

CHINESE FDI IN ETHIOPIA

A WORLD BANK SURVEY

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EXECUTIVE SUMMARY

Background

Chinese Foreign Direct Investment (FDI) into Africa is on the rise and Ethiopia is at the forefront of this trend. On request of the Government, the World Bank surveyed 69 Chinese enterprises doing business in Ethiopia with a 95-question survey in May/June 2012. The survey covered various aspects of the foreign direct investment climate in Ethiopia, including infrastructure, sales and supplies, land, crime, competition, finance, human resources, and questions about general opportunities and constraints for doing business in Ethiopia. This report summarizes the results of survey and provides policy suggestions in light of the analysis; the report also provides some broader background of the expected benefits of FDI into Ethiopia as well as current policies and approaches to promote incoming investment.

Experiences from East Asian countries show that growth cannot be sustained without technological and industrial upgrading and structural transformation of the country's economic activities. Attracting FDI is generally seen as an integral part of the development policy mix of successful emerging economies that leads the way to the required sustained economic transformation. But looking at the FDI levels (in percent of GDP) currently observed in Ethiopia, and specifically in comparison to successful East Asian countries, it is clear that there is an opportunity to improve the promotion of incoming foreign investment.

The starting process of a global industrial redistribution is providing an opportunity for Ethiopia to attract FDI and upgrade its economic structure by shifting productivity from East Asian countries to Ethiopia. Although East Asian countries have been

important FDI host countries over the past three decades, some of them are slowly losing their competitive advantage due to increasing costs of land, stricter regulatory compliance, and increasing cost of labor. Ethiopia has the potential to step in—but there is strong competition from within lower income countries in Asia and other parts of the world, including Africa—and promote itself as an alternative hub for global companies to find new and favorable production centers with a clear cost advantage and a stable economic outlook. Ethiopia's cheap and abundant labor, privileged access to high-income markets, and growing domestic and regional markets add to its attraction as a FDI host country.

China's economic cooperation with Ethiopia has expanded rapidly over the past decade. In 2011, China was both the largest import and largest export trading partner of Ethiopia. Similarly, China's investment to Ethiopia has increased steadily. According to China's Ministry of Commerce, FDI from China to Ethiopia increased from virtually zero in 2004 to an annual amount of US\$58.5 million in 2010 (US\$74 million in 2009). Behind the figure is a growing and vibrant Chinese business community represented by the Chinese Chamber of Commerce in Addis Ababa.

The expansion of ties between the two countries reflects the structural change happening in both the Chinese and the Ethiopian economies. China has stunned the world with its growth miracle, driven by labor-intensive produce exports during the past three decades. However, economic success brings with it rising labor costs across all segments of the labor market, thereby eroding competitiveness in low skill, labor intensive production in China. Estimates show that China's graduation from low-skilled manufacturing

jobs could free up nearly 100 million jobs, more than double the number of manufacturing employment in low-income countries. Ethiopia needs to get ready to step into this opportunity with both its huge population and low labor costs.

The economic cooperation between the two countries has also been facilitated by the strong political support from both governments. China's desire to anchor its African investment in Ethiopia comes both from economic and political considerations. On the other hand, the Ethiopian government is very keen on looking for insights from the East Asian development model and expects to learn much from China's experience over the past three decades (as much as Korea's) to further its own economic development.

Main Survey Findings

At the firm level, the survey shows that there are four principal drivers of Chinese FDI in Ethiopia:

1. **To take advantage of a good understanding of the investment climate gained from entrepreneurs' social networks.** The survey finds that the social networks of Chinese investors function as a significant factor in making their investment decision in favor of Ethiopia. Strikingly, potential investment opportunities seem to barely travel through formal channels, such as through the investment promotion agency or other government agencies.
2. **To take advantage of the perceived opportunities provided by the current state of the Ethiopian economy;** this includes the limited market capacity and market competition, cheap labor, cheap land, and an expanding Ethiopian market. The surveyed firms claim that increasing competition, intensified trade competition, rising labor costs, and currency appreciation in China have made it more and more difficult to do business in the Chinese market over the past years. At the same time, the production capacity in Ethiopia is still low, and the local market is rapidly expanding,

making the market there look very attractive for Chinese investors.

3. **To maximize cross-border investment incentives provided by the Ethiopian and Chinese governments.** During the last decade, the Ethiopian government has continuously provided FDI incentives, such as tax holidays and tariff-free policies for FDI equipment imports. On the other hand, the Chinese government has also adopted the "China Goes Global Policy," which awards Chinese firms investing abroad with tax credits in China. These incentives have proved to be a large motivation for Chinese firms' investment in Ethiopia, especially for the manufacturing industry.
4. **To make a strategic move of the parent company into the African market and to invest in favor of the stable political environment of Ethiopia.** Overall, survey respondents think the Ethiopian government provides a stable political environment for the firms to do business smoothly around the year. Eighty-one percent of the firms from manufacturing, service, and construction industries agree that they experienced little or no obstacles in political stability over the course of their engagement.

The motives to invest in Ethiopia are dampened by six principal obstacles that Chinese invested enterprises face in Ethiopia:

1. **Trade regulation and customs clearance efficiency.** Due to the lack of local supply network, Chinese firms in Ethiopia heavily rely on imported supplies and materials. But current regulations are not designed to facilitate fast customs clearance of imported materials. As a result, trade and customs regulation is regarded the main issue impeding Chinese FDI in Ethiopia.
2. **Perceived foreign exchange rate risks deter investment.** Restrictions on foreign currency transaction and conversion, in combination with perceived uncertainty over the foreign exchange rate path, deters new investment and discourages existing Chinese invested firms from increasing

investments. As light manufacturing/labor intensive firms rely more heavily on imported supplies, they are specifically concerned about foreign exchange risks.

3. **Tax administration inconsistency and inefficiency.** Many Chinese firms claim to suffer from inconsistency of tax law explanation and frequent law amendments. More than 70 percent of the surveyed firms find the inconsistency of tax law explanation and the frequent law amendment a major obstacle to doing business.
4. **Labor education impedes productivity and skill transfer.** Ethiopian workers hired by Chinese invested companies on average have an education of six to seven years, much lower than the average education of Chinese workers. In order to fill in the gap of inadequate education of local workers, Chinese firms usually hire Chinese lead workers with 10–12 years education and provide on-site trainings for Ethiopian employees.
5. **Insufficient local access to finance.** Only a fraction of surveyed companies got loans from Ethiopian Banks over the course of the past year. A number of firms, especially small and medium enterprises (SMEs), suggest that they did not even try to get loans because they felt it is impossible to get approval for them. Others claim that they do not need extra funding locally.
6. **Government regulation affects business efficiency.** Companies of all ownership and industry types spend a significant portion of senior management time on government relations. More than one-third of senior management time in Chinese Ethiopian joint ventures is spent on these activities; strikingly, Chinese state-owned enterprises

(SOEs) spend less than 10 percent of their time, somewhat indicating a special, possibly preferential status for SOEs.

The survey findings show that despite the perceived obstacles, Ethiopia is an attractive business destination for Chinese enterprises. Almost half of Chinese investors are in for the long run (10 years or more) and plan to increase investment in Ethiopia over coming years.

Policy Conclusions

Addressing identified obstacles could help Ethiopia to take better advantage of foreign investors in order to accelerate the shift from a predominantly low-productivity agriculture-based economy towards a higher-productivity manufacturing and export-based economy. Experiences in successful countries around the world, and especially East Asia show that foreign investment is instrumental to facilitate such a structural transformation and to maintain sustained and broad-based economic development

This study recommends five main areas for policy adjustments to facilitate foreign investors coming into Ethiopia:

- Adjust **customs clearance procedures and trade regulations.**
- Facilitate **currency convertibility and increase transparency** of the exchange rate policy.
- Improve **tax administration consistency and efficacy.**
- Execute impartial **labor regulation.**
- Increase the **supply and quality of skilled workers.**



Ethiopia has experienced strong and generally broad-based real economic growth of around 10.6 percent on average since 2004. Growth over the last nine years was far beyond the growth rates recorded in aggregate terms for Sub-Saharan Africa (SSA), which only reached 5.2 percent on average, less than half of Ethiopia's average real GDP growth rate during that period. Inspired by East Asian experiences, growth was induced through a mix of factors including agricultural modernization, the development of new export sectors, strong global commodity demand, and government-led development investments. The initial double digits growth rates have now manifested slightly lower but remain at high single-digit levels.¹

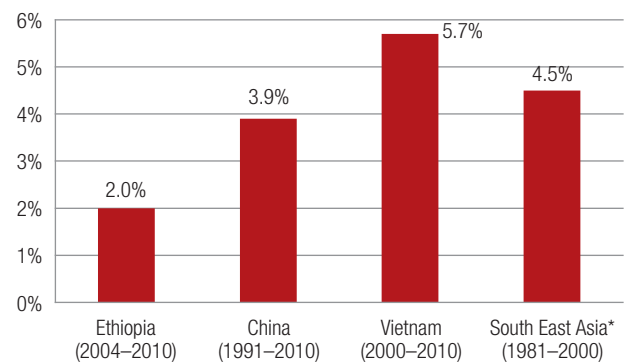
Foreign Investment in Ethiopia and Experiences from other Countries

Experiences from East Asian countries also show that growth cannot be sustained without technological and industrial upgrading and structural transformation of the country's economic activities. Attracting Foreign Direct Investment (FDI) is generally seen as an integral part of the development policy mix of successful emerging economies that leads the way to the required sustained economic transformation. But looking at the FDI levels (in percent of GDP) currently observed in Ethiopia and in comparison to the successful East Asian countries, it is clear that there is an opportunity to improve the promotion of incoming foreign investment. Figure 1 shows that FDI as percentage of GDP in Ethiopia has been at a relatively low level of 2.0 percent between

2004 and 2010, somewhat contrasted by 3.9 percent of GDP in China (1991–2010) and 5.7 percent in Vietnam (2000–2010).

FDI is not only important to sustain high investment rates, but also essential for knowledge and technology transfer. A review, for the purpose of this report, of the incentive packages and conditions of several East Asian countries in attracting FDI (in the 1970s/80s: Singapore, Malaysia, Indonesia and Thailand; and in 1990s/00s: Cambodia and Vietnam) brings to light some of the essential success factors in FDI promotion. In general, all these economies show commonality in the way they gradually embraced policies more favorable to FDI during a strategic, government-led transition process away

FIGURE 1: FDI in Percent of GDP in Selected Countries, Average per Year



Source: World Bank staff own calculations, based on World Development Indicators (WDI).

Notes: Time definition: GDP per capita growth exceeding 5 percent per year.

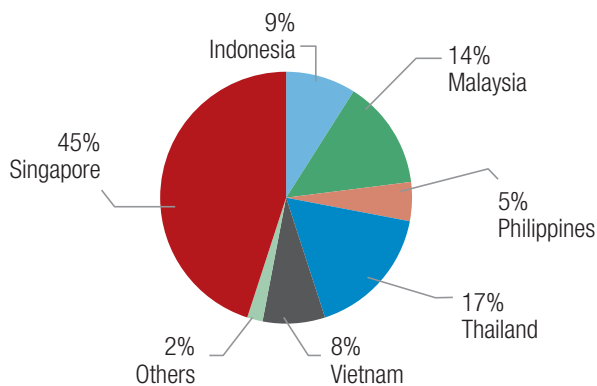
* Indonesia, Singapore, Malaysia, and Thailand

¹ Please see World Bank (2012) for a full assessment of Ethiopia's macro-economy since 2004.

from import-institution to export-orientation. This led to substantial gains in access to foreign capital and international markets. In addition, resulting FDI inflows supported the industrialization efforts in these countries and introduced then modern production technologies and managerial expertise into the economies. Though the strategies of the countries analyzed vary significantly in the details, there is a set of three factors that drove FDI inflows in the past:²

1. **Political stability is the corner stone of a favorable business environment to attract FDI.** For instance, Singapore received 45 percent of the FDI inflows into the Association of Southeast Asian Nations (ASEAN) countries between 1990 and 2009 (Figure 2). This period coincides with very strong political stability and policy coherence, which was in stark contrast to many of its ASEAN neighbors; and in fact, most of the other relatively less successful countries adopted incentive policies similar to those in Singapore, but in more volatile and unpredictable policy environments.
2. **Openness to trade (export orientation), labor cost, and tax rates can strongly influence the location decisions of foreign investors within**

FIGURE 2: The Share of FDI in ASEAN Countries, 1990 to 2009



Source: World Development Indicators (WDI), as reported in Thomson et al (2011).

Note: ASEAN was established on August 8, 1967 in Bangkok, Thailand, with the signing of the ASEAN Declaration (“Bangkok Declaration”). The founding members are: Indonesia, Malaysia, Philippines, Singapore and Thailand.

regional economic areas. For instance, Singh and Jun (1995) conclude in their analysis that export orientation of a country is instrumental to attract FDI; openness was also identified as a driving force of FDI in the analysis of Gastanaga et al. (1998). A specific example for the role of tax rates is Singapore again, where tax incentives (tax holidays) were used to encourage foreign investment in the 1980s and 90s. At that time, the corporate tax rate was decreased from 40 to 33 percent in 1987 and to 31 percent in 1990; likewise the personal income tax was lowered from 40 to 33 percent in 1987, followed with a special incentive to encourage Research and Development (R&D) in 1990 (an additional 20 percent of tax amounts could be saved by enterprises as a reward for increased R&D activities). Over the same period, Thailand also used similar tax incentives to promote FDI inflows and encourage the transfer of technology.

3. **Infrastructure plays a critical role to attract FDI, especially in the manufacturing sector. Meanwhile, FDI also helps to improve the infrastructure of host countries.** Cambodia benefited from improved infrastructure conditions to attract FDI early on in its development efforts in the 1980s, which in turn also led to more improvements of infrastructure through the increasing FDI. Realizing the time requirement to improve infrastructure all over the country, Cambodia adopted a pragmatic approach that started with the establishment of “Exports-Processing Zones;” these zones are equipped with relatively good infrastructure in a confined area.

² The review of past experiences also shows the importance of stable and favorable macroeconomic conditions as a supporting factor to attract incoming FDI. Countries in East Asia have used a mix of traditional and non-traditional instruments to achieve this. For instance, overall monetary and fiscal policies, sometime reinforced by wage and price controls probably have had direct and indirect effects on FDI flows. Other supporting instruments to promote FDI that were used in the past include Equity-Debt swap programs, guarantees for investors against political risks, access to finance for investors, and dispute settlement services.

And in fact, over time, the zones became the center of Cambodia's garment-exporting companies. China's experiences with "Special Economic Zones," especially in the 1990s, followed a similar successful approach. Ethiopia is attempting to set-up economic zones to attract more FDI and improve infrastructure.

A Good Time for Ethiopia to Attract FDI Inflows and Integrate into Global Production Chains

The starting process of a global industrial redistribution is providing an opportunity for Ethiopia to attract FDI and upgrade its economic structure by shifting the productivity from East Asian countries to Ethiopia. Although East Asian countries have been important FDI host countries over the past three decades, some of them are slowly losing their competitive advantage due to increasing costs of land, stricter regulatory compliance, and increasing cost of labor. A recent World Bank study showed, for instance, that China's coastal export manufacturing centers are faced with eroding cost advantages (World Bank, 2012a). Ethiopia has the potential to step in – but there is strong competition from within lower income countries in Asia and other parts of the world, including Africa – and promote itself as an alternative hub for global companies to find new and favorable production centers with a clear cost advantage and a stable economic outlook. Ethiopia's cheap and abundant labor, privileged access to high-income markets, and growing domestic and regional markets add to its attraction as a FDI host country.

It indeed seems a good time for Ethiopia to develop specific and targeted sets of policies to attract FDI, based on a clear understanding of the current conditions for FDI in Ethiopia and the main constraints in way of living up to the potential. Box 1 provides some initial insights on FDI policies in Ethiopia compared to China, one of the most successful countries in the world in attracting FDI, which can help to frame the discussion on policies.

Chinese FDI in Ethiopia: Opportunities and Challenges

China's economic cooperation with Ethiopia has expanded rapidly over the past decade.³ In 2011, China was both the largest import and largest export trading partner of Ethiopia. Similarly, China's investment to Ethiopia has increased steadily. According to China's Ministry of Commerce (Figure 3), FDI from China to Ethiopia increased from virtually zero in 2004 to an annual amount of US\$58.5 million in 2010 (US\$74 million in 2009). Behind the figure is a growing and vibrant Chinese business community represented by the Chinese Chamber of Commerce in Addis Ababa. According to the Ethiopian Ministry of Industry, 372 Chinese investors (not including those from the services sector) officially registered as of May 2012. On the other hand, business statistics from the Chinese Embassy in Addis Ababa indicates that 86 Chinese invested enterprises were in operation as of 2011 (including service sector enterprises such as 11 restaurants and four clinics). The difference between the two sets of statistics may reflect the fact that companies which stop operation in Ethiopia do not 'delist' from the registry in the Ministry of Industry, and therefore market exits are most likely not accurately captured in Ethiopian statistics on foreign invested enterprises in China.

The expansion of ties between the two countries reflects the structural change happening in both the Chinese and the Ethiopian economies. China has stunned the world with its growth miracle, driven by labor-intensive produce exports during the past three decades. However, economic success brings with it rising labor costs across all segments of the labor market, thereby eroding competitiveness in low skill, labor intensive production in China; this can only be

³ Geda and Meskel (2010) argue that FDI flows, trade flows, aid flows, and governance practices are the four primary channels of economic cooperation between China and Ethiopia. Among the four, FDI stands out in terms of economic impact due to its long-term impact on the country through market-based technology transfer and integrative power into the global production networks.

Box 1: FDI policies in Ethiopia and China

Table 1 compares the FDI policies of the 1990s in China with the current policies in Ethiopia. FDI policies in China had a largely decentralized character that allowed local authorities to attract foreign investors through localized incentives. While this is partly also the case in Ethiopia, where regional governments can provide variations in local incentive packages such as in the area of land access, the general FDI regime seems to be more centralized in nature. This is a difference by design due to the rather low capacity of regional governments; in fact, according to the federal government, regional states requested the federal level to administer FDI issues to overcome those capacity constraints. Another difference is the openness of the economy as such. In China in the 1990s, geographical and sectoral restrictions had been largely eliminated, while in Ethiopia 25 sectors are still closed for foreign investments.

It is to be expected, however, that an opening up of various sectors could come about once the ongoing WTO accession negotiations of Ethiopia are finalized.

Based on policies observed in China in the 1990s, there are a series of “quick-wins” that could be used to increase the potential for FDI inflows into Ethiopia. These could entail: decentralizing the approval authority of small-scale FDI projects to the provincial level; introducing more discretionary power for local levels to negotiate the terms and incentives; providing more longer-term incentives such as favorable taxation in special economic zones (SEZs), which currently is time bound; encouraging more joint-ventures to happen between SOEs and foreign investment enterprises (FIEs) to enhance technological transfer; and to broaden the FDI base by opening-up more sectors.

TABLE 1: A Comparison of Chinese and Ethiopian FDI Regulation

	China in 1990s	Ethiopia now
<i>Motivation and driver for the government to attract more FDI</i>	<ul style="list-style-type: none"> • Private sector constrained by credits • Technology transfer • Focus on strategic industries 	<ul style="list-style-type: none"> • Low savings rates in the economy at large • Technology transfer • Focus on strategic industries
<i>Enforcement of FDI regulations</i>	<ul style="list-style-type: none"> • Decentralized FDI approval framework • Discretionary administrative framework, such as favorable taxation in SEZs 	<ul style="list-style-type: none"> • Rather centralized FDI approval framework • Rather centralized administration of incentives, which are largely time bound (e.g. two-year tax holidays) • Varying regional incentives possible, for instance about land
<i>Benefits for FIEs</i>	<ul style="list-style-type: none"> • Encourage joint-ventures (JVs) between SOEs and FIEs • Removable of geographic and sectoral restrictions on the FDI activities • Improved private property rights protection 	<ul style="list-style-type: none"> • Lower capital requirement for JVs, but JVs barely happen between SOEs and FIEs • 25 sectors are still closed for foreign investors • Guarantee against expropriation

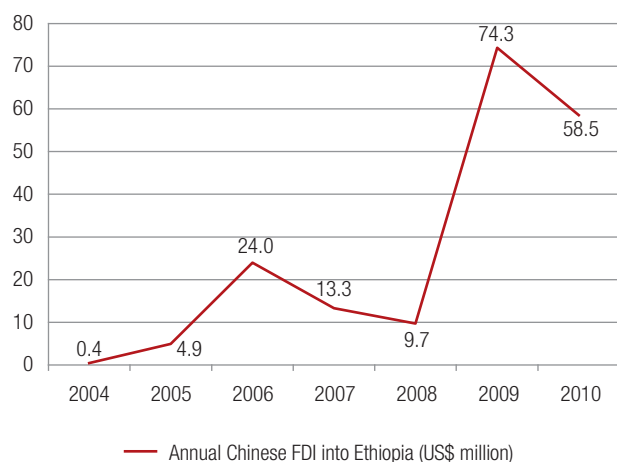
Source: World Bank staff compilation, based on Huang 1998, and EthioInvest 2012. A similar analysis was published in World Bank (2012).

countered by initiating appropriate structural change that facilitates innovation and has the power to propel China to the top of the technological frontier in some areas (World Bank, 2012b). Lin (2011) estimates that China’s graduation from low-skilled manufacturing jobs will free up nearly 100 million jobs, more than double the number of manufacturing employment in low-income countries. Ethiopia needs to get ready to

step into this opportunity with both its huge population and low labor costs.

The economic cooperation between the two countries has also been facilitated by the strong political support from both governments. Based on the close political cooperation of both countries, it appears that China is now looking to anchor its African investment in Ethiopia; this would also allow

FIGURE 3: Direct Investment from China to Ethiopia, 2004 to 2010



Source: FDI Bulletin of the Chinese Ministry of Commerce: ODI Statistics (2010).

Note: The statistics underlying the figure are based on official reporting in China and seem to understate the true investment volume of Chinese enterprises in Ethiopia. According to official statistics in China, the stock of FDI from China to Ethiopia in 2010 was US\$368 million. Crosschecks with the results of the survey used for this report indicate a total Chinese FDI stock of US\$403 million in 2010. The deviation likely comes from the fact that the survey covers both large and small firms with the latter less likely to be registered in China.

China to access the expanding supply of commodities in Ethiopia once the scale of the production has increased (which is planned). On the other hand, the Ethiopian government is very keen on looking for insights from the East Asian development model and expects to learn much from China's experience over the past three decades (as much as Korea's) to further its own economic development.

Opportunities come with challenges: Together with capital investment and technology transfer, Chinese interest into Ethiopia has also brought about controversies to the local community. Not surprisingly there are segments in the Ethiopian society—with vested interests—that are expressing anxiety given the sheer intensity of bilateral relations (Adem, 2012). Some other more specific issues that came up over the recent past vis-à-vis Chinese investment is the perception that Chinese companies seldom engage in joint ventures with Ethiopian

counterparts (Gebre-Edziabher, 2006) and tend to hire Chinese contract labor rather than local workers (Alden, 2005; and Brautigam, 2009); such practices would prevent the necessary technological transfer and prevent economic engagement to trickle down to the broader public. And indeed, Brautigam and Tang (2011) examined all Chinese Special Economic Zones (SEZs) in Africa and concluded that “inadequate local learning and local participation could affect the ability of the zones to catalyze African industrialization.” This survey of Chinese invested enterprises in Ethiopia tries, among other things, to shed some light on the benefits of Chinese investment in Ethiopia.

Previous Research on Chinese FDI into Africa

Over recent years, there were many studies published about China's economic engagement in Ethiopia (cf. Adem, 2012; and Brautigam, 2009), but only a few focused specifically on FDI. For instance, Desta (2009) conducted four China-Ethiopia investment case studies, emphasizing, among other things, their impact on human resources, management, exports, technology transfer, and the environment. The focus on the specific issue of human resources concludes for this area that “given the Chinese investors in Ethiopia are unfamiliar with cultural makeup of the local situation and the Ethiopian labor laws, Ethiopian employees seemed to be in charge of the human resources management in these companies.” Since the study is largely based on anecdotes, it is difficult to generalize its conclusions.

Other research by Geda and Meskel (2010) conducted general surveys among 33 Chinese firms, 50 local producers, and 20 consumers of Chinese products. The surveys focused on *qualitative questions* about the investment characteristics and business operations of firms, e.g. on the investment size, sources of supplies, perceived major constraints for investment in Ethiopia. The survey also reached out to local producers about the competitive impact and technological transfer coming

with the Chinese engagement. Given the *qualitative and descriptive* focus of the surveys the authors found it difficult to draw appropriate, more general policy conclusions. Yet, the research found that the technology and management skills transfers are significant in

Chinese investment and recommended more policy support from the Ethiopian government toward Chinese FDI. The World Bank Survey on Chinese FDI in Ethiopia tries to close some of the existing knowledge gap based on a more robust and coherent dataset.

2

METHODOLOGY AND OBJECTIVE OF THE SURVEY ON CHINESE FDI IN ETHIOPIA

In order to systematically understand Chinese investors' experience in Ethiopia and to draw lessons to facilitate future foreign business investments in the country, the Ethiopian Government requested the World Bank to carry out a survey on Chinese enterprises in Ethiopia in early 2012. Because the Ethiopian Government is eager to foster relationships with China and to learn lessons from China's successful economic development path over the past three decades, policy advice drawn from this survey was expected to be of a practical nature, focusing on quick-win areas, and to facilitate further exchange between the Ethiopian Government and the Chinese business community in Ethiopia. The survey specifically targets Chinese FDI and therefore goes beyond traditional World Bank surveys and instruments such as the Doing Business (DB) and Investment Climate Assessment (ICA).

A 95-question survey was designed and distributed among Chinese enterprises. With support of the Chinese Chamber of Commerce in Ethiopia, the survey was sent—both online and as hard copy—to 86 Chinese enterprises in Ethiopia in early May 2012 (to all companies known to the Chinese Embassy to

be in operation). Nineteen firms submitted responses through end of May, which were subsequently verified via telephone. To follow up on this process, the survey team conducted face-to-face interviews with 52 firms between May 28 and June 5. The result was the generation of a dataset with inputs from 71 companies. Due to data quality issues, surveys from two firms had to be removed from the final sample, making the dataset underlying this analysis a total of 69 companies with a response rate to the survey of 80 percent (69 out of 86).

The survey covers various aspects of the investment climate in Ethiopia, and includes categories such as basic information about enterprises, infrastructure, sales and supplies, land, crime, competition, finance, human resources, motivation, and constraints. Eighty-five percent of the survey questions are based on ICA investment climate questions and thus the results can be compared to other country experiences to deepen the analysis. Some specific questions were also added and modified to reflect the context of Ethiopia. The survey was translated and administered into Chinese in order to adapt to the language needs of respondents.



SETTING THE STAGE

MAIN FINDINGS FROM THE GENERAL ETHIOPIA ENTERPRISE SURVEY⁴

The most recent Enterprise Survey for Ethiopia (2011/12) shows that only four percent of the sampled firms in Ethiopia are private and foreign-owned, a proportion much lower than that in Sub-Saharan Africa (14.7 percent). The average percentage of all worldwide sampled private enterprises is 9.7 percent. This finding indicates that the potential exists for Ethiopia to catch up with other countries and increase the number of privately owned foreign companies that will contribute to the development of the domestic market and economy.

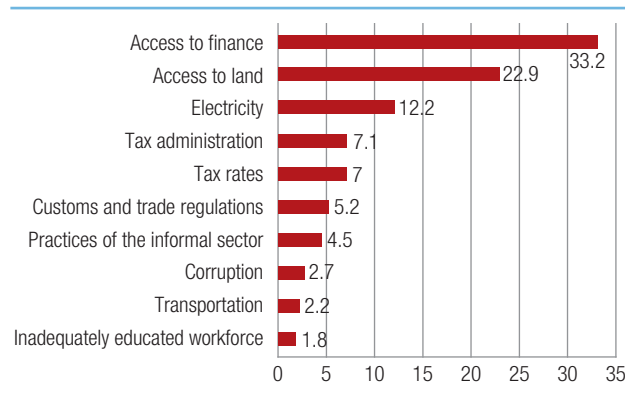
One third of sampled firms say that access to finance is the biggest obstacle for doing business in Ethiopia. Second and third on the list of obstacles are access to land and access to electricity (Figure 4). Firms of different sizes rank business obstacles differently. While small and medium firms are more likely to be constrained by the lack of access to finance and land, large firms have found electricity the biggest disturbance to their business operations. On the

other hand, customs and trade regulation rank as the third biggest obstacle for large firms, whereas high tax rates constrain the majority of small firms followed by finance and land access.

Firms in Ethiopia rely heavily on internal financing for investments. Of surveyed firms, 86.3 percent use internal finance for their investment (Figure 5), a proportion much higher than that in Sub-Saharan Africa (SSA, 79.3 percent) and the worldwide average (68.6 percent). On the other hand, while Ethiopian firms are less likely to use bank financing than those in SSA countries, Ethiopian firms do outperform in financing through stock issuance. In addition, only 0.7 percent of surveyed firms in Ethiopia report financing of working capital with supplier credits; this proportion lags considerably behind the percentage in SSA (12.2 percent) and the world average of 11.8 percent. The absence of supplier credits may indicate the weak state of the supply chain at large in Ethiopia.

Infrastructure obstacles, especially electricity, mostly refer to the long wait times to actually be connected to the desired services. Although surveyed firms named electricity as the third biggest obstacle, the comparison with SSA and the world average indicates that Ethiopian firms actually experience fewer

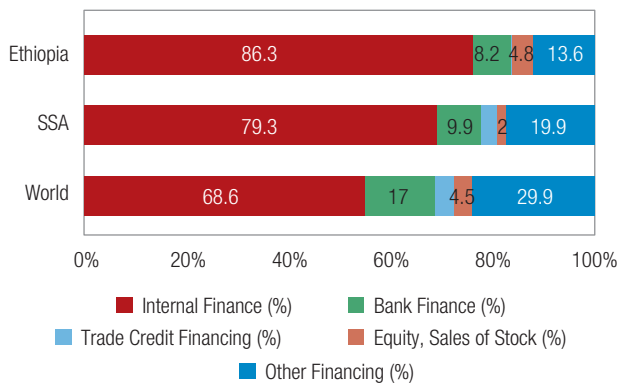
FIGURE 4: Top 10 Business Environment Constraints



Source: World Bank, Ethiopia Enterprise Survey (2011).

⁴ Enterprise Survey is a service of the World Bank that administers surveys worldwide on the firm-level of a representative sample of an economy's private sector. The most recent Enterprise Survey for Ethiopia was carried out in 2011/12, and the results have just been published. The surveys cover a broad range of business environment topics including access to finance, corruption, infrastructure, crime, competition, and performance measures. The World Bank has collected this data from face-to-face interviews with top managers and business owners in over 130,000 companies in 135 economies. Findings and recommendations are helping policymakers identify, prioritize, and implement reforms of policies and institutions that support efficient private economic activity. For more information, please consult the website at: <http://www.enterprisesurveys.org>.

FIGURE 5: Enterprise Financing Sources for Investment

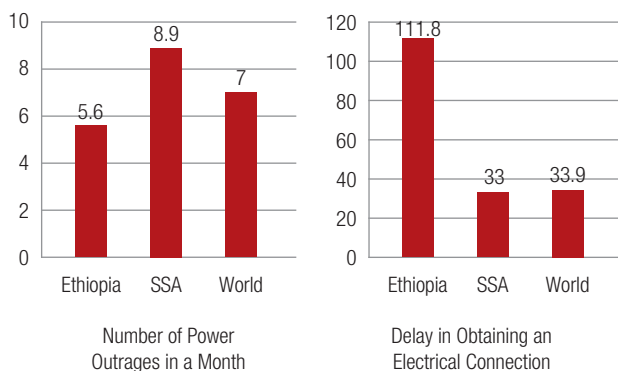


Source: World Bank, Ethiopia Enterprise Survey (2011).

number of power outages. Accordingly, the value loss due to power outages is also lower in Ethiopia (Figure 6). However, firms in Ethiopia expect to wait for 111.8 days to be connected to the electricity network after their submission of service application, nearly three times longer than the waiting time in SSA (33.0 days) and the world average (33.9 days). Similar longer delays in obtaining water connections and mainline telephone connections are also significant problems for doing business in Ethiopia.

Customs and trade regulation are another big constraint for Ethiopian businesses, especially those frequently engaging in international trade. The Enterprise Survey finds that the average time to

FIGURE 6: Electricity Provision and Service Delays

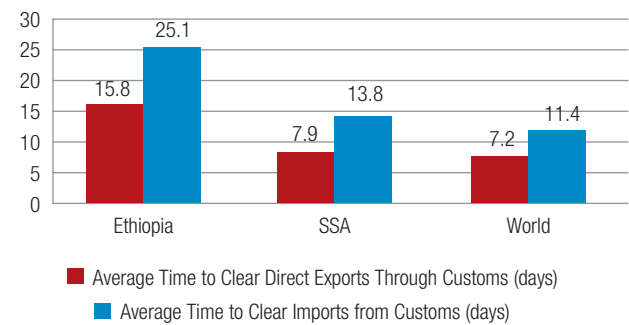


Source: World Bank, Ethiopia Enterprise Survey (2011).

clear exports/imports through customs is 15.8/25.1 days in Ethiopia (Figure 7), about twice long as the custom clearance time in SSA (7.9/13.8 days) and the worldwide level (7.2/11.4 days). Due to the recent change of custom clearance policies, time spent on custom clearance for Ethiopian firms seem to have further expanded over recent months (this will be discussed in detail in later chapters).

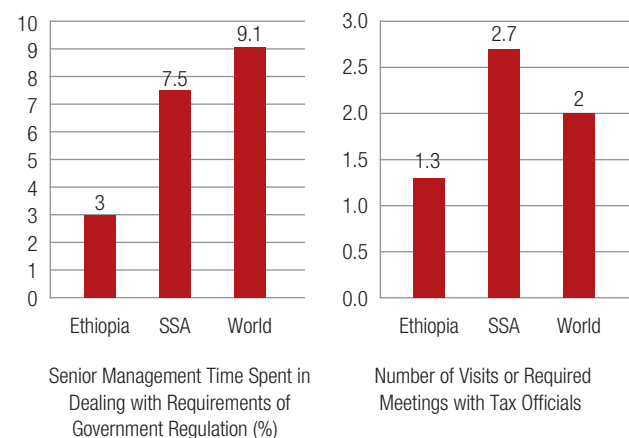
Efforts to cut down on bureaucracy and rent-seeking in Ethiopia are bearing fruits. Senior managers in Ethiopia spend about half the time of those in SSA countries in dealing with the requirements of government regulation (Figure 8). On average, to deal with Ethiopian regulations requires 1.3 meetings per year per firm for tax issues, compared with 2.7 meetings required in the SSA countries.

FIGURE 7: Custom Efficiency



Source: World Bank, Ethiopia Enterprise Survey (2011).

FIGURE 8: Regulation Burden



Source: World Bank Ethiopia Enterprise Survey (2011).

4

STYLIZED FACTS THE FOOTPRINT OF CHINESE INVESTED ENTERPRISES IN ETHIOPIA

Investment Volume

The Chinese FDI survey captures Chinese investment in Ethiopia totaling ETB 7.5 billion (US\$450 million). Comparing this figure with the officially reported figures of Chinese enterprises to the Chinese Ministry of Commerce in Figure 3 shows, on the one hand, that the official Chinese figures are understating the true size of Chinese investment by about 10 percent; but on the other hand, it indicates that the survey really is capturing the brunt of Chinese investment in Ethiopia, an important fact for the relevance of the policy conclusions at the end of this report. A simple average of the investment by the number of firms indicates an average investment size of ETB 122 million or US\$7 million per company. The distribution of the firm scales is shown in Table 2.

Ownership Types

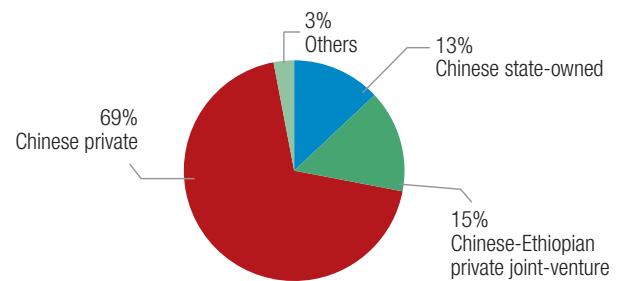
The majority of Chinese enterprises in Ethiopia are privately owned (69 percent). Nine companies are private joint ventures with an Ethiopian partner (Figure 9). Among these joint venture companies, Chinese owners usually have a larger share, ranging from 60 to 80 percent of the company ownership. 13 percent of the surveyed companies are state-owned,

TABLE 2: Investment Volumes of Chinese Firms: Distribution

Min	75%	50%	25%	5%	Max
1 Million	>3.5 million	>15 million	>50 million	>472.5 million	2 billion

Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

FIGURE 9: Ownership types of Chinese firms in Ethiopia



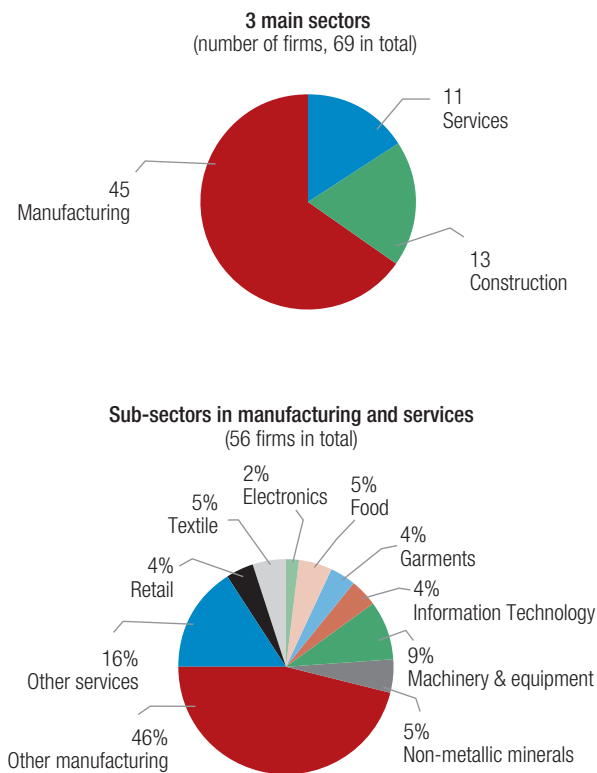
Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

which are typically in the construction and transportation business and subsidiaries to state-owned companies back in China assigned for overseas business.

Sector Focus of Chinese investment

Among the surveyed companies, 13 are construction and transportation firms, 45 are manufacturing, and 11 are in the service industries (Figure 10, first pie chart). Excluding the 13 construction firms, the 56 so-called “investments firms” consist of companies in textile manufacturing, garments/shoe manufacturing, non-metallic minerals, machinery and equipment supplies, information technology, electronics, food (restaurants), and other manufacturing (Figure 10, second pie chart). Chinese investors, similar to any other investor, usually try to maximize on their comparative advantage when selecting the entry industry in Ethiopia; two main determinants of such considerations are management expertise in the industry and the parent company’s price and technology advantages.

FIGURE 10: Sectoral Distribution of Chinese Invested Enterprises in Ethiopia



Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

Employment, Salaries, and Training

By the end of 2011, Chinese companies employed 18,368 permanent, full-time employees from both China and Ethiopia. The employment size has increased by 19 percent since the end of 2008. Among the full-time permanent employees, 15,910 are Ethiopians (Table 3). In addition, Chinese firms also hired 7,813 seasonal or temporary workers in 2011.

The majority of companies are of medium or large size, i.e. they employ at least 20 workers (Table 4). Twenty-four companies out of 69 employ even more than 100 employees, with eight of them employing more than 500 workers. Of these largest companies, not surprisingly, five of eight are in the construction and transportation business; two of eight are manufacturing companies and one is in the information technology industry (Table 4).

TABLE 3: Numbers of Ethiopian Employees in Chinese Invested Enterprises

Ethiopian employees	2008	2011
Total full-time and permanent	13,632	15,910
Average (by company) full-time and permanent	368	257
Total seasonal or temporary	NA	7,813
Number of firms reported	37	61

Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

TABLE 4: Number of Companies Surveyed: Distribution by Firm Size

Employment Size	# of companies
Small Size ≥ 5 and ≤ 19	15
Medium Size ≥ 20 and ≤ 99	30
Large Size ≥ 100	24

Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

The average monthly salary for Ethiopian employees hired by Chinese firms is ETB 1,445 (US\$85). This is above earnings seen in domestic companies and businesses. Unofficial estimates show that the average monthly salary in Ethiopia is about US\$75 (in Zambia, as a comparison, estimates are about US\$133). For instance, in Addis Ababa, unskilled workers in Government and state-owned companies earn from ETB 300 (cleaner) to ETB 950 (security); skilled workers earn from ETB 1,114 and up.

Sixty-nine percent of the surveyed Chinese companies provide formal training programs for Ethiopian workers, whereas only 38 percent of domestic firms would invest in such programs.⁵ The survey shows that 11,314 Ethiopian benefited from training programs provided by Chinese firms.

⁵ This is according to data of the International Finance Corporation's Enterprise Surveys of 2006.

Trade Activities: Import and Exports

The production processes of Chinese firms in Ethiopia heavily rely on imported supplies and materials. In 2011, 91.5 percent of the surveyed companies needed to import materials and supplies, and 61 percent of their total material inputs and supplies were from foreign origins. Therefore, customs and trade regulations, transportation policy, and foreign exchange rate policies have a strong impact on the productivity and profitability of the companies.

Interviews showed the main reasons for the high import content of Chinese invested firms are in the underdeveloped supply chain systems in Ethiopia. This makes it very costly for investors to buy supplies locally. As a result, Chinese invested enterprises often look for substitutes from abroad. For example, a tire in China is sold for CNY 300, or about ETB 900. In Ethiopia, a tire is sold for ETB 3,000, which is much higher than a tire that is imported from China even considering the transportation and customs clearance costs. On the other hand, some standard parts, for instance, used in the automobile

industry are simply not available in the local market, probably due to the low capacity of local producers. Thus, some companies, such as automobile companies, have to import a significant amount of their spare parts to service their customers.

Increasingly, firms are coming to Ethiopia to produce for export. According to the survey, seven manufacturing companies and one service company are exporting or planning to export products and services (e.g. automobile parts, leather, bone china, shoes). And this does not only refer to exports to China. In fact, there seems a trend starting to export to developed markets, such as the US and EU. During the past two years, six new Chinese firms came to Ethiopia to produce for that purpose. Many of these new entrants for export production (so called efficiency-seeking FDI) are large-scale companies with a long history and good exposure to the global market, such as a shoe factory from Guangdong (Box 3), which started operation in Ethiopia in late 2011. The current largest exporter is in the leather industry, and 100 percent of its products were exported in 2011 with a total value of ETB 250 million.



FDI MOTIVATION ANALYSIS

WHAT ATTRACTS CHINESE FIRMS TO INVEST IN ETHIOPIA?⁶

In order to understand the main drivers of Chinese investment in Ethiopia, the survey tested 20 potential motivations to set business in Ethiopia.

Figure 11 provides the details of all 20 motivations tested. The darker the area is, the more respondents agreed with the statements.

Four Principle Drivers

There are *four principal drivers* of Chinese FDI in Ethiopia. **First, to take advantage of a good understanding of the investment climate gained from entrepreneurs' social networks.** The survey finds that the social networks of Chinese investors function as a significant factor in making their investment decision in favor of Ethiopia. In fact it is striking to hear in the interviews that information about potential investment opportunities barely travels through formal channels, such as through the investment promotion agency or other government agencies. In contrast, most Chinese investors get to know about the Ethiopian business environment through their personal connections with people who have already been doing business there. This is manifested from the fact that managers/owners of more than 80 percent of surveyed firms are originally from only three Chinese Provinces, i.e. Liaoning, Zhejiang, and Fujian. Many know each other through business cooperation back in China or elsewhere and before they came to Ethiopia. Some others are relatives or family friends. Relying on personal accounts to make investment decisions seems particularly important in the service sector, such as the restaurant business.

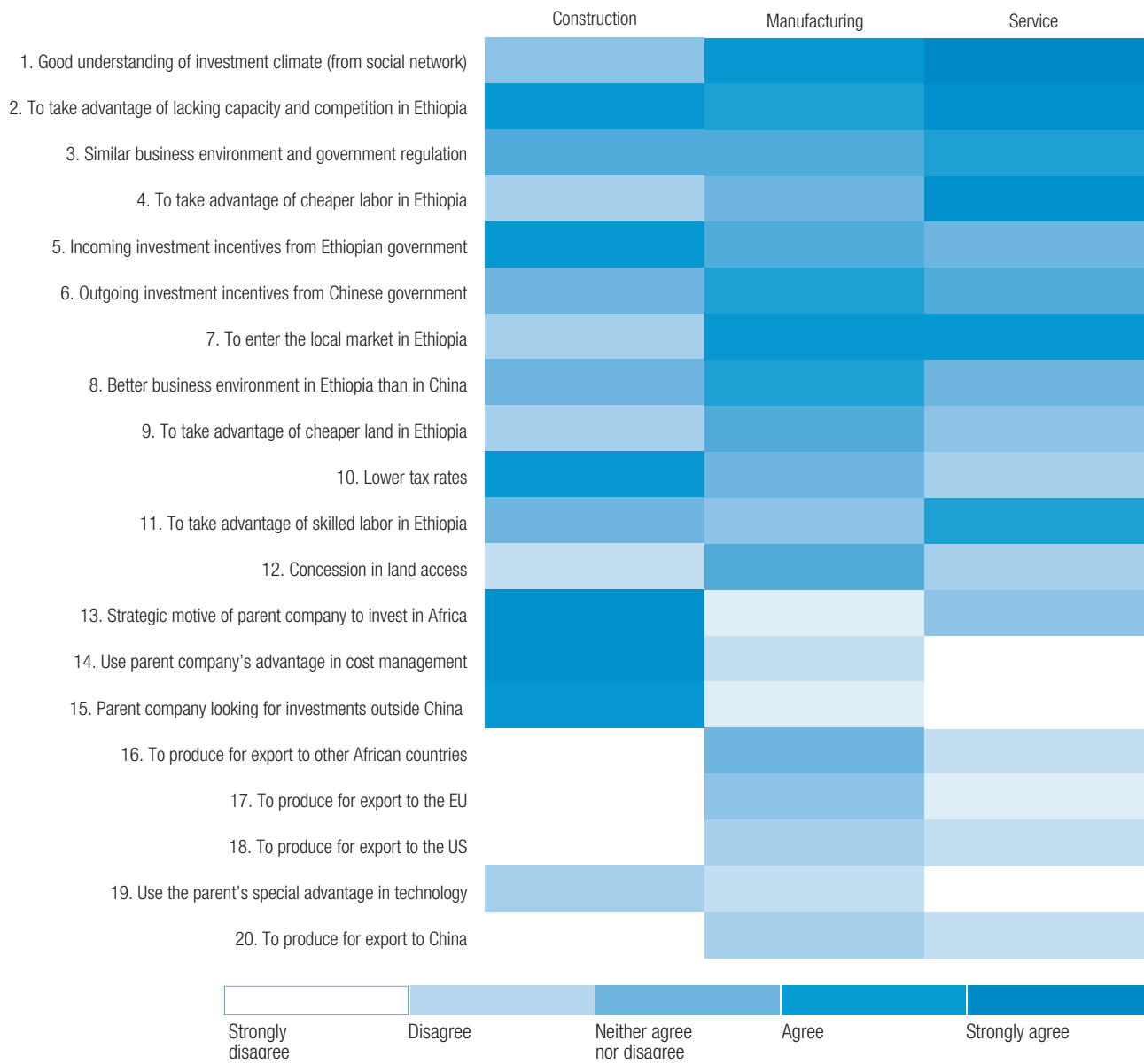
Second, to take advantage of the perceived opportunities provided by the current state of the

Ethiopian economy; this includes the limited market capacity and market competition, cheap labor, cheap land, and an expanding Ethiopian market. The surveyed firms claim that increasing competition, intensified trade competition, rising labor costs, and currency appreciation in China have made it more and more difficult to do business in the Chinese market over the past years. At the same time, the production capacity in Ethiopia is still low, and the local market is rapidly expanding, making the market there look very attractive for Chinese investors. In the manufacturing and service sector, cheap labor in Ethiopia is especially appealing. However, entering the market seems to be a sobering experience to many investors since most firms state that they are less optimistic about the perceived advantages and opportunities *after* entering the market. One important example is the realization that indeed local labor is cheaper than back in China and elsewhere, but labor productivity is also very low due to inadequate education.

Third, to maximize cross-border investment incentives provided by the Ethiopian and Chinese governments. During the last decade, the Ethiopian government has continuously provided FDI incentives, such as tax holidays and tariff free policy for FDI equipment imports. On the other hand, the Chinese government has also adopted the “China Goes Global Policy,” which awards Chinese firms investing abroad with tax credits in China. These incentives have proved to be a large motivation for Chinese firms’ investment

⁶ See also *Annex 2*: Selected breakdown of motives of Chinese investment into Ethiopia.

FIGURE 11: Summary Overview of Motives to Invest in Ethiopia



Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

in Ethiopia, especially for the manufacturing industry. Yet some firms find that incentives are still inadequate to help them overcome many of the doing business obstacles in Ethiopia. As a result, many Chinese businesses fail and exit the country despite the incentives they received from the both governments.

Fourth, to make a strategic move of the parent company into the African market and to invest in

favor of the stable political environment of Ethiopia. Most of the very large Chinese firms that have a parent company in China are construction firms (five of eight). The surveyed construction firms favor the political stability of Ethiopia, and perceive their presence in the country as an anchor for their business development in the East Africa region and beyond. Overall, survey respondents think the Ethiopian

government provides a stable political environment for the firms to do business smoothly around the year. Eighty-one percent of the firms from manufacturing, service, and construction industries agree that they

experienced little or no obstacles in political stability over the course of their engagement. Many of them also claim that Ethiopia stands out among all African countries in terms of continuous political stability.



FDI OBSTACLES ANALYSIS

OPPORTUNITIES TO IMPROVE CHINESE INVESTMENT INTO ETHIOPIA⁷

The survey examined 15 potential investment constraints based on the experiences of the Chinese investors in Ethiopia. Respondents indicate that customs and trade regulation, tax administration, and access to finance are the three largest obstacles for investing in Ethiopia (Figure 12).

Obstacles faced vary by size of the companies. Figure 13 compares the obstacles faced by small, medium, and large companies. The figure shows that SMEs experience more challenges than large companies in almost all categories. Customs and trade regulation are more likely to disrupt supply chains of

FIGURE 12: Largest Obstacles for Chinese Firms in Ethiopia



Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

Note: Ranking derived from number of times mentioned by surveyed firms as the top three obstacles by firm. Calculation method applied: selected once as largest obstacle equals three points, selected once as second largest obstacle equals two points, and selected once as third largest obstacle equals one point. This is then added up. As a result, number of points for a specific obstacle can be higher than total number of enterprises surveyed, which was 69.

Box 2: Two Main problems in Customs and Trade Regulations

Mismatch of tariff base value. When collecting tariffs for imported supplies, the customs authority often does not accept the documented value from Chinese sellers. Instead, customs usually uses an international ‘standard price’ for the imported goods to compute import tariffs accordingly. When collecting tariffs for imported supplies, the customs authority often does not accept the documented value from Chinese sellers. Instead, customs usually uses an international ‘standard price’ for the imported goods to compute import tariffs accordingly. Since most imports come from China, where product prices are among the lowest in the world, the value used by the customs authority can be higher by as much as twice the real value.

Unpredictable and long delay of customs clearance.

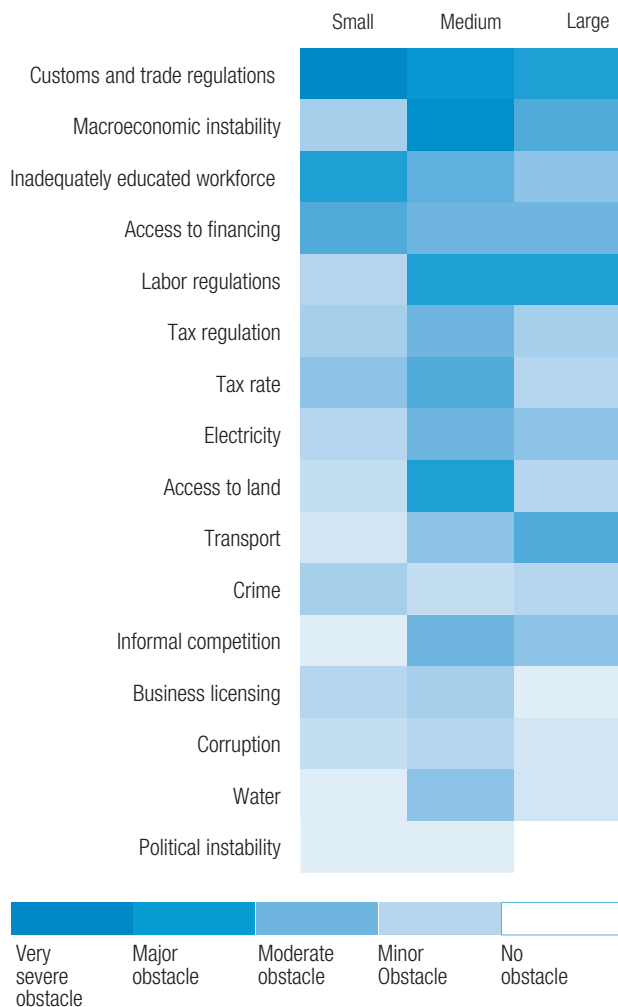
The customs authority closes at 11 AM on working days, and is perceived by importers as being unable to finish the customs clearance process on time. What seemed to prolong processes even further was a new policy that required that all customs clearance of imports should be done in Mojo (the rule was revised subsequently to include the option of the Addis Ababa customs terminal to keep imported goods). Before the revision of the rule, goods imported through Djibouti had to first be transported to Mojo, stay there at least for two days for all processes and papers, then be transported from Mojo to Addis Ababa. All in-land transportation services are required to be done by Ethiopian transportation companies. Due to the limited capacity of those transportation companies, a great number of imports were stuck in Mojo. One company reports that they stopped operating for one and a half months due to delays in Mojo.

Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

small businesses (e.g. the recent rule of compulsory customs clearance in Mojo, which was revised subsequently to include the option of the Addis Ababa

⁷ See also *Annex 2: Selected breakdown of possible obstacles for Chinese investment into Ethiopia.*

FIGURE 13: Obstacles and Opportunities to Improve: by Firm Size

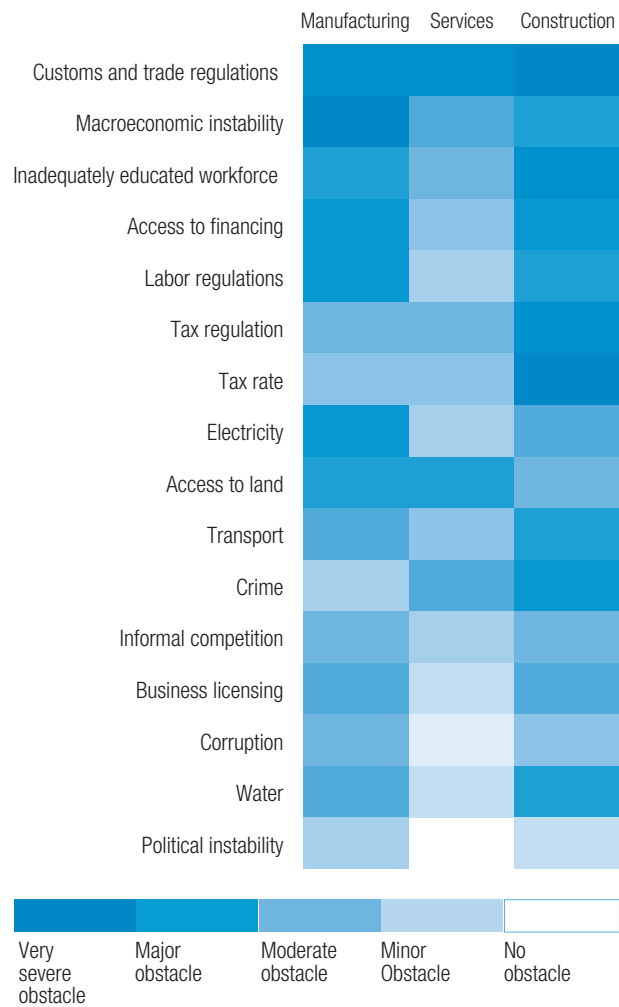


Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

customs terminal to keep imported goods), whereas larger companies are more concerned about transportation services, which are reported to be expensive, monopolized, and closed to foreign investors.

Perceived obstacles also vary across different industries. Figure 14 compares obstacle rankings in manufacturing, services, and construction industry. It shows that customs and trade regulations are rated as a significant obstacle for all sectors. For manufacturing firms, macroeconomic instability, especially foreign exchange risks, stands out as major problem. The service sector is specifically challenged by access to land.

FIGURE 14: Obstacles and Opportunities to Improve: by Industry



Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

Construction companies are highly concerned with taxation levels and inadequate workforce education.

Six Principle Obstacles

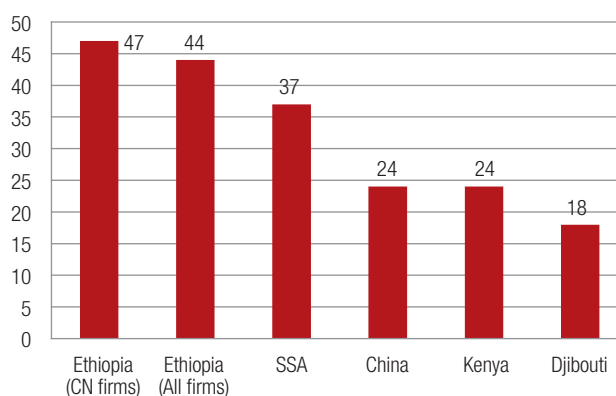
There are six principal obstacles of Chinese invested enterprises in Ethiopia. First, **trade regulation and customs clearance efficiency.** Due to the lack of local supply network, Chinese firms in Ethiopia rely heavily on imported supplies and materials (see stylized facts above). But current regulations are not designed well enough to facilitate fast customs clearance of imported

materials. According to the survey, the average customs clearance duration is 47 days, about twice longer than that in China and Kenya, and one month longer than that in Djibouti (Figure 15). The survey shows that 32.3 percent of the firms named customs and trade regulation as the biggest obstacle among all 15 factors. As a result, trade and customs regulation is the main issue impeding Chinese FDI in Ethiopia. Box 2 provides additional insights into customs and trade regulation issues.

Second, perceived foreign exchange rate risks deter investment. Restrictions on foreign currency transaction and conversion, in combination with perceived uncertainty over the foreign exchange rate path, deters new investment and discourages existing Chinese invested firms to increase investments. As light manufacturing/labor intensive firms rely more heavily on imported supplies, they are specifically concerned about foreign exchange risks. According to the survey, 90 percent of the firms perceive foreign exchange rate as one of the largest risks doing business in Ethiopia, and 78 percent of the firms experienced great losses in the past due to an unexpected depreciation. Manufacturing and construction firms are more concerned with foreign exchange risks than are the service firms (Figure 16).

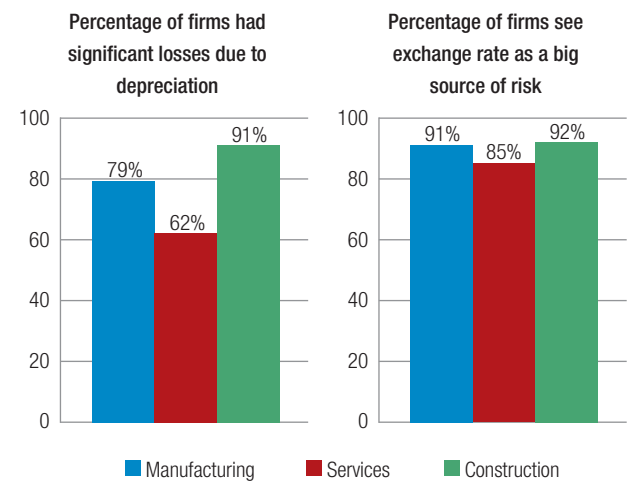
Third, tax administration inconsistency and inefficiency. Many Chinese firms claim to suffer from

FIGURE 15: Days Required for Customs Clearance, Selected Countries



Source: Doing Business Report (2011); World Bank Survey, Chinese FDI in Ethiopia (May 2012).

FIGURE 16: Investor Perceptions on Foreign Exchange Risks



Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

inconsistency of tax law explanation and frequent law amendments. According to the survey, 71 percent of the firms find the inconsistency of tax law explanation and the frequent law amendment a major obstacle to doing business. Accordingly, inconsistencies of tax laws greatly impede investments in Ethiopia, as investors do not have a clear expectation for the future cash flows of their new projects. A good illustration is the ongoing tax disputes of Chinese companies in Addis Ababa, which come from a lack of transparency and unpredictability of tax policies. According to the survey respondents, the government imposed a re-interpretation of tax rules during recent months, effectively making some companies paying retroactive sales tax (in the order of 30 percent) on each unit sold in past years. Other inconsistencies are also identified. For instance, regarding the lease of land, the central and local governments often have different interpretations of laws and rules, which cost foreign investors extra time and resources to understand and follow policies appropriately. Box 3 provides a more detailed list of problems with current tax administration.

Fourth, labor education impeded productivity and skill transfer. Ethiopian workers hired by Chinese invested companies have, on average, a six

Box 3: Perceived Issues in the Tax Administration

Profit Tax. Current regulation forbids firms to deduct expenses such as flights of staff, advertisement, and market promotion from the base for profits tax, while in fact these expenses are operation costs for businesses. The profit tax rate is 30 percent.

Tax authorities. Current disputes regarding consumption tax, value added tax, and profit tax are all required to be settled at one authority, the Customs Revenue Authority, rather than specialized authorities. In the experience of business owners, this overburdens the CRA, which seems to lack expertise in some of the areas and also has limited administrative capacity to settle disputes appropriately and efficiently.

Lack of access to legal receipts. It is often difficult to obtain legal receipts from local suppliers of input material, even though the suppliers are legal and formal entities. To avoid tax issues, companies then need to spend more time to seek other suppliers and often settle for higher prices.

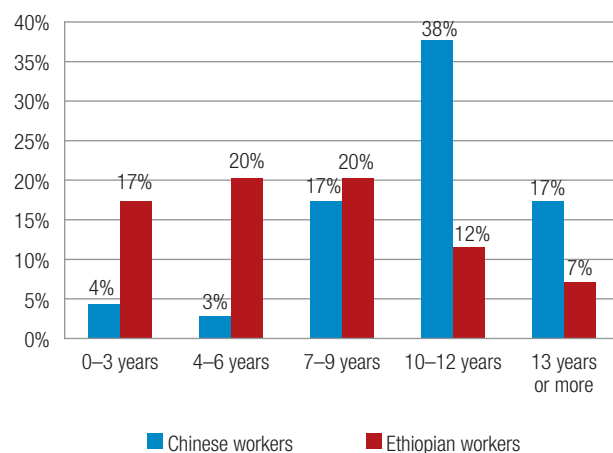
Unpredictable timetable of government auditing. Tax authorities usually come for on-site auditing with last-minute notification. Ad-hoc visits add to the difficulty and costs of small business operations in Ethiopia.

Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

to seven year education, much lower than the average education of Chinese workers. Inadequate education and lack of training of Ethiopian workers, especially those in the manufacturing and construction sectors, impede management communication and skill transfer (English is the working language in most cases). In order to fill in the gap of inadequate education of local workers, Chinese firms usually hire Chinese lead workers with 10–12 years education and provided on-site trainings for Ethiopian employees (Figure 17).

Fifth, insufficient local access to finance. The survey shows that only three companies obtained loans from Ethiopian Banks in the past year. A number of firms, especially SMEs, suggest that they did not even try to get loans because they felt it was impossible to obtain approval. Others claim that they do not need extra funding locally. So while there probably is an

FIGURE 17: Average Education of Workers in Chinese Invested Enterprises in Ethiopia

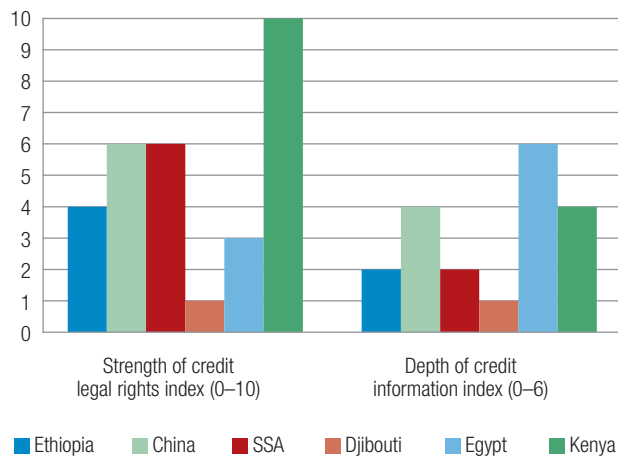


Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

issue in accessing finance locally, it is unclear to what extent Chinese invested firms actually would want to access the local financial market for starting their operations in Ethiopia.

The relatively low importance placed by Chinese enterprises on access to finance, especially compared to the finding of the Enterprise Survey presented in chapter III, could be that Chinese enterprises have access to finance in China that can be used to invest in Ethiopia. It is clear, however, that most firms have some need to locally finance their working capital. Figure 18 compares selected economies in terms of the ease of getting credit through June 2011. Ethiopia lags behind China in both credit legal rights index and the depth of credit information index.⁸ Moreover, the Doing Business Report 2012 shows that only 0.2 percent of the individuals/firms in Ethiopia are listed in a public credit registry with information on their borrowing history from the past five years, which is much lower than

⁸ “Strength of legal rights index” measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending. “Depth of credit information index” measures rules and practices affecting the coverage, scope and accessibility of credit information available through either a public credit registry or a private credit bureau.

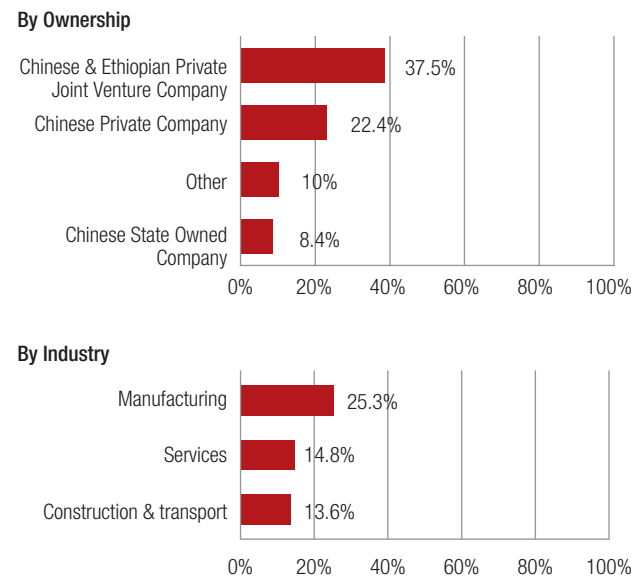
FIGURE 18: Doing Business Index – Getting Credit

Source: 2012 Doing Business Report.

that in China (82.5 percent) and below the average of sub-Saharan level (3.5 percent).

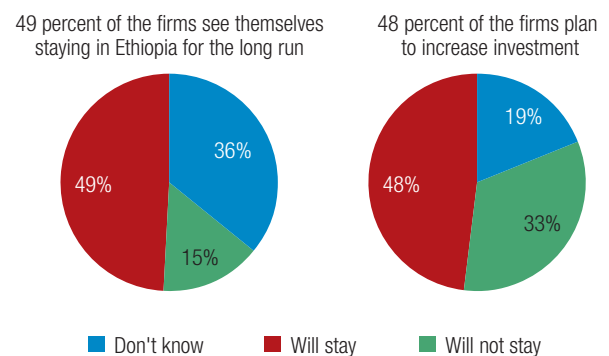
Sixth, government regulation affects business efficiency. Companies of all ownership and industry types spend a significant portion of senior management time on government relations (Figure 19, upper side). More than one-third of senior management time in Chinese Ethiopian joint ventures is spent on these activities; strikingly, Chinese SOEs spend less than 10 percent of their time, somewhat indicating a special, possibly preferential status for SOEs. Looking at industries mirrors this assessment. Manufacturing companies, which are predominantly private, spend one-fourth of their time on government relations; construction and transport companies, which are mainly SOEs, on the other hand, “only” use half the time needed by manufacturing companies (Figure 19, lower side).

Other findings regarding government regulation show that 65 percent of surveyed Chinese companies disagree with the sentence that “*the court system is fair, impartial and uncorrupted*”. Likewise, 74 percent of surveyed Chinese companies disagree that “*Government officials’ interpretations of the laws and regulations affecting this company are consistent and predictable*”.

FIGURE 19: Senior Management Time Spent on Handling Government Relations (2011)

Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).

Despite the perceived obstacles, Ethiopia is an attractive business destination for Chinese enterprises. According to the survey, almost half of Chinese investors are in for the long run (10 years or more) and plan to increase investment in Ethiopia over coming years (Figure 20).

FIGURE 20: Investors’ Willingness to Stay in Ethiopia

Source: World Bank Survey, Chinese FDI in Ethiopia (May 2012).



7

CASE STUDIES

Preliminary survey findings were presented to the Government in June 2012. Representatives of this small workshop requested to enrich the analysis through targeted interviews to analyze some of the specific constraints of key industries in Ethiopia. The team then had additional face-to-face interviews in the Eastern Industrial Zone to better understand the situation of a company that manages and runs the first special economic zone in Ethiopia, as well as Huajian, a large-scale shoe manufacturer, to provide insights of constraints in the way of exporting companies.

Ethiopia's approach to Special Economic Zones – Eastern Industrial Zone (EIZ)⁹

Eastern Industry Zone (EIZ) is a Special Economic Zone (SEZ) or Industrial Park in Ethiopia, located 37 km northwest to Addis Ababa, 900 km to the port of Djibouti and with 200 hectares of land in Dukem—the first of its kind through an investment from China.¹⁰ In 2007, Yonggang Group and Qiyuan Group—two Chinese private steel firms from Zhangjiagang City—won the bid of Chinese Ministry of Commerce's calling for a tender in November 2007. For Ethiopia, EIZ is the first and largest-scale industrial park of the nation, and the Ethiopian Government has prioritized this project in their “Sustainable Development and Poverty Reduction Program” to promote its industrial sector development. The Ministry of Industry of Ethiopia requires the EIZ to focus on Chinese companies in the area of textile, apparel, building materials, mechanical manufacturing, and agricultural processing. Currently, 11 Chinese

firms have signed investment agreements with EIZ in all targeted areas.

Challenges

Being the first of its kind, EIZ has gained preferential policies from the Ethiopian Government in developing the industrial park; however, EIZ has also encountered numerous challenges in financing, land ownership, and cooperation with local government. EIZ is an interesting case study to highlight challenges for investors doing business in this area in Ethiopia.

High cost of infrastructure investment. This puts a heavy financial burden on the Industrial Park investor and in fact questions the overall business model. A major cost of EIZ consists of investment in basic infrastructure for factory buildings as well as financial cost. Basic infrastructure refers to roads, electricity, water, communication, and drainage facilities in the industrial park. The EIZ estimates its cost is one and a half times higher than the cost of a similar investment in China, due to higher cost in construction materials, construction itself, and trade logistics. Moreover, in China, the local government shares 50 percent to 70 percent of the cost for basic infrastructure, which provides a very strong incentive for investors in China. To date, EIZ has invested US\$80 million in the development. This investment is made up of a mix of common basic infrastructure

⁹ World Bank Survey, Chinese FDI in Ethiopia (May 2012); and interview with Eastern Industry Zone.

¹⁰ This project is one of the 50 zones planned globally under China's “Going Out Policy”.

investment and investment specific for individual tenants of the zone. The latter comes from the fact that EIZ needs to solely shoulder infrastructure cost for each individual company wanting to use the EIZ as a tenant (not only to connect to basic infrastructure but also for building cost). Such costs vary depending on the tenant's business and company size. For this case study, the assumption is that costs for a tenant are in the order of ETB 86 million (around US\$5 million).

Limited sources of revenue. Large investments are only partly covered by revenues. Despite preferential policies from both Chinese and Ethiopian governments, EIZ has deep concerns over the limited possibilities in revenue generation, thereby questioning the sustainability of its own business model, if not the overall current approach to the set-up of SEZs in Ethiopia. Currently, there are three major revenue sources for EIZ: i) leasing fees of land and factory buildings; ii) maintenance and property management fees; and iii) a subsidy from the Chinese government.

Given the early stage of its operation, EIZ mainly relies on the first revenue source, i.e. leasing fees for land and factory buildings. However, in order to attract Chinese investors, EIZ needs to provide deeply discounted leasing fees. This means that the revenue per year generated—for the above mentioned tenant—would be around ETB 8.8 million, which is around 10 percent of EIZ's infrastructure cost for this tenant. EIZ estimates that it will take 15 years for EIZ to generate its first profit, based on these parameters.

Perceived lack of support

While the Ethiopian Government has enacted a series of policy incentives to help EIZ and to attract more Chinese companies to the zone, the measures are hardly targeted enough to help the specific problems of operating the zone. *First*, EIZ enjoys a tax free period of seven years, which started in 2007 (though EIZ apparently does not have any taxable income anyway). *Second*, each Chinese firm that opens its production line in EIZ enjoys a two-year free VAT period and is exempt from import customs duties.

While this is welcome, it obviously does not impact EIZ itself. *Third*, the Government is setting up a bonded warehouse to facilitate customs clearance. *Fourth*, EIZ was promised sufficient and uninterrupted electricity supply. *Finally*, a specific concern is the particularly low efficiency of local government. Being the first of its kind, both EIZ and the Ethiopian Government had to meet numerous new challenges. However, low efficiency in resolving problems as well as lack of coordination among different government agencies across all levels has resulted in even higher transaction cost.

Policy implications

Matching cost and revenues are the main concern of EIZ. Given the special characteristics and nature of an Economic Special Zone (ESZ), the government and the investor need to find a sustainable model of cooperation that caters to both interests. Since SEZs are being implemented across many countries in the world, it is of particular importance to look for other country experiences to ensure lessons learnt elsewhere. China could be one of those countries, where SEZs are often run and/or subsidized by Government entities; so could be Cambodia, where SEZ are predominantly run by private entities. Korea also has a long-standing history of SEZs, which started in the 1970s and 80s (for insights on Korea, see World Bank, 2012).

Global lessons underline that there are a number of necessary, albeit not sufficient, conditions required for SEZs to be successful (World Bank, 2011). To attract and retain investment, a combination of factors needs to come together, including:

- i. **Formulation of appropriate SEZ legal and regulatory framework:** This would include designing of a flexible, dynamic and multi-use national framework, complemented with smart/performance based incentives for a sustainable SEZ policy;

¹¹ World Bank Survey, Chinese FDI in Ethiopia (May 2012); and interview with Huajian.

- ii. **Institutional framework, implementation capacity and the SEZ authority:** The institutional mechanisms underpinning the SEZ regulatory authority must balance authority and independence with inclusivity. The SEZ regulatory authority, quality, capacity, and focus of the SEZ authority will often determine the success of the zone program;
- iii. **SEZ management and operations:** this includes zone management and “one-stop” service to investors in operationalizing their investments, including obtaining business licenses, export and import licenses, work permits, health and safety certificates, environmental clearances, and a wide range of other authorizations;
- iv. **Development of quality on-and-off-site infrastructure services** (such as power, water, roads), which enables and facilitates the operation of companies to be housed in the SEZ; and
- v. **Customs, trade facilitation, and transport:** In successful zones, the customs operations are identified as critical sources of competitive advantage and are given the authority and capacity to deliver an efficient clearance service.

Huajian – A Chinese Investor in Shoe Manufacturing for Exports¹¹

Huajian’s investment in the Ethiopian shoe industry marks a distinct change from traditional Chinese investment in infrastructure development in Ethiopia. Huajian Group, based in Dongguan, Guangdong province, produces about 20 million pairs of shoes a year for famous shoe brands worldwide. It is one of the largest Chinese shoe manufacturers, if not in the world. In Ethiopia, Huajian opened two production lines in Eastern Industry Zone at Dukem, 30 kilometers south of Addis Ababa, to produce about 2,000 pairs of shoes every day for the U.S. and European markets. It currently employs about 600 workers with the majority being Ethiopian.

Huajian came to Ethiopia as a manufacturing investor to tap into the benefits of cheap labor costs

(compared to China), abundant domestic supplies of leather, and its duty-free and quota-free access to European and U.S. markets. These benefits are contrasted with problems associated with inefficient customs clearance processes and the generally high cost of trade logistics, which have hindered the company’s competitiveness in producing in Ethiopia. As one of the primary manufacturing exporters from Ethiopia, Huajian’s experiences indicate some of the broader issues faced by exporting companies from Ethiopia. Main issues identified during interviews with the company are:

- **It is difficult to keep its production system processes lean and as short as in China.** In other words, for products produced in Ethiopia the time required from a client order to the delivery to the client is longer than the standard from a similar order in China. Huajian’s lead time to the U.S. American clients is around 45 to 60 days from China, but it jumps to around 100 days from Ethiopia. The latter includes 33 days of shipping raw materials from Hong Kong to Addis, 30 days of manufacturing in Addis, and 35 days of shipping to the U.S. Due to the special characteristics of the shoe industry, which is following fashion trends which tend to be short-lived, a short lead time is critical to lead a successful business operation.

According to Huajian, a possible remedy to the lead time problem may be to use airfreight instead of sea freight, especially on the delivery route of factory to client in the U.S. (where there is a direct flight between Addis Ababa and Washington, DC). But it comes down to cost, and airfreight is much costlier than sea transportation (US\$2.37 per kilogram compared to 0.6 per kilogram). Negotiations are ongoing with both freight forwarders and clients to shoulder part of the difference.

- **Customs clearance times are not predictable,** probably the result of inexperienced customs staff and inefficient management practices. Customs clearance times can vary from five to 30 days (for the same products) according to Huajian’s

experience. There is a perception that customs officers generally lack training and specific professional skills. At the same time, there is limited exposure to international experiences and competitors in the customs process, which adds to the problem.

According to Huajian, reforms in customs clearance process, setting up targeted and demand-driven training and incentive schemes, as well as introducing international experiences may help to overcome these problems.

- **Total logistics cost, labor cost, and rental cost are not as competitive as one would expect** and in fact are often higher than in China. For example, the cost of one container from China to Addis costs US\$6,000, but one container from China to the United States is US\$2,000. The land transportation from Djibouti to Addis and customs clearance cost account for eight percent of total cost, however, in China, the logistics cost can be as low as two percent. In China, labor cost only accounts for 22 percent of the total cost, whereas in Ethiopia labor cost makes up as much as 33 percent, according to Huajian's experience. The main reason for the latter lies in staff training. When Huajian set up their factory in Ethiopia it had to send 86 Ethiopian university graduates to China for two months. While these costs will diminish over time, they do represent a

major burden on new market entrants. Looking at rental cost, Huajian finds that these are almost double from similar cost in China (US\$17 per square meters vs. US\$33). Huajian is currently a tenant of EIZ.

According to Huajian, a review of labor regulations may help to address the issue of labor cost, especially related to staff training. In the meantime, additional tax incentives may help to ease the burden for new market entrants.

- **Inadequate infrastructure makes an overall very challenging business environment in Ethiopia.** The inadequacy lies in three main areas. First, blackouts are widespread and for long hours, especially in the rainy season, thereby significantly increasing cost. Second, the road from Djibouti's harbor to Huajian's factory near Addis is in poor condition, which results in longer transportation time and higher cost. And third, telecommunication fees are very expensive, which increases the cost of foreign investors who need to maintain close contact with headquarters overseas.

According to Huajian, targeted infrastructure quality improvement could make a big difference to foreign investors. To this end, the Government may want to think about dedicated industrial zones to offer cheap and infrastructure-connected land, dedicated electricity grids, and broadband telecommunication services.

In keeping with common perceptions the FDI survey shows evidence that Chinese investors are creating jobs and adding value to the Ethiopian economy. In line with policies observed in successful FDI destination countries, Ethiopia's political stability, cheap labor and land, as well as the growing domestic market are attractive factors to Chinese investors. However, there is still potential to improve policy priorities to provide an enabling investment climate for foreign investors and to reduce the restrictions on FDI.

Addressing identified obstacles could help Ethiopia to take better advantage of foreign investors to accelerate the shift from a predominantly low-productivity agriculture-based economy towards a higher-productivity manufacturing and export-based economy. Experiences in successful countries around the world, and especially in East Asia show that foreign investment is instrumental to the facilitation of such a structural transformation and to the maintenance of sustained and broad-based economic development

Based on the analysis of motives to invest in Ethiopia and perceived obstacles, **this study recommends five main areas for policy adjustments to facilitate foreign investors coming into Ethiopia so that Ethiopia can reap the benefits it needs to further its development path.** These five policy areas are:

- **Adjust customs clearance procedures and trade regulations.** Streamlining procedures for customs clearance would help foreign companies, which rely on importing, to improve their supply chains and thus increase firm productivity. It would also help to attract more export-oriented foreign companies, a key feature of successful countries in the past and especially in East Asia; special economic zones (SEZs) could play a crucial role in this.
- **Facilitate currency convertibility and increase transparency of the exchange rate policy.** Restrictions on foreign currency transaction and conversion affect business operations, and discourage existing foreign invested enterprises to increase investments and prevent entry of new investors. Large and unanticipated foreign exchange rate movements, like the one in August/September 2010, increase the risk of doing business. This is a particular concern of light manufacturing firms, which rely more heavily on imported supplies.
- **Improve tax administration consistency and efficacy.** Inconsistent tax law explanations and frequent law amendments increase uncertainty in business operations for foreign companies. A more predictable and stable tax law practice would likely attract more foreign investment.
- **Execute impartial labor regulation.** Ensuring predictable and impartial labor regulations to improve firm productivity and efficiency.
- **Increase the supply and quality of skilled workers.** In the long-term this means to deepen education sector reforms and programs with a particular view of enhancing business-related skills (e.g. through vocational training), and to set-up programs to improve English (and possibly Chinese) language skills. In the short-term this means to provide incentives for foreign companies to offer more formal and on-site training for local employees (e.g. through linking training schemes to tax holidays and other monetary incentives).



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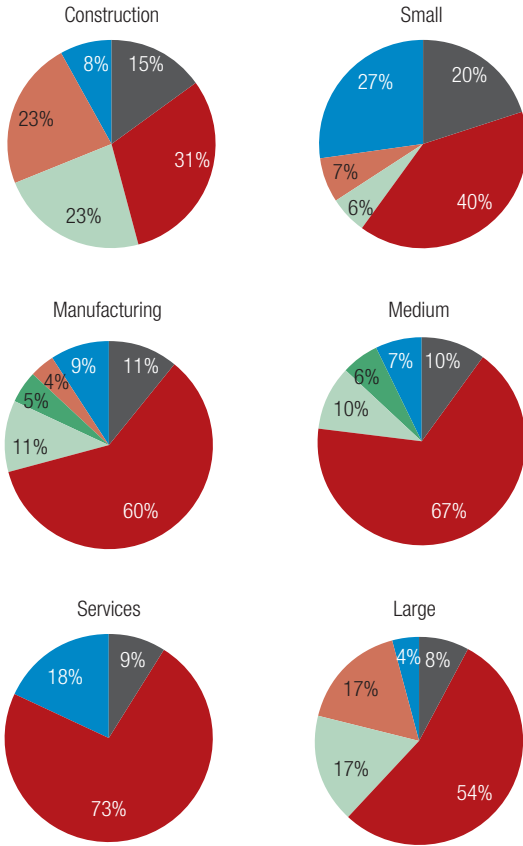


ANNEXES

Annex 1: Selected Breakdown of Motives of Chinese Investment into Ethiopia

BREAKDOWN OF MOTIVES TO INVEST: Good Understanding of Investment Climate (from social network)

Breakdown by Type of Business Breakdown by Size of Company

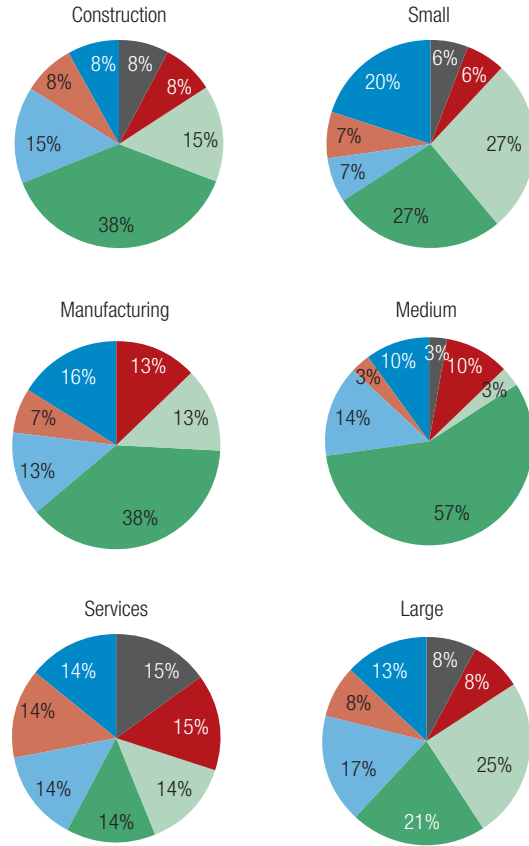


Legend: The color code shows the percentage of respondents in each category stating that:

- Fully agree ■ Mostly agree ■ Neither agree nor disagree
- Mostly disagree ■ Fully disagree ■ Question did not apply
- Did not know

BREAKDOWN OF MOTIVES TO INVEST: Ethiopia Business Environment is Similar to the one in China

Breakdown by Type of Business Breakdown by Size of Company

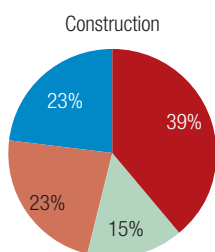


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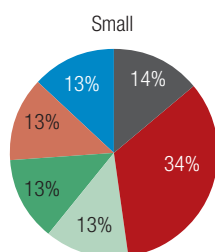
- Fully agree ■ Mostly agree ■ Neither agree nor disagree
- Mostly disagree ■ Fully disagree ■ Question did not apply
- Did not know

BREAKDOWN OF MOTIVES TO INVEST: To take Advantage of Cheaper Labor in Ethiopia

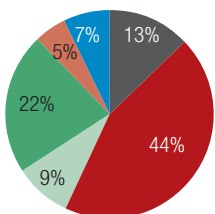
Breakdown by Type of Business



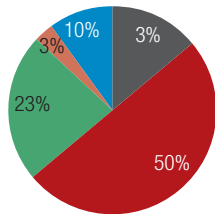
Breakdown by Size of Company



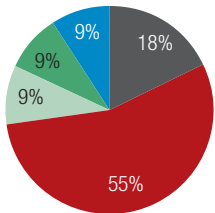
Manufacturing



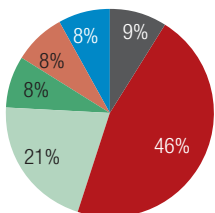
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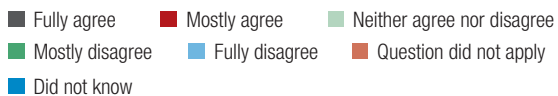
Services



Large

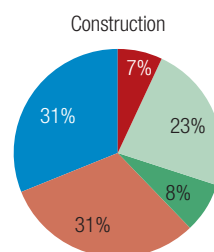


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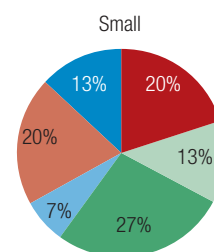


BREAKDOWN OF MOTIVES TO INVEST: To take Advantage of Cheaper Land in Ethiopia

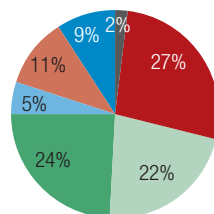
Breakdown by Type of Business



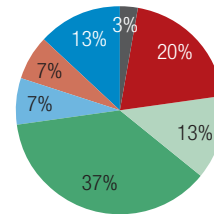
Breakdown by Size of Company



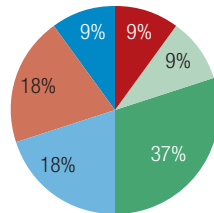
Manufacturing



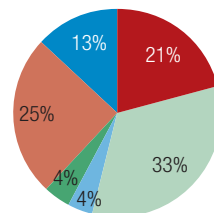
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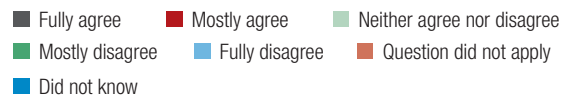
Services



Large

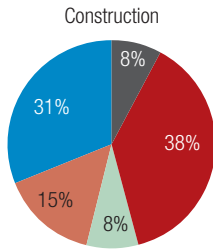


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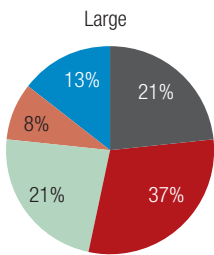
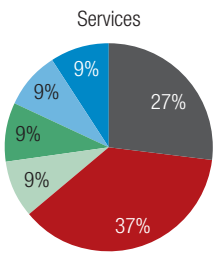
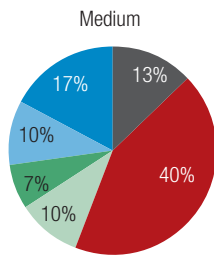
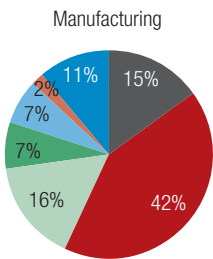
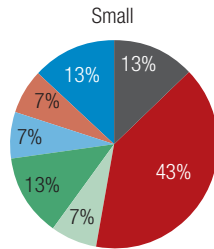


BREAKDOWN OF MOTIVES TO INVEST: To enter the Local Market in Ethiopia

Breakdown by Type of Business



Breakdown by Size of Company

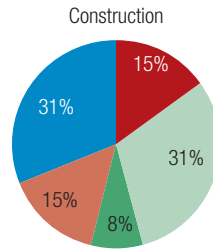


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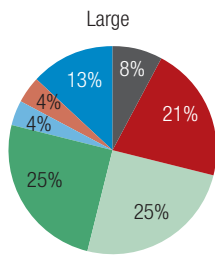
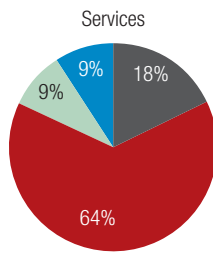
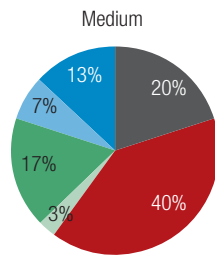
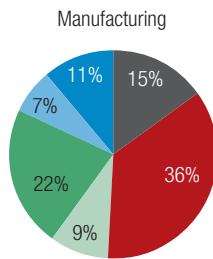
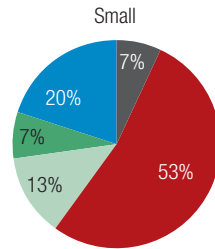
- Fully agree
- Mostly agree
- Neither agree nor disagree
- Mostly disagree
- Fully disagree
- Question did not apply
- Did not know

BREAKDOWN OF MOTIVES TO INVEST: To take Advantage of Limited Capacity and Competition in Ethiopia

Breakdown by Type of Business



Breakdown by Size of Company

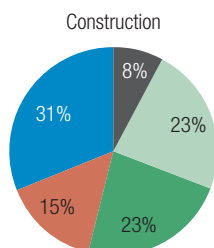


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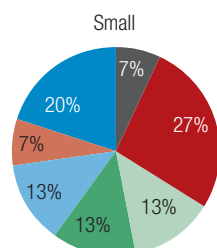
- Fully agree
- Mostly agree
- Neither agree nor disagree
- Mostly disagree
- Fully disagree
- Question did not apply
- Did not know

BREAKDOWN OF MOTIVES TO INVEST: Incoming Investment Incentives from Ethiopian Government

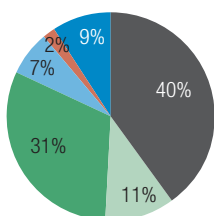
Breakdown by Type of Business



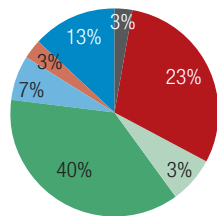
Breakdown by Size of Company



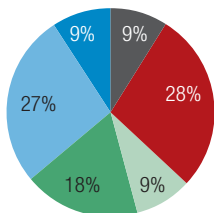
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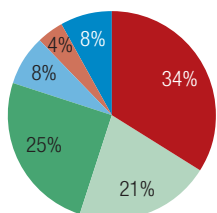
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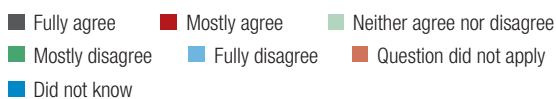
Services



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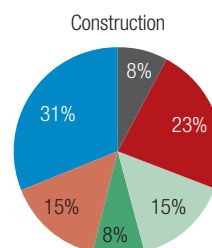


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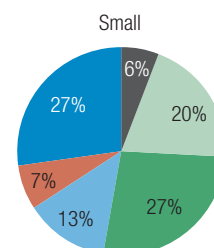


BREAKDOWN OF MOTIVES TO INVEST: Outgoing Investment Incentives from Chinese Government

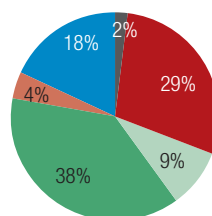
Breakdown by Type of Business



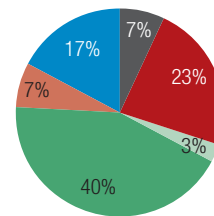
Breakdown by Size of Company



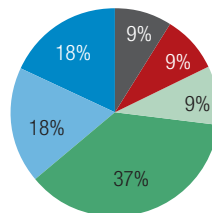
Manufacturing



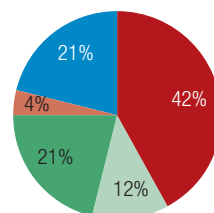
Medium



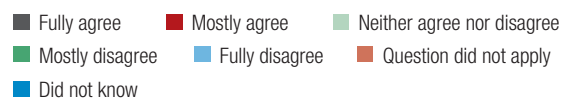
Services



Large

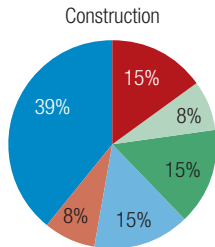


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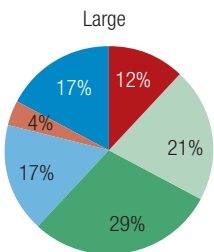
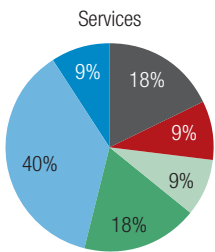
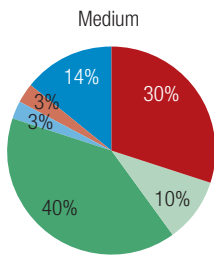
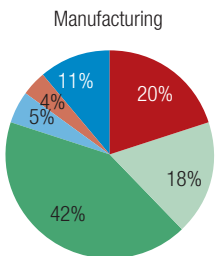
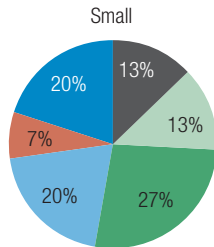


BREAKDOWN OF MOTIVES TO INVEST: Better Business Environment in Ethiopia than in China – in general

Breakdown by Type of Business



Breakdown by Size of Company

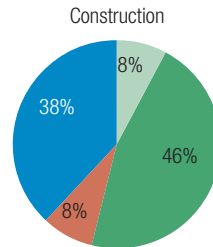


Legend: The color code shows the percentage of respondents in each category stating that:

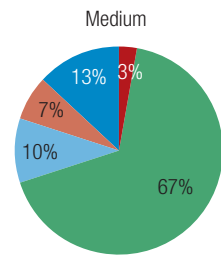
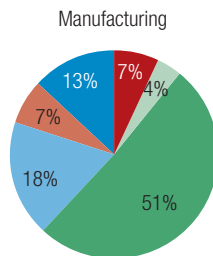
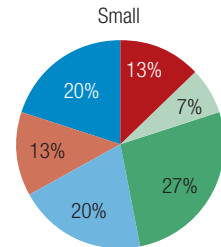
- Fully agree
- Mostly agree
- Neither agree nor disagree
- Mostly disagree
- Fully disagree
- Question did not apply
- Did not know

BREAKDOWN OF MOTIVES TO INVEST: Better Business Environment in Ethiopia than in China – lower tax

Breakdown by Type of Business



Breakdown by Size of Company



Legend: The color code shows the percentage of respondents in each category stating that:

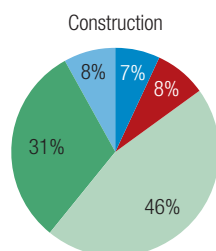
- Fully agree
- Mostly agree
- Neither agree nor disagree
- Mostly disagree
- Fully disagree
- Question did not apply
- Did not know

Annex 2:

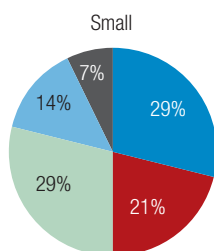
Selected Breakdown of Obstacles for Chinese Investment into Ethiopia

BREAKDOWN OF POSSIBLE OBSTACLES: Electricity

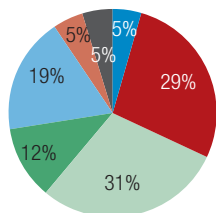
Breakdown by Type of Business



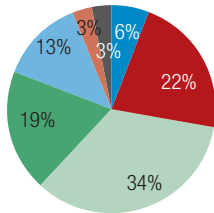
Breakdown by Size of Company



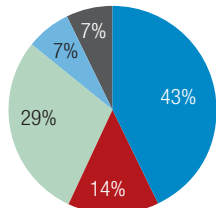
Manufacturing



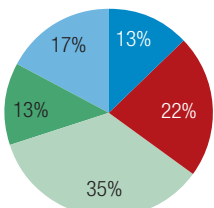
Medium



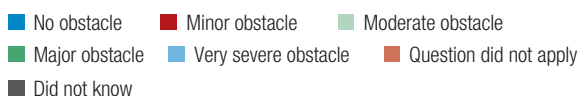
Services



Large

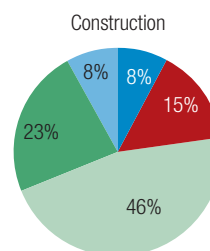


Legend: The color code shows the percentage of respondents in each category stating that there was:

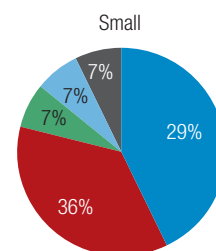


BREAKDOWN OF POSSIBLE OBSTACLES: Water

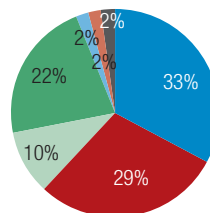
Breakdown by Type of Business



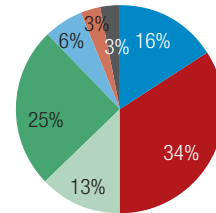
Breakdown by Size of Company



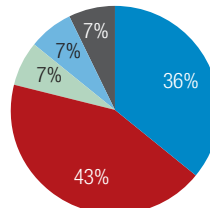
Manufacturing



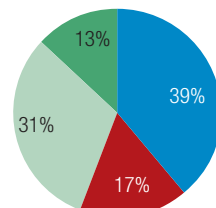
Medium



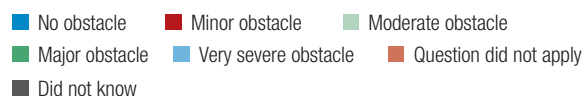
Services



Large

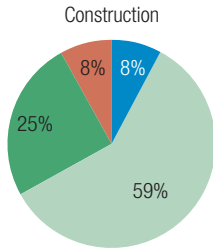


Legend: The color code shows the percentage of respondents in each category stating that there was:

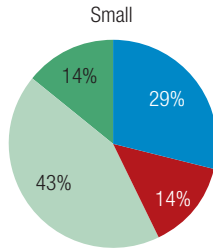


BREAKDOWN OF POSSIBLE OBSTACLES: Transport

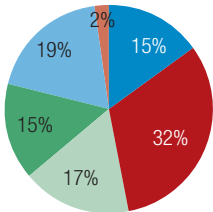
Breakdown by Type of Business



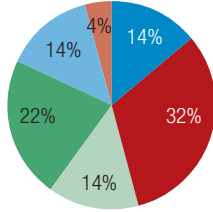
Breakdown by Size of Company



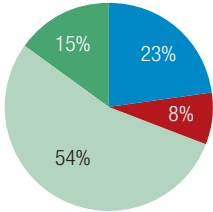
Manufacturing



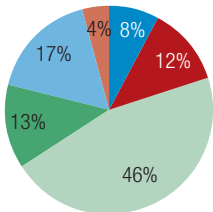
Medium



Services



Large

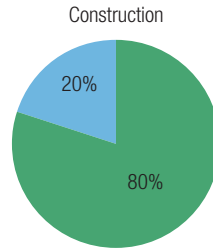


Legend: The color code shows the percentage of respondents in each category stating that there was:

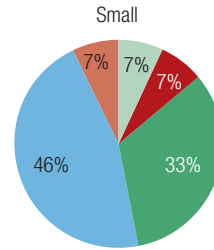
- No obstacle
- Minor obstacle
- Moderate obstacle
- Major obstacle
- Very severe obstacle
- Question did not apply
- Did not know

BREAKDOWN OF POSSIBLE OBSTACLES: Customs

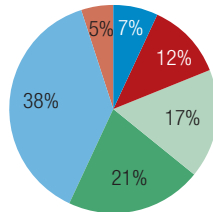
Breakdown by Type of Business



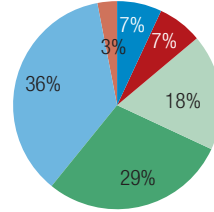
Breakdown by Size of Company



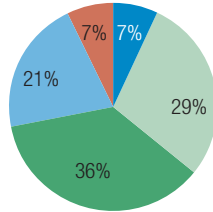
Manufacturing



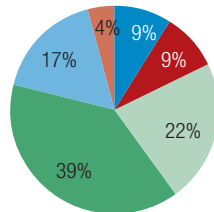
Medium



Services



Large

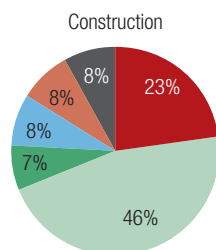


Legend: The color code shows the percentage of respondents in each category stating that there was:

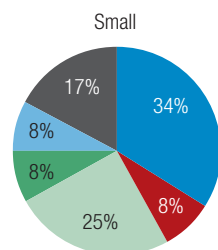
- No obstacle
- Minor obstacle
- Moderate obstacle
- Major obstacle
- Very severe obstacle
- Question did not apply
- Did not know

BREAKDOWN OF POSSIBLE OBSTACLES: Access to Land

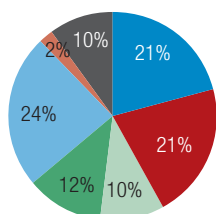
Breakdown by Type of Business



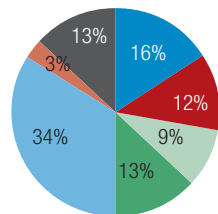
Breakdown by Size of Company



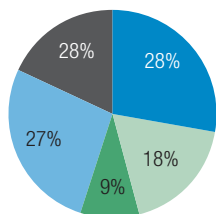
Manufacturing



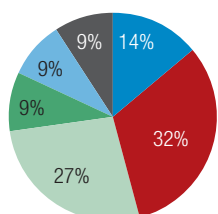
Medium



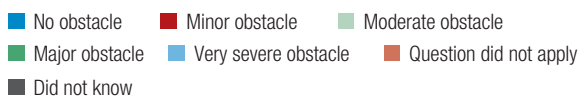
Services



Large

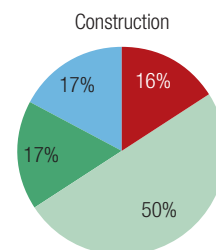


Legend: The color code shows the percentage of respondents in each category stating that there was:

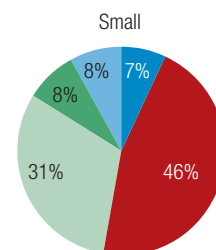


BREAKDOWN OF POSSIBLE OBSTACLES: Crime

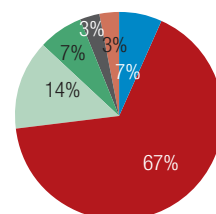
Breakdown by Type of Business



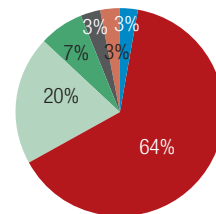
Breakdown by Size of Company



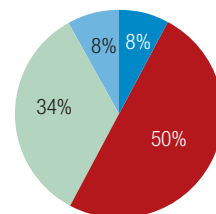
Manufacturing



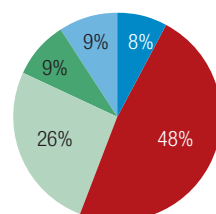
Medium



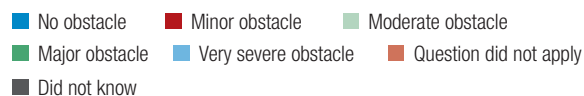
Services



Large

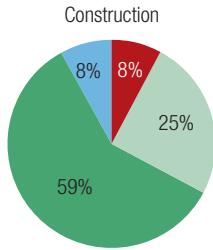


Legend: The color code shows the percentage of respondents in each category stating that there was:

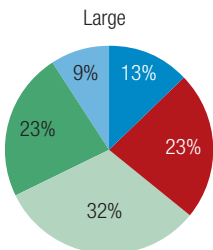
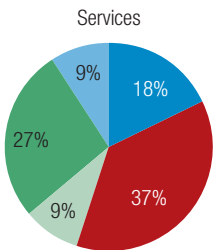
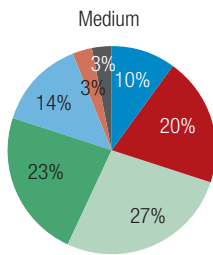
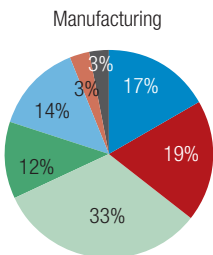
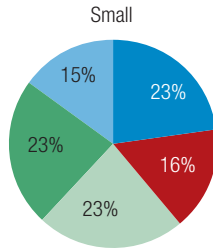


BREAKDOWN OF POSSIBLE OBSTACLES: Tax Regulation

Breakdown by Type of Business



Breakdown by Size of Company

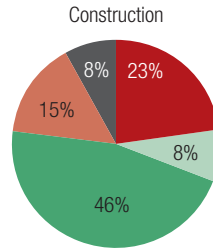


Legend: The color code shows the percentage of respondents in each category stating that there was:

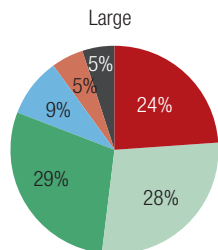
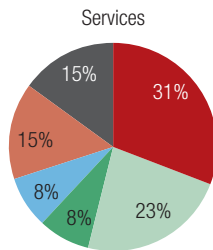
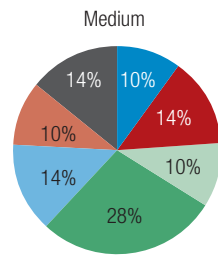
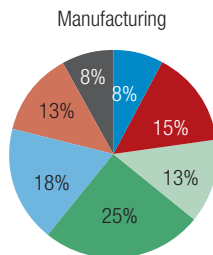
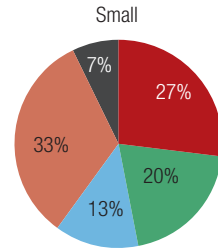
- No obstacle
- Minor obstacle
- Moderate obstacle
- Major obstacle
- Very severe obstacle
- Question did not apply
- Did not know

BREAKDOWN OF POSSIBLE OBSTACLES: Access to Financing

Breakdown by Type of Business



Breakdown by Size of Company

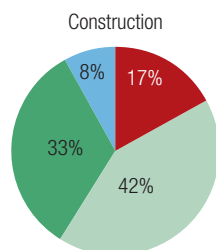


Legend: The color code shows the percentage of respondents in each category stating that there was:

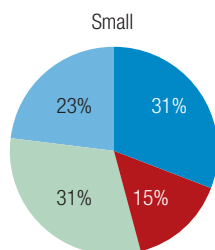
- No obstacle
- Minor obstacle
- Moderate obstacle
- Major obstacle
- Very severe obstacle
- Question did not apply
- Did not know

BREAKDOWN OF POSSIBLE OBSTACLES: Labor Regulations

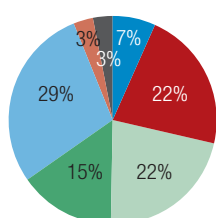
Breakdown by Type of Business



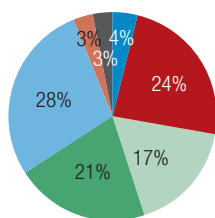
Breakdown by Size of Company



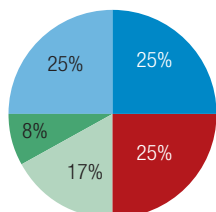
Manufacturing



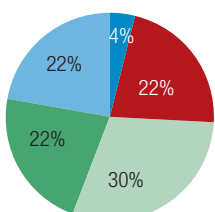
Medium



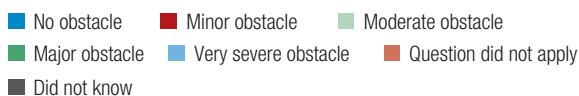
Services



Large

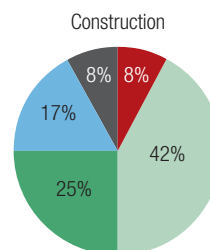


Legend: The color code shows the percentage of respondents in each category stating that there was:

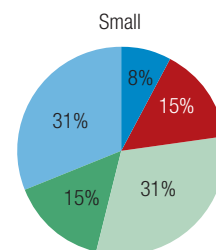


BREAKDOWN OF POSSIBLE OBSTACLES: Inadequately Educated Workforce

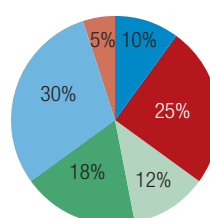
Breakdown by Type of Business



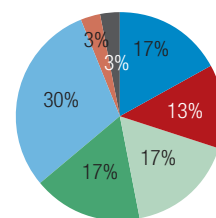
Breakdown by Size of Company



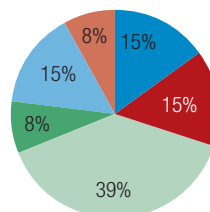
Manufacturing



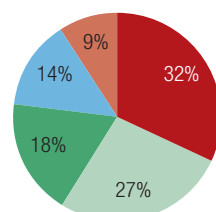
Medium



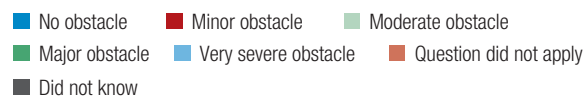
Services



Large



Legend: The color code shows the percentage of respondents in each category stating that there was:





THE WORLD BANK

1818 H STREET, NW
WASHINGTON, DC 20433