

THE NEW INVESTMENT LAW: BASIC FEATURES AND LIMITATIONS WITH REFERENCE TO THE INDUSTRIAL SECTOR

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1. INTRODUCTION

A nation's capacity to meet the growing demand and needs of its population much depends on the resource it could devote to increase and maintain the real capital stock. This, in turn, calls for the capacity and initiative to induce and mobilize savings and to attract foreign capital.

Contrary to this, in Ethiopia, the misguided policies of the past have been inimical to private investment. The cumulated effect of the deliberate suppressions and restrictions of private investment was a painful erosion of entrepreneurial capacities to initiate thrift and invest. Today, compared to the low-income economies of the world and the sub-Saharan African countries, the saving and investment rates in Ethiopia are at a record low level.

Changing this situation is a matter of urgency. Ultimately, the pace of economic growth and the success of the reform depends on the realized quantity and quality of investment. With this in mind, this paper looks into the changing Ethiopian policy environment of investment with particular emphasis to industry. The objective of the paper is to examine the extent and scope of the policy shift as reflected in the new investment law and to highlight the challenges to be confronted in the creation of an enabling environment. The next section of the paper gives a glimpse on some theoretical and principal issues related with investment, followed by a section that briefly looks into the industrial investment record of the country. The final section deals with the new legal framework of investment.

2. PROMOTING INVESTMENT: PRINCIPAL CONSIDERATION

The most important element in the chain of economic phenomena supposed to initiate economic growth is investment. The cyclical recession of the developed world and the sluggish growth of the developing countries have to do with the quantity and quality of investment. In a competitive market economy a healthy investment rate indicates an expanding capacity to generate future income and increased supply of goods and services. Furthermore, in view of the irreversible nature of investment, a growth in the magnitude of investment is a sign of confidence and enabling environment.

In most of today's economic reform programmes of developing countries increasing savings and investment rates are among the central targets of development effort and

indicators of economic performance. The liberalization and growth phase of a reform programme is expected to be marked by increased rate of investment and accelerated growth.

A number of factors, including those with extra-economic nature, can affect an investment climate. Therefore, it is plausible to state that establishing a simple cause-effect relationship for investment is difficult. Risk and uncertainty are detrimental to decisions of investment. Hence, investment is to a certain extent autonomous, and an automatic response to policy changes or savings may not be realized.

The cause for this can be traced back to the nature of investment itself. Unlike consumption, investment is postponable, indivisible and non-repetitive. While the indivisibility and irreversibility nature of investment increase the cost associated with probable failure, the possibility of postponement of investment gives a discretionary power to potential investors, whether to invest or not. Therefore, in an environment of policy uncertainty, there is always a danger of decline in investment. Driver and Moreton (1992) had this in mind when they said:

Uncertainty is more severe for investment, the effects of errors are more serious for investment decisions; and opportunities for evading uncertainty by non-action are greater for investment.

A full swing of investment, therefore, primarily depends on the presence of a healthy economy, the degree of political stability, and the availability of resources and markets. Furthermore, the existence of positive policy climate and infrastructure would be a stimulant for investment.

Due to this complex nature of investment, in an economic reform programme there is hardly any one element that would not affect investment environment. Kruger (1990) identifies, the following four broadly classified types of economic policies that can be contemplated in relation to economic reform programme:

- a) those affecting macro-economic stability including especially inflation, but also the level of economic activity;
- b) the provision, or failure to provide, infrastructure services which are essential to private production;
- c) direct undertakings by the public sector of economic activities where there are few of the characteristics traditionally associated with public services; and
- d) the set of controls and incentives used by governments that intentionally or otherwise affect the allocation of resources in the private sector.

The above policy areas are interlinked and eventually affect the overall growth of an economy. The twin objectives of a structural adjustment programme are stability and growth. Stability-focused policy measures aim to correct economic imbalances, which cannot be sustained in a deteriorating situation of resource gaps. The imbalances and instabilities would, if tolerated, disturb the normal functioning of the economy and inhibit its expansion and further growth. Therefore, a close look at the above areas of economic policies reveal that all or most of the policy instruments would affect the magnitude, sectoral distribution and performance of investment. Depending on their ability to ease entry and operation and to spur competition and growth, a set of policies could be of enabling or discouraging nature.

The critical link between policy reform and investment lies in the business confidence and certainty it could generate. Even the argument for speed ultimately rests upon considerations of credibility. In this connection what Douglas (1992) said on reform is instructive:

Even at a maximum speed the total/reform/programme will take some years to implement, and the short-term trade-off costs start from day one ...

...It is uncertainty, not speed, that endangers the success of structural reform programme. Speed is an essential ingredient in keeping uncertainty down to the lowest achievable level.

In the transition from a command to a market-based economy the creation of a comprehensive enabling environment, at once, may not be possible. But, signals in the right direction and commitment to it would avoid the undesirable lack of faith in what lies ahead. It is vision and predictability of the future that matters for the potential investor.

3. INDUSTRIAL INVESTMENT: A LOOK AT THE RECORD

As shown in Table 1 below, the share of gross domestic investment and savings have been stagnating and declining in the past two decades or so. In fact, compared to both the low-income economies and the sub-Saharan African countries, the share is significantly lower.

Table 1: The Share of Gross Domestic Investment(GDI) and Gross Domestic Savings(GDS)
(as a percentage of GDP)

	1965		1990	
	GDI	GDS	GDI	GDS
Ethiopia	13	12	13	6
Low income economies	19	18	28	28
Sub-Saharan Africa	15	13	16	16

Source: World Bank, 1992, p.225.

Such developments are basically the reflection and cumulative effect of a weakened private sector and increased government consumption observed in the past seventeen years.

The industrial sector nationalization and the rapid course of socialization effectively marginalized the private sector. As the state sector consolidated and took the commanding role, the magnitude and pattern of industrial investment hinged upon the state's capacity to avail resources and to implement projects. The basic features of industrial investment in this period and the factors behind them can be summarized as follows:

- a) Private industrial investment was curtailed by overwhelming entry barriers. Sectoral restrictions, capital ceiling and the overly regulated licensing practice barred private investors from entrance into a number of industries and checked their growth. The difficulties associated with land, credit and operational inputs also used to be further deterrents to potential investors.
- b) Therefore, for the private sector, the chance of increased investment and asset build-up was very limited. In the 1984/85 survey of the small-scale industry and handicraft sector (which included what otherwise could be labelled as the informal sector) the total fixed asset was estimated to be only Birr 84.3 million. In the three-year period before the 1988/89 proclamation that raised the capital ceiling for private investment to Birr 2 million, the total permanent licences issued by the former Handicrafts and Small-scale Industry Development Agency (HASIDA) were only for 110 small-scale firms with an estimated total investment of only about Birr 6 million. The Ten Year Perspective Plan, which set the private-state proportion of planned investment in a 1:42 ratio, further underscored the then existing downward pressure on the relative capacity of the private sector.
- c) To fill the deliberately created gap of private investment in industry, the state was overstretched both in terms of investible resources and project management. In the whole period of the regime, nearly Birr 1.5 billion is estimated to have been invested in new and expansion industrial projects (see Table 2), about 70% of which was financed by government budget and foreign loan.
- d) As Table 2 shows, capital expenditure in the public industrial sector was marked by an irregular growth pattern. Other than economic factors that had to do with the budgetary situation of the state, government aspirations to mark certain political events by project accomplishments seem to have created such irregularity - an upsurge of capital expenditure followed by a retrogression.

Table 2: Government Capital Expenditure in New and Expansion Industrial Projects

Year	New		Expansion	
	Magnitude (million birr)	Growth Rate (%)	Magnitude (million birr)	Growth Rate (%)
Before 1979/80	3.0	-	8.4	-
1979/80	20.0	567	59.0	602
1980/81	58.5	193	49.0	-17
1981/82	83.0	42	20.2	-59
1982/83	163.0	96	4.0	-80
1983/84	169.0	2	11.0	175
1984/85	132.0	-22	6.0	-46
1985/86	74.0	-44	7.0	17
1986/87	80.0	8	35.0	400
1987/88	132.0	65	77.0	120
1988/89	154.0	17	96.0	25
Total	1068.5	84	372.6	103

Source: Compiled and estimated from MOI, *Statistical Bulletins*, various issues.

In short, therefore, industrial investment was characterized by an expanding public sector with irregular pattern of capital expenditure and a peripheral private sector destined to struggle within the limit of survival. Against this background, whatever reform is in the making should be seen in terms of its ability to redress the structural anomalies of the past and to create an enabling environment for private investors.

4. THE POLICY CHANGE: A COMPARATIVE ASSESSMENT

In this initial stage of the current reform, it is difficult to know what the impact of the evolving policy changes would be. As it stands now, reflections on policy changes as regard to industrial investment climate can only be based on two documents:

- a) *The Economic Policy for the Transition Period* (TGE, 1991); and
- b) the new investment law (*Proclamation No. 15/1992*).

Although it seems to be limited in some areas, the new economic policy basically departs from the legacy of the past. Regarding industrial investment it:

- redefines the role of the state and broadens the scope of private investment;
- gives autonomy to State-Owned Enterprises(SOEs);
- gravitates to ownership neutrality, whereby SOEs would be required to operate on the basis of profitability and in competition with private industries; and
- envisages privatization for loss-making SOEs.

Although the policy is generally positive with respect to inducing private investment, it cannot be labelled as a radical shift to a market-based economy. The fact that it refrains from liberalizing the factor markets (land and financial markets) signals the incompleteness of the move towards a full-fledged market system.

The major features of the new investment environment can be detected, however, in the investment code of the Transitional Government, *Proclamation No. 15/92*.

Investment proclamations in this country have experienced a series of changes beginning in the Imperial era. During the Imperial era the enactment of legislations aimed at encouraging private investment date back to the year 1950s. However, the conscious move of the Imperial regime to attract private investment got momentum at the end of the First Five Year Plan, when the pieces of notices and legislations were consolidated in the 1963 Investment Decree (which became enacted as proclamation in 1966). Although the decree was aimed at encouraging both domestic and foreign investment, the particular intention of attracting foreign capital was evident. This fact can also be observed from the planned capital investment of the Second and Third Five Year Plans, where the foreign capital inflow was targeted at 44% and 33% of the total investment expenditure respectively.

Critiques may say that the investment law of the Imperial era has rather opened the way for penetration and domination of foreign capital. Yes, the feudal economic system which encouraged aristocratic consumption style rather than saving and industrial investment, and the liberal investment climate that called for foreign capital to fill the void has resulted in a significant foreign ownership of capital in almost all industrial sectors. In spite of this, however, the investment environment was generally conducive to growth.

In the years 1967/68 to 1973/74 the domestic savings and the gross fixed capital formation were in the tune of 13 per cent of Gross Domestic Product. As a result, despite the declining trend that started in 1972/73, the general economic performance in the second half of the sixties and at the turn of the seventies was an encouraging one.

Whatever limitations the investment proclamation of the Imperial era might had, the flavour of its openness and certainty indicates that the direction of the experiment was towards a liberalized market-based economy. The investment pattern envisaged for the Third Five Year Plan, where the state was to concentrate on infrastructure building and the private sector in direct productive activities, was also an additional evidence of this fact.

However, the logical projection of the experiment was aborted. Historical development took a new course with a complete shift to socialist orientation. In fact, whatever embryonic elements of capital development were there were deliberately stifled due to the incompatibility of the socialist ideals and the "evils of capitalism". However, history has moved so quickly. The new social practice of socialism itself has already completed its course with failure and the "negation of negation" is in force. The half-hearted reform attempt initiated in the last days of the regime were simply too late to be effective.

Against this background, the new investment law can be better understood if investigated in comparison to the investment laws of the Imperial era and the Derg regime, which were enacted in the years 1966 and 1990 respectively. The comparative features in terms of similarities and differences in objectives, industrial promotion, magnitude of incentives, administrative procedures, etc. are outlined in Exhibit 1.

Exhibit 1: Basic Features of the New Investment Law in Comparison to Investment Laws of the Imperial Era and the Derg Regime

S/N		I	II	III
		Proclamation 242/1966 of the Imperial Era	Proclamation 17/90 of the Derg Regime	Proclamation 15/92 of the Transitional Government
1	Objective of investment policy	Capital formation particularly attraction of foreign capital.	Growth and development objectives (employment, income, technology, resource devt., foreign exchange, regional devt.) were spelled out.	Objectives similar to those in Proclamation 17/90 are spelled out, but domestic capital formation is underscored.
2	Sectors open to private investment/role of the state	No provision is made to restrict specific sectors for the state.	a. Following sectors were reserved for the state: defense industry, postal and telecommunication services, air, rail and large marine transport, radio and television services. b. Investment in power, electricity, tobacco manufacturing, banking and insurance, water supply was subject to prior permit by Council of Ministers.	a. In addition to sectors listed under Section II; 2a, power and electricity, insurance and banking which were conditionally permitted for pvt. investment in Proclamation 17/90 are reserved for the state. b. Furthermore, import-export trade in selected products having crucial role in the economic life of the country is supposed to be reserved for the state. c. Pvt. investment in the following sectors requires participation of the state:

3	The role of foreign investment	The policy and the incentives were mainly targeted at foreign investors.	Foreign investment was encouraged subject to certain regulations, for example, for industry: - no less than Birr 1 million, - no less than Birr500 thousand in case of import substitution, - without restriction on minimum capital in the case of an industry with export of at least 20% its products, - no agriculture and in construction there were certain qualifications.	Large-scale engineering and metallurgical industries, capital-intensive and technology-intensive investment in large-scale mining and energy production, large-scale pharmaceutical and fertilizer plants and industries which supply strategic raw materials to chemical industries. Unless it is in technology areas of special interest or know-how, the minimum requirement of capital is fixed at US 500 thousand dollars, of which 25% should be deposited in cash/convertible currency (lowering the capital floor, when necessary is left to the Council of Ministries). In addition to the above regulation, the local-foreign investor dichotomy and the intended preferential treatment for the former is implied from the various clauses of the proclamation that underline the priority privileges to be enjoyed by local investors. Projects with capital no less than Birr250 thousand for local investors and with capital not less than 500 thousand dollars for foreign investors in the areas of agriculture, manufacturing and construction.
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	Regional development	No Provision.	Additional 1-2 years of income tax holidays.	Additional income tax holidays of 3-5 years for investment in preferred areas. The minimum investment (Birr250,000) is not scaled down for the purpose of promoting regional devt.
	Research and Development	No provision.	No provision.	Research and development expenses are deductible for tax purposes.
	Maximum duration for income tax holidays			
	- a new investment - special areas - expansion - profit re-investment (foreign)	5 years 3 years	Up to 5 years Up to 2 years Up to 3 years	3 years Up to 5 years 2 years Up to 3 years
5.	Joint venture		Joint venture necessitated the participation of the Ethiopian state or state enterprise of financial agency.	In sectors prone to joint venture, participation of the state is a necessary condition. The watchfulness of the state to protect the right of domestic investors participating in domestic-foreign partnership is underlined.
6.	Administration of the investment law/qualification for incentives	A permanent investment committee was set up in the Ministry of Commerce and Industry.	Investment committee accountable to the Council of Ministers was established.	Investment office of Ethiopia is established.
	Administration of the investment law qualification for incentive	Upon the recommendation of the committee to the Ministry of Finance. Investors would be granted tax holidays.	An investor could be considered for incentive only if: he had been licenced by the respective ministry.	An investor who fulfills the minimum capital requirement and at least one of the investment objectives would be issued investment certificate by the investment office in no more than

7	Nationalization	The investor is requested to furnish only the following: the proof for the amount he invested, evidence for the date of commencement of the enterprise. As to duty exemptions on import, the Ministry of Finance was to issue a regulation in which items eligible for exemption were to be listed out. Nothing is stated that implied nationalization.	his project is supported and defended by the respective Ministry. The final decision was that of the investment committee. Nothing is stated that implied nationalization.	60 days after consulting the respective sectoral Ministry. The certificate does not exempt from commercial registration and operating licence. Within 30 days of the start-up, the investor should produce evidence showing the exact amount of capital invested. Article on investment guarantees and protection is inserted, where the possibility of nationalization without adequate compensation and legal procedure is ruled out.
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The following comments can be made on the new investment code:

- a) The conditions imposed on foreign investment and the clauses on priority for local investors (which are superfluous) underrate the need for foreign capital attraction and seem to give signals to repulse it. In fact, the promotion of local capital and investment, while being desirable, is overly underlined and seems to be divorced from the reality of existing capability. The absence of a robust local capital is evident from the fact that local private industrial investment is dominated by small-scale industries. Currently, in 90% of the cases, new applications and establishments are in the capital range of below Birr 500,000. In other words, the effort to promote local capital should have been better targeted at promoting Small- and Medium-scale Industries (SMIs). However, the existing policy framework ignored SMIs.
- b) Compared to *Proclamations Nos. 242/66 and 17/90*, the new investment law gives more incentives to those investments in preferred areas than it does for new investments. Although this is understandable, as experiences of other countries revealed, its likely impact to narrow the regional imbalance is low. Rather, *Proclamation No. 17/90*, which links regional development with small-scale industry promotion (through tax holidays), seems to be better targeted.
- c) Even by the standards of *Proclamation No. 17/90*, the new investment law seems to be more cautious in inviting private investment. Apart from the activities reserved for the state, there are four categories which are designated as strategic and demand the compulsory participation of the state. In the large-scale metallurgical and engineering industries, which may not see domestic private investment in the short run, the state cannot withdraw immediately without negative consequences. The same applies even in the case of large-scale light industries. However, whatever positive role the state plays in this regard, policies that overstretch the limited resources of the state and marginalize the private sector should be avoided. Hence, it would be harmful to make private investment in such important sectors conditional on participation of the state. In view of the limited capacity of the state to raise capital and of the capital-intensive nature of these sectors, such a condition would inhibit the development of these very sectors.
- d) On the issues of joint venture, the new investment law is at best vague and, at worst, sticks to the rules of the old days. The article that obliges the participation of the state in establishing the so-called 'strategic industries' implied that a joint venture, between local and foreign private investors, at least in the large and heavy industries, is still impossible. It should be noted that, a similar provision on joint ventures, in the past, did not bear fruit.
- e) Unlike the previous laws, a specific article on investment guarantee and protection is inserted although this article seems to be intended to provide a legal basis to forbid

arbitrary and uncompensated nationalization. Of course, a similar article is common in investment codes of many developing countries. But, in view of the nationalization record this country has, it is doubtful, whether the clause serves the intended purpose.

- f) As a common practice in many developing countries, the establishment of an investment office is partly dictated by the need to provide a one-stop service. In the Ethiopian case, the capability of the investment office to provide a one-stop service is a matter to be seen. Two points must be kept in mind:
 - i) As a centralized system of investment administration, there is also the possibility of creating more bureaucracy from overstretched control and regulation.
 - ii) The concept of one-stop service can only be realized through adherence to simplified procedures and efficient services by all institutions that are involved in industrial investment. One-stop service has to do with land acquisition, access to credit, import and port clearances, provision of foreign exchange, etc. The debilitating investment bottlenecks and bureaucratic hurdles are yet intact. As Exhibit 2 shows, in the existing set-up, industry start-up could take up to 88.5 months. Therefore, simplifying the investment process should mean removal of entry barriers. This is a long way off.

Exhibit 2: Estimated Lead Time for Industry Start-up

Activity	Involved Institution(s)	Estimated time
Licensing (Provisional)	Ministry of Industry (MOI) Investment Office(10)	Up to 1.5 months
Land acquisition . Plot estimate and support letter . Land acquisition	MOI(14) IO Municipality(28)	Up to 36 months
Building . Building permit . Bill of quantity and support letter . Purchase of building materials . Construction	Municipality(10)	Up to 24 months
Credit . Support letter . Project appraisal, loan approval and disbursement	MOI, IO AID Bank	Up to 12 months
Import of machinery (in case of import) . Review and support letter . Clearance	IO MTSC & Customs (45)	Up to 6 months
Utilities, health and safety standards . Water . Power . Obtain authorizations	EWSSA EELPA Municipality and Labour Office	Up to 6 months
Operational licence	MOI	Up to 1 month
Municipal permit	Municipality (22)	Up to 2 months
Total estimated lead time		Up to 88.5 months

Note: Some activities can be carried out simultaneously and/or some investors may start-up in their own premises in which case the start-up period would be shortened.

The figures in the parentheses refer to the minimum stop-overs or signatures required.

It is only a few months since the issuance of the new investment code. Therefore, it would be difficult to objectively evaluate or assess its impact. Of course, it is tempting to associate the increased trend of investment applications to the changed policy and legal framework, and definitely, there is some truth in this. However, such statement must be qualified to avoid wrong generalizations. For serious investors, the period is rather more for queries than actual commitment. Furthermore, the reading of the events and optimism generated from them must be sobered by the following facts:

- a) The up-turn of investment applications has started long before the investment code *Proclamation 15/92*, immediately after the issuance of the earlier *Proclamation 17/90*. In fact, since the issuance of *Proclamation 17/90* in May 1990 and until June 1992, i.e., right before the issuance of the new investment law, 6,059 provisional licences have been issued by the Ministry of Industry.
- b) Though the share companies being established can be regarded as promising and sustainable business organizations, most of them are in trade and services rather than in the manufacturing business. In the first four months period since the issuance of the new investment law, share companies intended to begin manufacturing account for 29% of the total, while those in trade and services take up 69%.
- c) In view of the various entry barriers and difficulties for start-up, the realization of actual investment is much lower than the number of applications submitted.

Therefore, whatever optimism resulting from the increasing trend in the number of new applications and investment intentions, should not obscure the hard fact that exists behind them. The long suppressed private sector shows the desire to invest. But, the force required to reach a turning point is not yet in motion. Unless an enabling environment is created for investors, such desires could die out.

5. CONCLUSIONS

The damage inflicted upon the nation's capacity to save and invest is a result of the misguided policies of the past. Compared to low income economies and sub-Saharan African countries, Ethiopia's saving and investment rates are at record low levels. Changing the economic conditions in the country is unthinkable without reversing these.

The new economic policy and the investment law aim to create a conducive policy environment for increased investment. Definitely, both the policy and the law mark a departure from the restrictive and inhibiting legacies of the past. However, compared to the investment law of the Imperial era and even to that of the Derg regime (promulgated in its last days), the new investment code is with more flaws and ambivalence. Second, even if the hitherto existing

restrictions are removed, the real entry barriers and hurdles that prolong and inhibit industrial start-up have yet to be addressed.

Furthermore, since investment is likely to be affected by a range of macro and micro policies, the initiated reform programme must be pursued and maintained with the ultimate aim of restoring investors' confidence and creating an enabling environment. In the Ethiopian context, the reform programme should be perceived not only "as a response to emergency conditions, but also as a deliberate action to make fundamental alterations in the underlying structure of the economic policy" (Krueger, 1992). Anything that leads investors to doubt, whether decision-makers genuinely support the changes or not, should be avoided. More than any other phenomenon, investment is likely to be affected by uncertainty. Definitely, a quick-fix solution is not available. The reform is a process in nature. The important thing is establishing credibility.

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