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The Impact of Tax Holiday on Investment in Ethiopia: The Case of LTO Branch

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Abstract
Many developing nations formulate tax policies aimed at stimulating rapid economic growth. One of the policies in Ethiopia is a tax holiday with the main goal of enhancing investment. But, many writers argue that tax holiday is not an effective measure of attracting investment. The present study attempts to look into the impact of the tax holiday on investment using experimental research in a case-control study design. Specifically, this paper tries to investigate whether (1) tax holiday has an impact on increasing employment opportunity, (2) tax holiday has a role in attracting new manufacturing investments and (3) tax holiday is reducing tax revenue.The study utilized a total of 70 taxpayers from manufacturing and construction sectors and 20 tax employees.To undertake this study, in addition to the secondary data, primary data collected through interviews and questionnaires are utilized to arrive at the findings. The T- distribution and ANNOVA statistical methods werealso used to examine the relative impact of the tax holiday on employment creation, revenue reduction, attracting of new investment and to identify the most tax sensitive sectors. The impact of tax holiday incentive for investment of Ethiopia is significant, but has not motivated investors effectively since the time period of the tax holiday is too short for investors who produce for local consumption purpose.
Keywords: Tax holiday, Investments, Employment creation, revenue reduction

I. Introduction

Tax policy has been widely used by governments as a means of influencing firms' investment decisions (Chislom, 1999). The increasing mobility of international firms and the gradual elimination of barriers to global capital flows have stimulated competition among governments to attract investment, often through tax incentives (Klemm, 2009).

Under this premise, granting a tax incentive implies that the capital stock either of some type or in aggregate is considered too low and that either the tax system is the obstacle or other obstacles exist that can be compensated by the tax system. Other incentives exist, such as those which are not aimed at the real economy, but at attracting reported profits or those aimed at improving social outcomes, for example, by encouraging education or saving for a pension (ibid).

Tax incentives are those provisions in the tax code that afford preferential treatment to some activities over others (say, tax holidays and credits for investment in manufacturing industries), some assets over others (accelerated depreciation provisions for specified assets), some form of organization over others (for example, lower tax rates for small rather than for large businesses), or some forms of financing over others (debt versus equity). Tax incentives include those provisions in the tax code that attempt to change the time distribution of use of assets (for example, tax holidays, accelerated capital consumption allowances, time-variant statutory tax rates, and depletion allowances for resource industries). The primary intent of all these provisions is to encourage capital accumulation in specific activities (Saha, 1995).

Tax holidays have long been a popular device for encouraging firms to locate in a particular area. Under a tax holiday, a firm is given a reduced (usually zero) tax rate for a specified period of time, at the end of which the firm begins to pay taxes at the usual rate (Bond, 2011). This type of program has been used as one of the primary policy tools in a number of countries, including Ethiopia, which are relying on an export-led growth policy. Tax holiday is a subsidy to a particular characteristic of capital goods; specifically the amount of output produced during the tax holiday.

In Ethiopia, any income derived from an approved new manufacturing and agro-industry investment or investment made in agriculture is exempted from the payment of income tax for the periods depicted on Investment Proclamation No. 280/2002 and Regulation No.84/2003 from 2 up to 7 years, depending upon the area of investment, the volume of export, and the location in which the investment is undertaken.

It is in this context, that this paper will present the impact of income tax holiday on investment in ERCA-LTO branch.

Statement of the Problem

Tax holiday is used as a tool in promoting investments in Ethiopia. Having this in mind, even though there are studies conducted by the International Monetary Fund (IMF), World Bank (WB), developed countries and a few in developing countries regarding tax holiday, there is no clearly known studies undertaken in Ethiopia. Given this gap, the researchers sought answers to the following questions:

- A relationship exists between tax holiday, employment creation and attracting of additional investments?

- The investments that are most sensitive to tax change?
- The effects of forgone revenue on expansion of private output, and after tax profit?

II. Literature Review

1. Tax Incentives

The tax incentive can be defined as any incentives that reduce the tax burden of an enterprise in order to induce them to invest in particular projects or sectors(UNCTAD, 1995). Tax incentives can take the form of tax holidays for a limited duration, current deductibility for certain types of expenditures, or reduced import tariffs or customs duties. According to Bond (2011), tax holidays are among the most widely used incentives, especially in developing countries. Tax holidays are commonly used by governments to help stimulate foreign investment, used in the hopes of increasing the gross domestic product (GDP) in developing countries. Tax holidays are a way in which governments attract foreign investors and often put in place in particular industries to help promote growth (Investopedia, 2011).

Tax holiday has been a popular device for encouraging firms to locate in a particular area. Under a tax holiday, a firm is given a reduced (usually zero) tax rate for a specified period of time, at the end of which the firm begins to pay taxes at the usual rate. This type of program has been used as one of the primary policy tools in a number of countries which are relying on an export-led growth policy(ibid).

According to Roca (2010), non-tax factors are more important when it comes to assessing the amount and the quality of the investment than the tax benefits, particularly in the case of developing countries. The non-tax factors usually cited are political stability, legal security, undistorted macroeconomic politics, the quality of the workforce and the state of the infrastructure. But developing countries have not stopped using tax benefits with a view to increasing investment, particularly foreign direct investment (FDI).

Fiscal incentives are necessary to compensate for the extra expense foreign investors have to face when doing business, especially where there are significant shortcomings in the non-tax factors. But there are arguments in today's global economy, characterized by high capital mobility; a low effective tax rate has to be offered to attract foreign investment. The procedure for reducing taxation on capital, which countries resort to so as to attract foreign investment is called tax competition. Although the rate of return of the taxes may then be positive in country A, the investment could be found in country B if; after tax, that rate is higher in B because of a lower taxation on the capital (Klemm, 2009). Eliminating the corporate income tax is the full application of increasing investment. But another way of getting into tax competition for mobile capital is by granting fiscal incentives.

Easson&Zolt (2002) pointed out that designing tax incentives requires two basic decisions such as determining the types of investment and determining the form of tax incentive to adopt. Tax incentives for investment take a variety of forms such as investment allowances and credits, accelerated depreciation, reinvestment incentives, reduced import taxes and custom duties.

2. Tax Holiday

Arguments in favor of investment tax incentives are widely known. According to Easso&Zolt (2002), tax incentives clearly enhance returns on investment; they may be justified by positive externalities stemming from investments. They are relatively easy to target and fine tune, they signal openness to private investment, they are useful in a world of capital mobility, they are necessary for responding to tax competition from other jurisdictions, increases capital transfers, transfers of know-how and technology, increases employment, and assistance in improving conditions in less-developed areas and they compensate for other deficiencies in the investment climate. Another common argument is that incentives can actually enhance revenue by stimulating investments that generate other taxable income via employment and linkage effects. Tax incentives also offer political advantages over direct expenditure programs to stimulate investment. Finally, proponents of tax incentive pointed out that tax incentives have been successfully used in well known countries like Malaysia, Ireland, and Mauritius (Nathan−MSI Group, 2004).

Tax holiday has also drawbacks. The tax holiday may cause too much allocation of resources that may result in huge investments in certain activities or too little investment in other non-tax favored areas (Easson & Zolt, 2002).Tax holidays are not cost effective because profits are exempt regardless of their amount. The most profitable investments, which would have taken place in any event, benefit most. Tax holidays are most attractive for footloose industries that tend to exit the country at the end of the holiday period. These industries are likely to bring the smallest benefit to the overall economy. Instead, firms investing in long-lived assets whose revenues may not fully recover costs during the period of the holiday, benefit least from tax holidays.(Klemm etal, 2008).

When the rationale for granting tax incentives is based more on discretionary and subjective qualification requirements, instead of automatic and objective requirements, they can originate rent-seeking behavior and facilitate officials' abuse of the granting process. In particular, for developing and emerging economies, it is important to move away from discretionary incentives towards greater reliance on rules-based means of attracting FDI - national and international rules that maintain or strengthen environmental and labor standards and create stability, predictability and transparency for policy makers and investors alike (OECD, 2001) and (Fletcher, 2002).

When a temporary exemption is given for income tax (tax holidays) to new investments, it is common for established companies to close down and reopen as "new" companies so as to be able to receive the benefit(Roca,2010).

Some authors state that tax incentives neither make up for serious deficiencies in a country's investment environment nor generate the desired externalities, but if other infrastructures are equal, tax incentive may have a significant effect on investors' choice (Pirina & Moriesset, 1999).

According to Klemm & Parys (2009), empirical studies of 40 Latin American, Caribian and African countries for the period 1985-2004 revealed thatlower corporate income tax rates and longer tax holidays are effective in attracting FDI, but not in boosting gross private fixed capital formation or growth.

Ethiopia has made tax treaty with more than 20 countries to avoid double taxation (Ethiopian Investment Agency Pamphlet, 2011). So, granting tax holiday privilege did not help international investors from paying tax rather, it assisted them to pay the tax in their country.

3. Experience of Different Countries that Provide Tax Holiday

According to the United Nations Conference on Trade and Development (1995), as many as 67 countries offer tax incentives. Tax holidays provide benefits as soon as a company begins earning income, while the benefits of a lower corporate tax rate accrue more slowly and over a longer time. But tax holidays benefit primarily short-term investments, typical of footloose industries (such as textiles and assembly of light manufacturing goods) in which companies can move quickly from one jurisdiction to another (Cottarelli, 2011). They also tend to reward the founding of a company rather than invest in existing companies, and to discriminate against investments that rely on long-lived depreciable capital. Likewise, they can lead to erosion of the tax base as taxpayers learn how to evade taxation of income from other sources.

In some countries, the application of tax holiday for a period ranging from 5-10 years has proven successful to increase the value of investments, including in Thailand, China, India, and Vietnam. The tax holidayfacility should be directed to investments in disadvantaged areas, pioneering industries and industries that can absorb a lot of labor (Jakarta updates.com, 2010).

Indonesia provides tax holiday for investors committing at least 1 trillion rupiah ($117 million) into base metals, oil refining, petrochemicals, renewable energy, machinery or telecoms equipment. Investors are alsoexempted from paying taxes from 5to 10 years after their companies started operations.Existing investors that have operated commercially for less than one year may also ask for a tax holiday (Suharmoko, 2011).

A few governments, such as those of Ireland and Singapore, have had marked success with targeted tax incentives. But many more have failed to attract foreign direct investment with such incentives, explaining why the recent trend has been to eliminate and streamline tax incentive programs. These moves appear to be sensible ones, since multinationals appear to give greater weight to simplicity and stability in the tax system than to generous tax rebates, especially in an environment with great political and institutional risks (World Bank,2003).

Kuo & Jenkins (2007) emphasized also that tax holiday incentives in Taiwan could be in the form of accelerated depreciation or tax holiday that begins at the start of business production. The tax incentives are given to new businesses as well as to those who expand their projects. A greater emphasis was placed on the promotion of investment in high technology sectors, energy conservation, and pollution control equipment.

If the effective tax rate is high, the more a company uses long-lived assets, the more taxes the company pays after the tax holiday expires. The effective tax rate is higher in manufacturing than in service in Central and Eastern European countries due to manufacturing's greater use of long-lived depreciable capital, relative to service activities which use more short-lived capital (Mintz & Tsiopoulos, 1992).

Tax holidays are only important if investments are financed by equity and/or foreign borrowing in low-inflation countries and/or when the host countries experience low inflation. In some countries, unused tax credits may be carried forward to offset future tax liabilities for the next years.

In July 2000, Croatia introduced a new Investment Promotion Law that provides for a 20 years corporate tax holiday on profits derived from investments in qualifying "newly established" companies. To qualify, the investment must be at least 10.289 million dollars. Also, the project must employ a minimum of 75 employees over the tax holiday period, beginning with the first year of investment. In certain cases, tax holidays may be provided at the discretion of the Government of the Republic of Croatia, to companies that were already existing in the tourism industry (mainly hotels) (Clark, 2000).

Similarly, the Federation of Bosnia and Herzegovina (FB&H) and the Republic of Srpska both offer a 5 year tax holiday for newly established companies. The exemption of tax on profits is proportionate to the level of investment. Therefore, where an investment project is 100% foreign-owned, corporate income tax is fully waived for a period of 5 years. Where foreign participation is less, the percentage of corporate profits exempted under the tax holiday are proportionately reduced. This tax relief is not available where foreign participation is less than 20% (ibid). Such kind of tax incentive is totally outward looking. It does not consider locally owned investments even though they may have greater participation in the enhancement of the investment.

According to Masters (2006) and Easson (2004),the most common tax holiday period is 5 years, but it may range from 3-20 years. South East Asian countries provide tax holiday to their investors based on the nature of the business such as Cambodia up to 8 years, Indonesia 3 to 8 years for new enterprises in 22 specific sectors, Malaysia for 5 years tax holiday on 70-100% of statutory income (10 years for companies of national/strategic importance), Philippines and Thailand 3 to 8 years in the income tax holiday. African countries such as Kenya, gives tax holiday for 10 years and a flat 25% tax rate for the next 10 years, unlike the 30% rate on others, and a 100% investment allowance (Moyi & Ronge, 2006).

Ethiopia allows tax holiday for the period ranging from 2-7 years based on the nature of the business and, grants loss carry forward after the expiration of the holiday period for half of the tax holiday period; but is ignoring the accelerated depreciation method, instead it uses the straight line method. This period is not competitive enough with that of other countries, including Kenya to compete based on tax benefits.

4. Tax Holiday in Ethiopia

Any income derived from an approved investment in new manufacturing, agro-industry and information and communication technology (ICT) development or agriculture is exempted from the payment of income tax for the periods shown in table 1, depending upon the volume of export and the location in which the investment is made. The profit tax holiday is granted subject to Council of Ministers Regulation No.84/2003 (as amended) issued pursuant to the Investment Proclamation No. 280/2002 (as amended) (Council of Ministers, 2003).

Comparing the tax holiday provided in Ethiopia and other developing countries such as Kenya, Cambodia, Vietnam, Malaysia, the successful achievers of investment through tax holiday, their tax holiday period is on the average of 5 years. In Kenya, the tax holiday period is 10 years for newly established businesses.

The tax incentive is a factor for investment, especially in some sectors that do not generate income at the time of commencement of the business. Those who may have a significant role in technology transfer and comprise many employees by investing huge capital need to share the risk that may occur. To encourage private investment and promote the inflow of foreign capital and technology to Ethiopia, tax incentives are granted by the Ethiopian Investment Code to both domestic and foreign investors engaged in areas eligible for investment incentives (Embassy of The Federal Democratic Republic of Ethiopia, 2011). Beyond foreign currency inflow due to foreign direct investment, the aim of the tax holiday in Ethiopia is the employment creation. As a result, tax holiday is granted not only to foreign investors, but also to local investors to have labor intensive investments especially agriculture and manufacturing sectors.

Table 1 Tax holiday provision in Ethiopia

Conditions for eligibility	Income tax exemption	Income tax exemption in emerging regions
An investor engaged in a new manufacturing, agro-industry, ICT or agriculture		
Exports at least 50% of his products or services	5 years	6 years
Supplies at least 75% of his products or services, to an exporter, as a production or service input under special circumstance the Board may grant	5 - 7	6 - 8
Exports less than 50% of his products or services, or supplies his products or services only to the domestic market under special circumstance the Board may grant	2 - 5	3 - 6
Exports at least 50% of his products or services and increases, in value his production or services by over 25% through the expansion or upgrading of an existing enterprise	2	2

Source: Ethiopian investment Authority

Having this in mind the study is going to use the arguments, the advantages, experience of different countries on tax holiday and disadvantages of tax holiday as an input for analyzing the data with some supportive ideas from the literature, which can give a better understanding of the subject matter and also contributes its share for the comments to be forwarded at the end of the analysis.

III. Research Design and Methodology

The study utilized primary and secondary data.The research method employed was mixed method.The data were triangulated after collecting them from the taxpayers and employees. In addition, the paper employed case control study design.

The population includes registered large tax payers in ERCA-LTO Branch. Taxpayers that have been enjoying the tax holiday benefit in the past six years from 2005/06 up to 2009/10. In this case, the total population employed in ERCA- LTO branch in all sectors are 855, out of which 196 of the organizations are engaged in the manufacturing sector, of which around 49 taxpayers are enjoying the tax holiday benefit within the stated period of time. For tax officials, it was based on their experiences, and their nearness to management activities.

The sample size, a total of 35 taxpayers for the experimental group, was selected from the 49 taxpayers of ERCA-LTO branch. The researchers also employed 35 taxpayers for the control group,who were from the construction sector. A total of 70 questionnaires was distributed both to the case study group and the control group. From the70 questionnaires, 52 valid questionnaires were collected, 26 from the experimental group and 26 from a control group. The questionnaires were distributed to taxpayers on a purposive- random sampling basis. For tax officials, 12 samples were taken from a total of 56 employees of the branch who are engaged in the auditing activity and 8 samples are taken from a total of 10 employees of government privileges execution department, using purposive sampling method. With regard to interview, the researchers worked in conjunction with the management in choosing participants, based on their level of experience in conducting audits, granting benefits and their managerial qualifications.

This study followed an experimental and estimation focus. The data were analyzed according to parts presented in questionnaire classification. The statements that fell into comparable themes or codes are then examined to see if they have specific meaning in relationship to the purpose of the study. The data were presented, analyzed, and interpreted in counts and percentages, using Chi-square variable, T-test distribution, and ANOVA statistical methods.ANOVA table was used to analyze respondents' feedback on the necessity of tax holiday, chi-square variable was used to compare the responses of two respondents, when it is not able to determine based on mean and standard deviation for data collected through questionnaires. The T-test is also used to compare the means of the construction sector and manufacturing sector regarding employment opportunities and additional investments generated.

IV. Discussion and Analysis

Most of the investors who have gotten tax holiday privilege have 6-8 years of work experience as managers. Likewise, investors from the construction sector have7-10 years work experience and most of the respondents are managers. These profiles of the respondents helped to increase the accuracy of data collected through questionnaires.

A. Determinant of Tax Holiday

Tax holiday is a tool used by many countries to compete with tax special in Asian countries and is now a basic instrument to attract foreign investors. It is not only in Asia, African countries are also competing using tax holiday to attract foreign investment, according to some researchers stated in this literature. Ethiopia is one of the African countries that grant tax holiday to local and foreign investors in selected sectors. The researchers distributed questionnaires to know which sector is more sensitive to a tax change and to what extent do taxpayers agree on the necessity of tax holiday. Table 2 shows the results:

Table 2. Sectors in need of tax holiday

		Variable	Responses				
			employee	control	experimental	Weighted average mean	frequency
1	To which Sector is tax holiday privilege more necessary?	Manufacturing	17	23	26	22	37%
		Agriculture	13	16	22	17	29%
		Agro processing	14	15	7	12	20%
		Construction	7	4	-	4	7%
		Real state	-	2	-	0.5	1%
		ICT	-	6	6	4	7%

Source: Survey questionnaire

Table 3. One Way ANOVA

Source of Variation	Degree of Freedom	Sum of Squares	Mean Square	Value of the Test Statistics
Between	2	10.7778	5.8889	f=0.049
With in	15	1655.67	110.378	
Total	17	1666.448		

As shown from the above ANOVA table, the computed value of "F" is 0.049, which is less than the tabular value of "F", 6.36. Therefore, it falls in the non rejection area. Hence, the researchers fail to reject the null hypothesis and conclude that the mean of the three populations is equal. In other words, these three respondents had similar responsesto the question raised. The difference in these three means obtained from three samples occurred because of sampling error. Therefore, the manufacturing sector is the priority of the respondents to have tax holiday privilege with a frequency of the mean value 37%, agriculture 29%, agro-processing 20%, construction 7%,Realestate 1% and ICT 7% as shown in table 2.

The above data shows that all of the respondents agree on the importance of tax holiday to investment, but the difference is on the proportion and to which sector tax holiday should be provided most. These three different respondents point out manufacturing industry, should be on top, and followed by other sectors. For them, manufacturing sector is the one that accommodates many employees, has the potential to generate hard currency, with a longer payback period and needs huge capital investment without any guarantee.

B. Effects of Tax Holiday

Table 4.Responses from employees of ERCA

		yes	%	no	%
1	Is tax holiday effective in meeting the set social and economic objective?	12	60	8	40
2	Is tax holiday suited to the investment in question?	17	85	3	15
3	Is additional analysis necessary to demonstrate the non quantifiable benefits from investment projects?	11	55	9	45

Source: Survey questionnaire

The above table indicates that, 60% of respondents have agreed on the social and economic objective of tax holiday as effective, and 40%, as not effective. The respondents think that tax holiday is not effective because the proclamations and regulations they used are not clear and are not capable of controlling the activity of the investor after the investor has granted tax holiday privilege. On the other hand, those who accepted the effectiveness of tax holiday expressed that, it favors employment opportunity, secure hard currency both as a substitution effect and as a means of generating additional hard currency to the country through export, plays significant role in the transfer of technology. They also argued that tax holiday has significant effect in bringing political stability. Therefore, tax holiday has social and economic benefits, but it needs amendment of Investment Proclamation and Regulation in order to be easily understood, especially the tax holiday permission done by Customs Administration.

Regarding the suitability of tax holiday for the investment, 85% of the respondents agreed with tax holiday suitability and only 15% did not. Even if a majority of the respondents agreed on the issue, many problems are attached to it. Many international and local investors invest to get the benefit, then they liquidate, merge after the tax holiday ends. According to the interview result with the audit process owner of ERCA (Dec, 2011), there are transfer prices that may declare the cost of the tax holiday user as their sister company cost, investors overstate the cost of the sister company and reduce income so as not to pay taxes or the sister company may sell goods for the tax holiday user organization at least price, because tax holiday user is not paying taxes for the income earned.

With regard to the necessity of additional analysis to demonstrate the non quantifiable benefits from investment projects, 55% of the respondents believed on the additional analysis to incorporate non quantifiable benefits and 45% of them did not. This only implies that most of them are not convinced with the current situation of tax holiday, hence they agreed on the need of additional analysis. Other benefits such as loan opportunity from the government, availability of raw materials, the potential of using duty free should be considered.

Table 5 Effectiveness of Tax Holiday Incentives

	Responses from Employees of ERCA	SD	D	N	A	SA	Weighted Average mean	S.D	Chi-square
1	Is sufficient attention given to maximizing effectiveness and minimizing overall long-term costs with regard to tax holiday incentives?	2	6	1	6	5	3.3	1.42	5.5
2	Are the effects on local business of offering tax holiday treatment to foreign-owned enterprises sufficiently well understood?	8	5	2	4	1	2.25	1.33	

Source: survey questionnaire of employees

As we can see in table 5, the mean value of 3.3 shows sufficient attention is given to maximize effectiveness and minimize overall long term costs. However, the standard deviationof 1.42 shows huge gap from the mean. Therefore, the researcher chooses another measurement chi-square, to test its significance. The Chi-square variable calculation shows that the critical value at 0.01 significance level is 11.14, where the computed value is 5.5. Therefore, since the computed value is less than the critical value,the null hypothesis is accepted. This shows that sufficient attention is given to maximize the effectiveness and minimize long-term costs.On the other hand, the mean score of 2.25, which is less than the average and its standard deviation of 1.33, show that the effect of tax holiday is not well understood or it is not clear if it actually attracts investment or not.

C. Control Group Understanding of Tax Holiday

Table 6. Responses from control group

		Yes	%	No	%
1	All incomes generated by your company are subject to tax?	21	81	5	19
2	Is the level of income considered before imposing tax?	19	73	7	27
3	Tax has a negative impact on my company's investment decisions.	18	69	8	31
4	Does tax holiday privilege motivate you to invest in the privileged sectors?	22	85	4	15

Source: survey questionnaire

These four dichotomous questions are forwarded to non users of tax holiday. For question no. 1, 81% of them confirmed that all incomes are subject to tax while 19% opposed because of the possibility of tax avoidance. On the other hand, 73% of the respondents affirmed that their level of income is being considered before the tax is imposed. This shows that, there is sufficient attention given to the taxpayers, which helped them build their confidence on the tax authority after investing.

As regards the negative impact of tax on investment decision, 69% replied "yes", and 31% said "no". This encourages the investor to invest in an industry where he can enjoy the tax holiday. In an informal interview, the taxpayer expressed his feeling as:

> *"Before, we were able to participate in any investment sectors since there is a possibility of tax evasion and avoidance in any case. But in the current time, the rules are becoming stringent and highly exercised that block the room for evasion which affects the profitability of the business, so we are urged to invest in tax incentive offered sectors."*

This only reflects that the suitability of the environment for evasion undermines the importance of tax holiday for a longer period of time.

Also shown in the table,that 85% of the respondents agreed that tax holiday motivates them to invest in the privileged sectors However, their lack of interest to invest in the privileged sector is brought about by some factors like the non-availability of skilled labor who can handle huge factories with sophisticated machine, insufficient capital to operate manufacturing firms and the question of profitability

Table 7 Control group understanding of tax holidays

		SD	D	N	A	SA	Weighted average Mean	S.D	Chi square
1	There are other means by which government can raise funds aside from tax.	5	3	1	10	7	3.38	1.52	27.4
2	The linkages between enabling environment and tax holiday aresufficiently well understood?	3	5	1	11	6	3.46	1.36	-
3	The effects on local business of tax holiday treatment to foreign-owned enterprises are sufficiently well understood?	1	2	1	16	6	3.92	0.98	-

Source: survey questionnaire

Question no. 1 got a weighted mean of 3.38, and standard deviation of 1.52 which shows a significant difference. The result was further analyzed using the Chi-square, with a critical value of 13.2767 and a computed value of 27.4. Therefore, the null hypothesis was rejected. This implies that if there is no other alternative to enhance government revenue, care should be taken when offering tax holiday.

With regard to the linkage between tax holiday and enabling environment relationship, its mean of 3.46 and the standard deviation of 1.36 both assure that there is a linkage between enabling environment and tax holiday. Hence, the existing tax holiday opportunity focuses on the right route.

Finally, as to the effect of foreign owned enterprises on locally owned enterprises, the mean of 3.92 and a standard deviation of 0.98 imply that by the investors already understood its effect. However, the employees of ERCA did not agree with the effects of foreign investors on local investors. For them, foreign investors have an edge in terms of capital, knowledge, market assessment and others over local investors. Better tax holiday may be offered to local taxpayers, but such kind of treatment is contradictory with international experiences of different countries as explained in the literature.

D. Advantages of Tax Holiday

Table 8 Responses from Experimental Group

		yes	%	no	%
1	Will you make an investment had there been no tax holiday?	3	12	23	88
2	Does your company receive adequate tax holiday incentives?	12	46	14	54
3	The tax holiday incentive is more relevant to existing companies than the potential ones.	9	35	17	65
4	Does tax holiday incentive more relevant for big companies thanthe small one?	15	58	11	42

Source: Survey Questionnaire

As seen in table 8, 12% of the respondents said that they will still make the investment even if there is no tax holiday given to them while 88% of them responded they will not make any investment in the manufacturing sector. This implies that the majority of the respondents does not want to invest in the manufacturing sector. Therefore, it is obvious that the tax holiday is necessary for the manufacturing sector to reduce uncertainties in the sector such as, risk of insolvency, to attract other investors who are not engaged in this sector, and to bring political stability in the country by hiring many employees in the established business.

With regard to the second question, 46% of them said “yes” and 54% of them said “no”. The reason for those who rejected the idea is that, the tax law of Ethiopia did not allow them to use the tax holiday provided properly. The law exempts them from payment of business income for two years after the commencement of the business, but their company was not profitable within the first two up to three years. Some of them said that even their project proposal shows profit will be earned after three years, they have still loans from banks that earn huge amount of interests. Moreover, there is a market failure that needs promotion for the new products of the organization and other expenses that make the organizations not profitable in the first two years. On the other hand, the majority of the respondents were using their tax holiday properly. Based on the secondary data collected, they have used their tax holiday properly, even though there are some discrepancies on few organizations.

Third, only 35% of the respondents were convinced that the tax holiday is more relevant to existing companies than the potential ones. Existing companies already know how to enhance their available resources rather than those potential firms or those who are new in the business. From this perspective, it is clear that the tax holiday is necessary for new companies who want to participate in manufacturing industries than to existing businesses. In addition to the other benefits, the grace period help them to know tax system and policy of Ethiopia for the future.

As to whether the tax holiday is more relevant to which group, 58% of them said tax holiday incentive is more relevant for big companies than small one and 42% said it is not. Those who said “yes” believed that it is more important to the big companies because they are investing huge amounts of money in a project, their payback period is too long, they employ number of employees, can generate hard currency from export since these companies are capable to compete internationally, substitutes import, and its contribution to GDP is large. Therefore, tax holiday is necessary for big companies than small one to compensate these risks.

Table 9. Response of experimental group

		SD	D	N	A	SA	Chi-square
1	Does the tax revenue derived is justified by the level of infrastructure provided?	2	4	2	13	5	41.4

Source: Survey Questionnaire

Respondents’ response to the above question whether the revenue derived is justified by the level of infrastructure was analyzed using Chi- square method. Based on that, the critical value is 13.28whereas the computed value is 41.4. Therefore, the null hypothesis is rejected and the alternate hypothesis is accepted. This means the revenue derived is not justified by level of infrastructure provided. It is simply collecting the revenue at the same rate throughout the country without having even distribution of infrastructure or alternate incentives to the investor. So, there is nothing in the emerging regions that can attract investors to invest with the exception of the limited tax holiday incentive. On the other hand, investment can be concentrated in the developed areas of the country that have enough infrastructures. In addition to this, even though there may be findings that can generate new revenue for the country, there is nothing that can motivate such kind of investments in terms of tax.

E. Experimental and Control Group Responses on Tax Holiday Effectiveness

Table 10. Response from Control and Experimental Group

	Responses from investors	Exper.		Control		Cumulative %		
		yes	no	yes	no	yes	no	abstain
1	Does tax holiday incentive used to off-set other disadvantages that investors may face?	23	3	22	4	87%	13%	-
2	Do tax holiday incentive leads to reduction of revenue to the government?	10	13	17	9	52%	42%	6%
3	Is the time period provided for tax holiday incentive enough?	8	15	15	9	44%	46%	10%

Source: Survey Questionnaire

As shown in table 10, 87% of the respondents agreed that the tax holiday incentive is used to offset other disadvantages that an investor may face. This shows the importance of tax holiday for an inventor to engage in the manufacturing sector or others that require huge capital investment.

The second question in table 10 investigates whether tax holiday leads to a reduction of revenue to the government or not. Cumulatively, 52% of the total investors said it reduces the revenue, 42% said it did not reduce and 6% of them abstained. However, for those who said "no", if the tax holiday is provided for one investor, it has the potential to attract other investors, as a result, its long term effect will become positive and the tax revenue will increase as a result of tax holiday.

On one hand, based on the secondary data collected from the file of 26 samples of the manufacturing sector, the government is losing birr 31,560,206. Meanwhile, in the long term, after the tax holiday winds up, the tax amount paid is greater than the contribution of the construction sector. In this regard, the government revenue is not reduced rather there is a postponement of paying the tax as compared to the construction sector.

The third question is with regard to the time period of tax holiday, whether it is enough or not. Of the total respondents, 44% said the time period is enough, while 46% said it is not enough. This only shows that that tax holiday users did not use the tax holiday provided because of the loss incurred in the first two years. But the control group, on the other hand, claimed that this two yearperiod is enough, it can help the investor to know the nature and tax policy of Ethiopia within these years, otherwise offering more than two years for those who produce for local consumption hampers the government revenue.

The interview results with the audit process owner of ERCA revealed that it is very difficult to be profitable in the first two years because of high depreciation of new machineries, high interest expense for loans they get from banks, lack of penetrating the market demand and having high promotional costs are some of the constraints of a new business not to become profitable. Other countries provide tax holiday from 3-8 years. Kenya provides full exemption for ten years and reduced rate for the next additional ten years.

Therefore, tax holiday provided in Ethiopia is short to attract additional investment, The current tax holiday gives meaning to small businesses that can be profitable immediately after the commencement of the business.

Table 11 Responses from experimental and control Group

	Response	Experimental				Control			
		D	N	A	%	D	N	A	%
1	Is tax holiday an appropriate tool to attract investment?	1	0	25	96%	1	0	25	96%
2	Is tax holiday incentive offered that reflects the degree of the selectiveness of the policy goals they are intended to support?	2	0	24	92%	5	1	20	77%

Source: Survey questionnaire

Table 11 shows that 96% of the experimental and control groups agree on the appropriateness of tax holiday as a tool to attract investment to the market.Therefore, tax holiday is appropriate and can be continued. Likewise, it can also support the policy goal it is intended to support, since majority of the respondents confirmed the necessity of tax holiday.

Table 12. Responses from experimental, control investors &employees

	Responses	Experimental			Control			Employees			Cumulative percentage		
		D	**N**	**A**	**D**	**N**	**A**	**D**	**N**	**A**	**D**	**N**	**A**
1	Tax holiday incentives allow local companies to compete favorably well with foreign companies?	8	0	18	5	0	21	5	0	15	25	0	75
2	Foreign investors can be discouraged with tax regime (tax rate and types of taxes) of Ethiopia?	24	1	1	24	0	2	18	0	2	92	1	7
3	Is tax holiday open to abuse?	12	1	13	14	1	11	8	1	11	48	4	48

Source: Survey Questionnaire

Seventy five percent of the respondents agree on the smooth competitive environments, both for local and foreign investors, whereas 25% of the respondents reply it does not allow favorable environment. To those who said "no", they opined that international and local companies do not have equal power of competition in capital, knowledge, availability of new technologies and access to international market. As a result, local companies are forced to invest in small scale industries that do not have stiff competition and can profit easily. They also emphasized that if they have been given better tax holiday opportunity than international companies, they may invest in large scale industries.

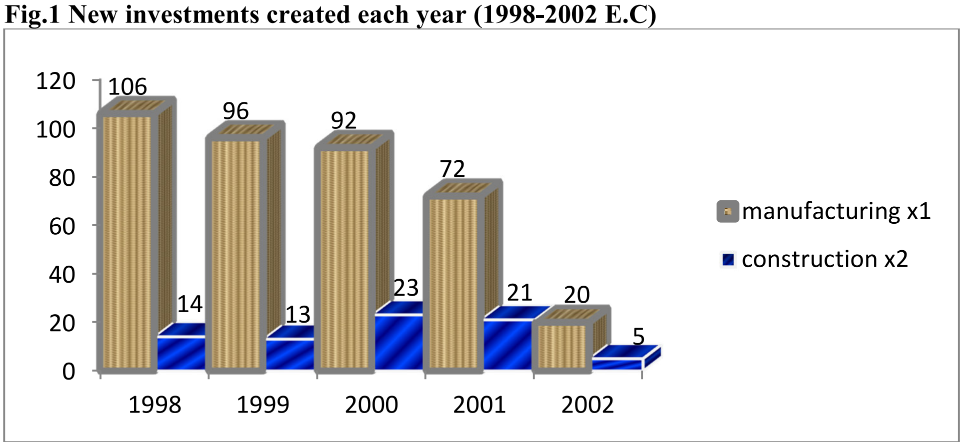
So, even though the tax holiday has the potential of attracting local and foreign investors equally based on the above statement, there are also investors who did not invest in the selected areas due to uncompetitive potential and a few period of tax holiday to investors.

With regard to foreign investors discouragement with the tax regime of Ethiopia, 92% of the respondents replied as they do not agree and 7% agree, the rest 1% being neutral. The tax regime of Ethiopia is not as such worst than other African countries since most of the African country's tax rate is 30% of the net income for income tax purpose.

Forty eight percent agreed, another 48% disagreed and 4% are neutral when asked if tax holiday is open to abuse. Those who answeredit is open to abuse described it in many ways such as: it is open to avoid tax with their sister companies through transfer pricing, the possibilities of liquidating the business after completion of tax exemption period, merging of two businesses after tax holiday ends, government officials abuses permit of tax holiday since there is no mechanism of controlling whether the organization expand its business more than 25% or not, the taxpayer may ask tax holiday for the second time since there is no data base whether the tax payer used tax holiday formerly or not, unclear rules and regulations of tax authority, unclear extension of tax holiday for investors by Ethiopian investment board (EIB), unfounded criteria required by tax officials, and weak linkage between ERCA and National Bank of Ethiopia(NBE) enables the taxpayer to cheat the tax authority. Therefore, these deceit practices can affect the positive impact of tax holiday rather than encouraging genuine taxpayers.

F. The Role of Tax Holiday in Attracting New Investment

Fig.1 New investments created each year (1998-2002 E.C)



Source: Ethiopian Investment Authority

As shown in Figure 1, about 386 new manufacturing industries have been created and engaged in operation from 1998-2002 E.C. On the other hand, 76 new construction investments were created in the last five years from 1998-2002E.C. It can be gleaned from the chart that the trend is decreasing despite of the tax holiday opportunities available to both industries.

To compare the two means between Manufacturing and construction sector the author used T-test analysis method. The hypothesis tested are as follows:

The null hypothesis is the mean of the two sectors is equal; and
The alternate hypothesis is the mean of newly created industries in the manufacturing sector are more than construction sector.

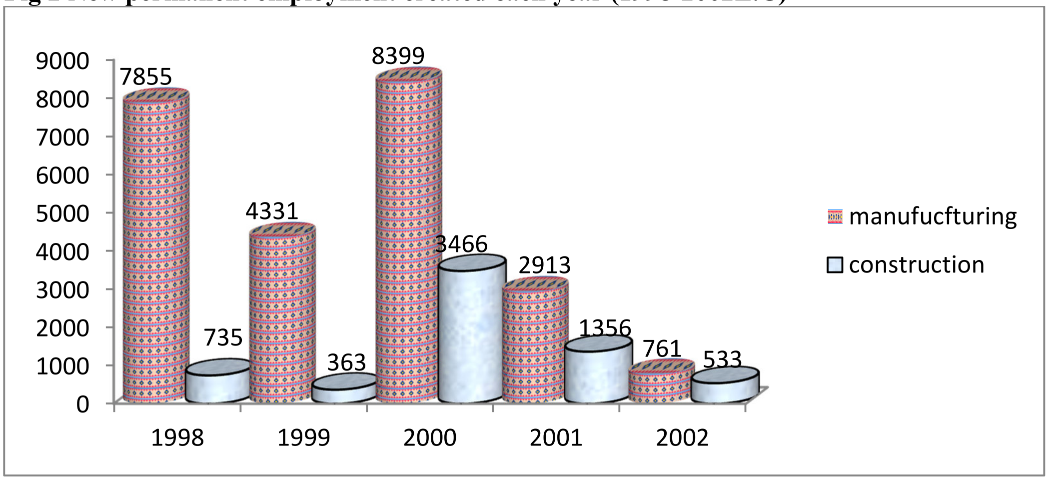
The result shows that the computed value of the T-distribution is 12.52 for a table value of T-distribution 2.896 of one tailed test at a significance level of 0.01. Since the t-distribution statistics falls in the rejection region, more than table value 2.896, the researchers rejected the null hypothesis. Consequently, the researchers concluded that there is difference in the mean of the two projects per year. The mean of the manufacturing sector is greater than the mean of construction sector in terms of additional investments. So, tax holiday plays a role in attracting additional investment to Ethiopia.

G. The Role of Tax Holiday on Creating Employment Opportunity

A. Permanent Employment

Tax holiday enhances the employment opportunity by attracting additional investments. Figure 2 shows a comparison of the permanent employment created by the manufacturing and construction firm from 1998- 2002 E.C.

Fig 2 New permanent employment created each year (1998-2002E.C)



Source: Ethiopian Investment Authority

It can be gleaned from Figure 2, that the total number of permanent employment created by manufacturing sector is 24, 259 whereas the construction sector has created 6,453 permanent employees from the year 1998-2002 E.C.With a difference of 17,806 employees created by the manufacturing sector. To analyze the difference, the researchers used the T-distribution statistical method of analysis. The hypotheses tested were:

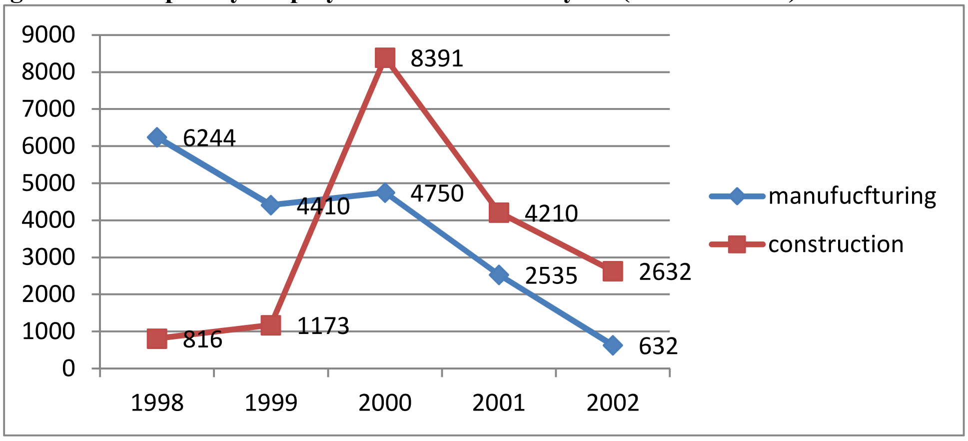
H_o *: there is no difference between mean of construction and mean of the manufacturing on permanent employment creation; and*

H_o *: the mean of construction sector in creating permanent employment opportunity is less than the mean of the manufacturing sector*

Sincethe computed value of the T-distribution is 50.73 which exceeded the tabular value of 2.896, one tailed test at 0.01 level of significance, the researchers rejected the null hypothesis. This implies that the manufacturing sector generates more permanent employment than the construction sector. It can be seen from figure 2 the employment created by each sector is decreasing from time to time, but still the difference between the two sectors is significant and the employment opportunity created by manufacturing sector is greater than the construction industry. Therefore, the tax holiday plays a role in creating employment opportunity in Ethiopia.

B. Temporary Employment

Fig. 3 New Temporary Employments created each year (1998-2002E.C)



Source: Ethiopian Investment Authority

As shown in Figure 3, the total number of temporary employment created by manufacturing sector is 18,571 whereas the construction sector has created 17,222 temporary employees for the year 1998-2002 E.C, with a difference of 1,349 employees created by the manufacturing sector. To analyze the difference, the researchers used the T-distribution statistical method. The hypotheses tested were:

H_o : *there is no difference between mean of the construction sector and the mean of the manufacturing sector.*

H_a : *the mean of the construction sector is less than the mean of the manufacturing sector.*

Since the computed value of the T-distribution is 3.84, which exceeded the tabular value of 2.896, one tailed test at a significance level of 0.01, hence, the researchers rejected the null hypothesis. This only implies that the manufacturing sector can create more employment, though temporary in nature, than that of the construction sector.

H. The Impact of Tax Holiday on Revenue Collection

Table 13 Tax revenue collected each year (1998-2002E.C)

	1998	1999	2000	2001	2002	Total
Construction	14,234 234	17,361,678	35,344,482	47,776,565	24,480,819	**141,197,780**
Manufacturing	1,141,817	6,997,334	23,929,878	47,454,492	47,477,884	**127,001,407**
Difference	13,092,417	10,364,343	11,414,604	322,072.28	(20,997,064)	**14,196,373**

Source: ERCA- SIGTAS

Table 13 shows the tax revenue collected each year for the construction and manufacturing firms.The total tax collected from year 1998-2002 by construction sector is 141,197,780 birr whereas from the manufacturing sector, it reaches 127,001,407 birr, with a difference of 14,196,372.73 birr. The construction sector contributed more than the manufacturing sector with in this five years based on the 26 sample taxpayers.

Table 13 shows the tax revenue collected each year for the construction and manufacturing firms.

The total tax collected from year 1998-2002 by Construction sector is birr 141,197,780 where as from Manufacturing sector it reaches birr 127,001,407, with a difference birr of 14,196,373. Construction sector contributed in excess of Manufacturing sector with in this five years. Total revenue foregone from these 26 manufacturing organizations is birr *31,560,206.49* based on the tax holiday given fro manufacturing sector.

Manufacturing contributes equal business income tax revenue with construction after four years of operation, since most of the manufacturing industry's exemption from income tax period is within the range of 1998-2002E.C. In the manufacturing industries, still 5 companies have no contribution on tax revenue due to the long period of tax holiday. Manufacturing industry is able to generate higher revenue in 2002 than that of the construction sector. The inflationary effect that happpened in Ethiopia as of 2002 curbs construction works to be reduced. As a result, the revenue collected during 2002 declined.

The tax holiday given to manufacturing industries and the tax reforms conducted in 2000 E.C enables the government to make the tax rules stringent. As a result, it facilitates the manufacturing industry contribution to boost. Currently, the government is helping the manufacturing sector to increase its capacity through different methods and is showing a progressive result.

In addition to this, the lion share of VAT is also contributed by the manufacturing sector. Thus, even though tax holiday reduces revenue for a short period of time it is able to have a greater share in the long run. The government is giving equal opportunity to the manufacturing sector industries. It does not consider the environmental factor, the positive and negative externalities of the industries and other factors.

Conclusion and Recommendation

Conclusions

The manuscript examined the impact of the tax holiday from 1998 to 2002E.C, with employees and taxpayers from the manufacturing and construction sectors as respondents. The study found that tax holiday had a positive impact on attracting additional investment, creation of new employment opportunity, and enhancing long term revenue of the government. However, there are some obstacles that minimize the role of tax holiday on investment, such as abuse of the tax holiday privilege both by tax authorities and taxpayers. In addition, the possibility of evading tax makes tax holiday insignificant for investors to rely on it. Tax holiday is purely necessary forthe manufacturing sector, which is the most tax sensitive areaa to invest. All the respondents' opinion confirmedto the necessity of tax holiday to manufacturing sector to diversify manufacturing industries. Respondents believed that manufacturing industry has the potential of generating more employment opportunities and creating additional investments in the country.

As regards tax revenue generation, even though the revenue collected from the manufacturing sector in 1998 E.C is extremely low compared to the contribution of construction, it has the potential to increase the long-term tax revenue as a result of the business tax exemption. The findings also revealed that the criteria used by the government are weak and the tax holiday period is not enough to serve its purpose.

Recommendations

Tax holidays have the potential of attracting additional investments. However, some activities should be done in conjunction with it. Hence, the researchers are recommending the following:

- Tax holiday should be granted to all manufacturing sectors regardless of their status. However, the government should also consider the external effect to the environment and society of the industry. Likewise, to reap the benefits of tax holiday, it should be granted to an organization who can generate more employment opportunities for the country.
- Tax holiday criteria should be set by the EIB to avoid partiality among investors.
- To know the effects of tax holiday and how much revenue it generates, tax holiday should be administered by Inland Revenue Administration. Similarly, rules and regulations should be made clear to all stakeholders.
- The tax holiday period for local producers should also be extended to get a significant result.

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