2	0.2	124.5
Harari	2	63.05	0.5	0.15	420.3
Addis Ababa	150	7165.05	59.7	2.35	3049.0
Dire Dawa	7	93.95	0.8	0.29	324.0
Somali	-	-	-	3.51	-
Benishangul-Gumuz	-	-	-	0.51	-
Ethiopia	232	12008.27	100	59.87	200.6

Sources: Adapted from EIA (1999), *Statistics on Investment in Ethiopia,* No.2, various pages and unpublished documents of EIA. Population data: EEA (2000:67).

The data in Table 4.7 indicate that there is a high degree of variation in the distribution of both investment projects and capital across different regions of the country. Most notably, FDI inflows are highly concentrated in Addis Ababa, this region alone taking

about 60% of the total investment capital, which constitutes 150 (65%) of the approved projects.

Both in terms of approved investment capital and the number of projects, the Oromia region ranks second, attracting 47 (20%) of the projects and 14.2% of the investment capital. In terms of investment capital, the Amhara region has also attracted a considerable proportion (12.5%). Apparently, FDI inflows are mainly concentrated in these three regions—Addis Ababa, Oromia and Amhara—they together constituting 203 (88%) of the approved projects and 86% of the investment capital. The remaining 14% of the investment capital (12% of the projects) is also unevenly distributed across six regions of the country, Gambella and Harari being the least recipients, attracting 0.2% and 0.5%, respectively, of the investment capital.

During the period under consideration, Gambella attracted only one foreign investment project, while Harari attracted only two of them. It should be noted that during the period under discussion, no foreign investor expressed its plan to invest in two of the regional states of the country—Benishangul-Gumuz, and Somali. The investment policy offers the highest tax-holidays of 5 years for investments undertaken in these regions (See Table 3.3). Nevertheless, these regions, being the least underdeveloped areas of the country, were not able to attract any foreign direct investment. Lack of interest by foreign investors to invest in the Somali region may also be partly due to occasionally reported political unrest in the Ogaden area of the region because of movements of some dissidents of the government in that area.

A more accurate picture of the regional distribution of approved FDI may be seen by considering it relative to respective regional population. To this effect, approved per capita FDI inflows are provided in the last column of Table 4.7. As shown in the table, Addis Ababa again ranks first by attracting 3049 Birr per head. It is, however, interesting to note that the Oromia and Amhara regions, the second and third highest recipients in terms of approved investment capital, owing to their large population, now rank second and third least recipients in per capita terms, in that order.

In contrast, the Harari region, the second lowest recipient in terms of both approved number of projects and investment capital, stands third highest recipient in terms of approved per capita FDI inflows, owing to its small population. The Afar region, fourth highest ranking in terms of approved total investment capital, stands second highest recipient in terms of approved per capita FDI inflows. Moreover, the Tigray region ranks fifth highest recipient of FDI inflows both in absolute and per capita terms.

It is also a noteworthy that, both in absolute and per capita terms, the performance of SNNPR in attracting FDI is very low although surveys indicate that the region is endowed with rich natural resources[66], as well as a highly stable political environment. This is perhaps because the region is not well known by foreigners and/or due to the region's poor infranstructural facilities.

66 See Ministry of Information and Culture (1998), *Investment Opportunities in Ethiopia*, pp. 39-42.

The conclusion that can be derived from the regional distribution of foreign private investment observed above is that FDI is mainly concentrated in relatively highly developed regions of the country, as clearly seen from its extreme concentration in Addis Ababa, this region alone claiming 65% and 60% of the approved investment projects and capital, respectively, during the period of eight years considered. These observations are consistent with surveys of several foreign investors over a wide range of countries that show the quality of infrastructure is an important factor in ranking investment sites[67].

The evidence of relatively high attractiveness of the Afar region also supports this conclusion. The Afar region, strategically located as it is close to the Red Sea ports, also takes the advantage of infrastructural development along the Awash River basin, the only well utilized river basin of the country[68].

Moreover, in absolute terms, the attractiveness of the Oromia and Amhara regions also hinges upon the availability of both rich natural resources (including arable land) and infrustructural facilities, such as telephones, roads, and electricity that, in addition to creating better living conditions, facilitate business activities in general and connections between operations in fields and the central decision-making bodies in headquarters. Thus, to enhance the participation of the private sector, which is the central actor in market oriented economic system, besides providing investment incentives, the crucial role played by other determinants of private investment should be underlined. In particular, policies that promote local development, and

67 World Bank, *World Development Report 1994*:18.

68 Interview information with EIA official, April 2001.

hence facilitate, expand and improve the functioning of the private sector should be paid the greatest attention. More discussions on such policy implications will be provided in the next chapter.

CHAPTER FIVE

POLICY IMPLICATIONS, SUMMARY AND CONCLUSIONS

5.1. Policy Implications

The observed patterns of FDI, both sectoral and regional, send out several messages for policy implications. As indicated earlier, considering manufacturing and processing, which claims 33.4% of the approved FDI, at subsectoral level reveals that it is mainly concentrated in production of consumer goods, which may not have significant contribution to the long-term industrialization objectives of the country. Therefore, the Ethiopian government, (through its pertinent agencies), besides providing packages of investment incentives, should actively play a catalystic role in identifying and promoting industries that stimulate long term growth through strong backward and forward linkages and positive externalities[69]. This may involve going as far as preparing projects (by such an agency) and approaching specifically-targeted foreign companies with a view of attracting strategically important technologies into the country[70].

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69 See Stiglitz (1996) for experiences of the East Asian Countries in this regard.

70 Such an approach sometimes results in interesting outcomes. For example, Bridge Oil of Australia became involved in Guinea following an approach by the Guinean government to a Swiss banker in 1981 looking for a joint venture partner. The Swiss banker was a friend of the chairman of Bridge Oil. As a result, Bridge Oil did a feasibility study and the more it looked at the prospect, the more it felt it should be involved (For this and more such examples, see Cockcroft and Ridden, 1991:65).

In addition, it has been indicated earlier that Ethiopia has adopted Agriculture Development Led Industrialization (ADLI) growth strategy. This is a correct strategy because it is inconceivable to think of overall development in Ethiopia without fundamentally improving the sector that directly affects the life of the majority of the population. Nevertheless, as noted from the sectoral distribution of the approved FDI, this sector attracted only 2381.43 million Birr in eight years, that is equal to a yearly average of Birr 297.68 million, or a mere 0.6% of the GDP.

Given that agriculture contributes to more than 50% of the GDP, and the local food production falls short of local demand (see Table 3.2), the amount of FDI attracted to this sector is so dismal that its contribution toward achieving the development objectives of the country may not be substantial. Such a low level of attractiveness of the pioneer sector, which is expected to act as a driving force of the country's economic growth, may be a reflection of poor attractiveness of the country for foreign investors, sad to say, as the name Ethiopia has been associated with famine in recent decades. This requires a concerted effort to redress the image of the country through continuous activities of image building and promotion of Ethiopia's potentials to the rest of the world.

Similar implications apply to the rest of the sectors. Most notably, studies indicate that Ethiopia has vast hydropower and promising geothermal energy resources. Its hydropower potential has been estimated at about 650 million KWh/year. So far, the total electricity generated is less than only one percent of the potential, which is far

from being adequate. Power failures are common phenomena even in the capital city, indicating the severity of the problem (Leulseged, 2000:22). Yet it is noted earlier that this is one of the areas opened to foreign private investment recently (1998), after long overdue. Such areas of strategic significance should have been made readily accessible for both domestic and foreign investment without spending much time.

The present Investment Code still maintains some barriers to investment entry. In particular, the law contains high minimum investment capital requirements and several investments reserved for domestic investors. These restrictions have discouraged foreign investors, who often prefer to begin with small investments before launching into larger ones (FIAS, 1997:ix). Therefore, the government should consider further opening up of the economy by removing such entry restrictions if its goal of attracting large amounts of FDI is to be realized.

The consideration of geographical distribution of approved FDI (in absolute terms) has indicated that it is highly concentrated in regions with relatively better physical infrastructures as clearly observed from its extreme concentration in Addis Ababa, followed with a wide gap by the Oromia and the Amhara regions, which are close to the administrative center and share improved infrastructures compared to the regions far away from the center.

As noted earlier, with a view of attracting investments to all regions and promoting a balanced regional development, the Ethiopian Investment Code makes special

provisions for investors who want to undertake their investments in the least developed areas of the country. Although this is a correct strategy, the strategy fails to achieve its goals unless it is complemented with other critical ingredients. In particular, provision of adequate and reliable infrastructure—transport, roads, power-supply communication networks (including the most advanced information and communication technologies, such as e-mail, internet and fax)—is indispensable for a proper functioning of the private sector.

In recognition of the limited capacity of the least developed regional states to develop the basic necessities for achieving a sustainable economic growth, the Federal Government has been providing financial and technical supports to the regional states[71]. However, the assistances made so far were not adequate to bring about considerable changes in the development of infrastructures of the regions. Thus, besides loans, other avenues of financing infrastructural projects should be sought.

The Chinese experience is worth considering in this regard. Where the government was not able to finance some infrastructures, the Chinese introduced commercial principles in such a way that whoever built was to benefit, and whoever used was to pay. In particular, tolls were collected from users of newly built roads and bridges. The results were so significant that the regional states' ability to finance infrastructural projects was greatly enhanced. Moreover, regional states solicited and harnessed donations from overseas Chinese, particularly, in building roads and bridges. Further,

71 For details, see Tegegne (2000).

to some extent, telecommunication facilities were also financed by pooling contributions from potential users, both enterprises and individuals. The outcome was that the Chinese, by creating conducive physical infrastructure, managed to attract large amounts of foreign direct investments, which had a considerable impact on the unprecedented rapid growth of the economy[72].

The rule of law in general and enforcing contracts and ensuring property ownership rights, as well as efficiency of the bureaucracy are other essential factors that influence investment decisions. As Ethiopia is one of the least developed countries, it is a widely recognized fact that such institutional capabilities are not yet well developed in the country. The problem is even more severe in the least developed regional states like Somali and Benishangul-Gumuz (Tegegne, 2000). Cross-national evidences show that low-quality public institutions are highly likely to impede economic growth (Rodrik, 2000).

Some efforts have been made by the present government with regard to improving the quality of the public institutions of the regional states. For instance, it redeployed civil servants and technical experts from the center to the regions. It has been conducting training programs for executive committee members and regional bureaus and departments heads in the areas of policy analysis, development planning, public finance, project management etc. Similarly, several workshops and study tours were organized for experts in various fields. Perhaps, the most important measure taken to strengthen

72 See Zhang (1994), Chen (1995) and Hu and Khan (1997).

the regional states' capacity is the establishment of the Ethiopian Civil Service College, whose primary objective is training civil servants from regions at degree level in various fields (MEDaC, 1998).

Nevertheless, experiences of countries that made a significant use of foreign direct investment to achieve a rapid economic growth points to the well recognized fact that they channeled immense resources to development of human resource, educating a large number of skilled engineers able to absorb and adapt the most advanced technology (Stiglitz, 1996). Thus, in this respect, much remains to be done to create an economic atmosphere conducive to foreign direct investment in the country. Therefore, policies that focus establishment and expansion of high level technical, managerial and legal staff development should be given the uttermost priority in all regions of the country.

5.2. Summary

The central objectives of this thesis have been investigating the sectoral and regional distributions of the approved FDI in Ethiopia during 1992 – 2000, and exploring possible explanations for the observed patterns, as well as deriving policy recommendations. By accomplishing these objectives, the study has found that, sectorally, FDI in Ethiopia is mainly concentrated in the manufacturing and processing sector, agriculture following at a wide gap. Real estates development, construction, and hotels and tourism have also attracted a substantial amount of FDI, in that order. Fishing, and mining and quarrying attracted the least amounts of foreign private capital

during the period considered. The relative shares of health and education were also low. In general, the sectoral distribution of FDI in Ethiopia appears that it is largely concentrated in areas at which large domestic markets are highly perceivable. The Investment Code has also contributed to the observed sectoral pattern. Thus, the study suggests further opening up of the economy both to increase the volume and diversity of foreign private capital in the country.

Regionally, FDI is observed to be mainly located in Addis Ababa; the Oromia and the Amhara regions ranking second and third, respectively. The Afar region has also attracted a considerable amount of FDI. During the period under reference, no foreign investor showed an interest to invest in the Somali and Benishangul-Gumuz regions, which are the least developed of all regions of the country. The study suggests an emphasis on policies that focus on local development to enhance the flow of FDI to all regions of the country. To expedite local development, apart from depending on loans, it is suggested that commercialization of infrastructure, pooling funds from potential users, and soliciting and harnessing financial assistances from Ethiopians at diaspora can be other venues that enhance the financial capacities of the states in development of physical infrastructure.

5.3. Conclusions

Following the adoption of the new economic policy in 1991, there has been a high degree of expectation of a wide-ranging participation of foreign private capital in the

Ethiopian economy. However, investigations into available data for the period 1992 - 2000 lead to conclusions contrary to these expectations. Sectoral investigations show that Ethiopia has not yet attracted a considerable amount of FDI particularly to strategically important sectors that would stimulate the growth of the economy. There is some trend of increased inflow of FDI into the manufacturing and processing sector. Yet these enterprises are primarily engaged in production of consumer goods, which contribute very little to the industrialization drive of the country.

Therefore, taking more active approaches, such as preparing projects in areas of priority and approaching specifically-targeted foreign companies may be helpful to attract important technologies, organizational and managerial practices, and research and development capabilities that would be essential for the growth of the economy.

Considerations of geographical distributions of FDI in Ethiopia show that FDI is principally located in the capital—Addis Ababa. Other regions that have attracted considerable amounts of FDI are those with relatively improved physical infrastructure. Thus, it is imperative that policies that stress domestic development should be given the uttermost priority to attract increased amounts of FDI into all regions of the country and that a balanced regional development would be expedited.

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Annex 1:

Secotral Distribution of Approved FDI

(July 1992 - July 2000)

Sector/Sub-Sector	Number of Projects		Investment Capital (Millions of Birr)	
	Approved	% of total	Approved	% of total
Agriculture	28	12.1	2454.21	20.4
Food crops farming	5	2.2	1193.76	9.9
Cash crops farming	7	3.0	321.02	2.7
Mixed food and cash crops farming	3	1.3	757.61	6.3
Livestock farming	6	2.6	55.36	0.5
Integrated crops and livestock farming	4	1.7	53.68	0.4
Fishing	1	0.4	12.57	0.1
Mining and Quarrying	2	0.9	60.21	0.5
Manufacturing and Processing	107	46	4007.34	33.4
Food products	16	6.9	396.13	3.3
Beverages	17	7.3	1718.01	14.3
Textiles (including garments)	4	4.7	89.42	0.7
Tanneries and footwear	6	2.6	222.36	1.9
Wood products (including furniture)	4	1.7	127.43	1.1
Paper, paper products and printing	3	1.3	21.22	0.2
Pharmaceuticals	5	2.2	176.59	1.5
Chemicals	10	4.3	203.91	1.7
Plastic/rubber products	12	5.2	288.08	2.4
Non-Metallic Mineral products	9	3.9	214.0	1.8
Metal products including machinery and equipment	14	6	289.71	2.4
Electrical machinery and apparatus	3	1.3	200.21	1.7
Motor vehicles and other transport equipment	4	1.7	60.27	0.5
Construction	30	12.9	1345.01	11.2
Real estate development	9	3.9	1946.60	16.2
Distributive trade and maintenance service	4	1.7	113.83	0.9
Hotel and tourism	8	3.4	1253.32	10.4
Education	12	5.2	371.66	3.1
Health	12	5.2	261.80	2.2
Other businesses	22	9.5	254.50	2.1
Total	232		12008.27	

Source: Adapted from EIA (1999), *Statistics on Investment in Ethiopia*, and unpublished documents of EIA.

Annex 2:

Areas of Investment Reserved for Domestic Investors

1. Banking and Insurance business (exclusively reserved for Ethiopian nationals).
2. Production and supply of electrical energy with installed capacity of up to 25 mega watts (exclusively reserved for Ethiopian nationals).
3. Air transport services using aircraft with seating capacity of up to 20 passengers or with a cargo capacity of up to 2700kg. (Exclusively reserved for Ethiopian nationals).
4. Radio and television broadcasting services.
5. Retail trade and brokerage.
6. Wholesale trade (excluding fuel and fuel products and the sale by foreign investors of their products produced locally).
7. Import trade.
8. Export trade of raw coffee, oil seeds, pulses, hides and skins and live sheep, goats and cattle not raised or fattened on own farm.
9. Construction companies excluding grade 1 contractor.
10. Tanning hides and skins up to crust level.
11. Hotels other than star designated, motels, pensions, tearooms, coffee shops, bars, nightclubs and restaurants excluding international and specialized restaurants.
12. Tour operations, travel agency, commission agency and ticket offices.
13. Car hire and taxi – cab transport.
14. Commercial road transport and inland water transport services.
15. Bakery products and pastries exclusively for the domestic market.
16. Grinding mills for grain.
17. Barber shops, beauty saloons, goldsmith shops and tailoring, excluding garment factories.
18. Building maintenance services, repair and maintenance of vehicles.
19. Saw milling, slicing, peeling and chopping of logs, and manufacture of wood products exclusively for the domestic market.
20. Customs clearance service.
21. Museums, theatres and cinema halls operations.
22. Printing industry.

Source: EIA (1998), *Invest in Ethiopia*, p. 27.

DECLARATION

I, the undersigned, declare that the thesis is my original work and has not been presented for a degree in any other university and that all sources of the materials used for the thesis have been dully acknowledged.

Name: Tagese Sugebo Lechebo.

Signature: _____

Date: July 2001.

Place: Addis Ababa, Ethiopia.