

**The Impact of Export Incentives on Its Contribution to Manufacturing Export
growth in Ethiopia**

By

HUSSIEN, Abiy Mohammed

THESIS

Submitted to

KDI School of Public Policy and Management

In Partial Fulfillment of the Requirements

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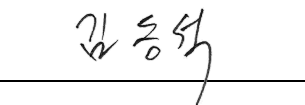
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Abstract

Export incentives have played a catalytic role in encouraging exports in poor countries. However, it is important to recognize the impact of export incentives on manufacturing export growth. The study has examined the effect of manufacturing export incentives on Ethiopian manufacturing export performance. The study aims to shed light on whether there is an impact and to what degree the government's incentives have contributed to the country's manufacturing export value by using time-series quarterly data on manufacturing export incentives, world GDP growth rate, and real effective exchange rates from 2005 quarter 1 to 2019 quarter 4. Three phases of research were carried out, including a review of the trends in the scheme of export incentives and growth of manufacturing exports, a review of the correlation between variables, and subsequently, quarterly time series econometric analysis conducted among the manufacturing export value against the independent variables. The study results showed that Ethiopian manufacturing export growth increased after the implementation of export tax incentives, but manufacturing exports share to the total export is still minimal. This study concluded that export incentives have a positive role in improving manufacturing export growth. It has also been noted that the effect of world GDP growth rate and real effective exchange rate on manufacturing exports are limited to the long run only.

Contents

1. Introduction.....	6
2. Literature Review	9
2.1. Theoretical Framework	9
2.2. Export Tax Incentives and Export Growth	10
2.2.1. Fiscal Incentives.....	11
2.2.2. Financial Incentives.....	12
2.3. Review of Empirical Literature.....	12
3. Data and Methodology.....	15
4. Ethiopian Manufacturing Industry Export Growth.....	17
5. Result and Discussion.....	18
5.1. Export Incentive Schemes of Ethiopia Manufacturing Sector	18
5.2. Trends of Manufacturing Export Growth and Export Incentives	22
5.3. Regression Analysis	25
6. Discussion and Conclusions	31
Appendix.....	33
Table A.1. Share of Export by Incentive Beneficiaries to Total Export.....	33
Table A.2 Government Revenue Forgiven through the Export Incentive	34
References.....	35

List of Tables

Table 5.1 Correlation results among the study variables.....	26
Table 5.2 Augmented Dickey-Fuller Test at First Difference	오류! 책갈피가 정의되어 있지 않습니다.
Table 5.3 Dickey-Fuller test for the predicted error	26
Table 5.4 Engle-Granger test for cointegration	26
Table 5.5 Johansen tests for cointegration.....	27
Table 5.6 Regression result for the determinants of Manufacturing export value.....	29
Table 5.7 Regression result for the determinants of Manufacturing export value.....	30
Table A.1 Share of Export by Incentive Beneficiaries to Total Export	32
Table A.2 Government Revenue Forgiven through the Export Incentive.....	33

List of Figures

Figure 5. 1 Trends of export incentives scheme for Ethiopia	20
Figure 5. 2 Trend of Manufacturing export value.....	22
Figure 5. 3 Share of export by incentive beneficiaries to total export.....	23
Figure 5. 4 Trends in manufacturing Export in Ethiopia (%GDP).....	24
Figure 5. 5 The share of manufactured exports to total export in Ethiopia	25

1. Introduction

Over the last half-century, the world has undergone a trade transition involving a change from inward-oriented policy to outward-oriented trade policy. The importance of trade in global economic growth is significant as we all know. Policymakers have widely agreed that developed countries should follow an additional outward-oriented trade policy and use export subsidies. The Asian success story experience is being held aloft as a blueprint for developing countries to pursue an outward-oriented policy. On the contrary, however, Bhagwati, 1988 observes that South Asian countries are providing several incentives to raise exports by moving from growth strategies focused predominantly on replacing imports to those focused on promoting export.

Countries providing tax incentives may benefit from non-economic benefits from industrial development, creating job opportunities, technology transfer and training, and a rise in tax revenues if they exist in the long run and pay taxes (Gray, 1987). Some researchers have argued that investment decisions are reasonably resilient to tax incentives, and thus indicate that tax policy is an effective method for assessing investment flows (Gruber, 2005). These incentives are intended to lead to higher economic and job growth rates and to decrease poverty levels. In conjunction with exchange rates, the export tax incentive is justified: First, the lowering of the exchange rate, which usually raises export income, but is likely to result in much domestic inflation because, at the same time, the cost of basic imports increased. Second, the motivational impact is proscribed within the case of exports which have a huge import content. Third, incentives are often simpler in targeting specific exported products, particularly rising and value-added export products (Megersa, 2019).

Developing countries have a long history of export incentives to decrease overall export tax burdens, allowing exporters to minimize costs without lowering profit. Benefits like these have taken for various kinds over the years, including tax and non-tax benefits. This covers tax credits, export funding programs, and export facilitation. As well as justifying improving incentives to encourage the export sector investment, export incentives are also politically driven, and their impact on economic distortions is sometimes ignored.

In Ethiopia, there have been attempts to promote exports since the imperial government although, throughout this period, a lot of stress has been given to import substitution over export promotion. Despite the imperial and Derge regimes have taken different measures to diversify the export market and to promote exports, the Ethiopian export sector is dominated by the export of just

certain primary commodities that include agricultural products, primarily coffee, oilseeds, gold, chat, flower, pulses, live animals and hide skins(Oqubay Arkebe, 2018). Since 2002, the government of Ethiopia has been taking significant measures to promote the manufacturing exporter by implementing export trade duty incentive schemes. The main objective of these incentive schemes is to ensure economic development through the industrial growth of the country to realize a transformation into an industrial-led economy, and besides this, to create a conducive environment for manufacturing producers to become competitive within the international and domestic market by providing incentives. Moreover, the Ethiopian government strives to promote exports by introducing new incentives having a direct or indirect impact and motivating investors engaged in export.

The manufacturing sector is still in an early stage in Ethiopia with its proportion of GDP much less than 7%, nor is it a considerable employer. Yet, manufacturing gives future opportunities for the country to achieve some of its development goals. Efficient manufacturing increases will enhance profits and create a demand for agricultural products, offer export tax incentives and it is miles on the heart of the modernization of the economy (Ethiopia: Diagnostic Trade Integration Study (DTIS), 2004). Additionally, the Central Statistics Agency of Ethiopia (CSA) survey reports (2018) explain that export income to the overall income percentage of the medium-size and large-size manufacturing (MLSM) sector decreased from approximately 10 percent in 2005/06 to 4 percent in 2017/18. Only Five Percent of manufacturers competed in the export market in 2019. This shows that the maximum of the exporting companies has emerged as an increasing number of those interested in home marketplaces, suggesting the relative elegance of the home marketplace in evaluation to the export marketplace. The main objective of the paper is to evaluate the effectiveness of export tax incentives on Ethiopia's manufacturing export growth.

Research showed that tax incentives in certain investment sites are not the most important consideration for multinational companies. Elements such as necessary facilities, stability of the political situation, and labor cost and access seem more crucial (Madani & Mas-Guix, 2011). There are still many other instances (e.g. Ireland or Caribbean and South Pacific tax havens) that reveal that tax incentive has played a significant role in encouraging foreign investment. Parys & James, 2010 survey findings show that export-oriented investors react substantially more to incentives than domestic-based investors. This paper examines manufacturing export incentive policy effectiveness or miscarriage by comparing export growth and trying to investigate the role

and association of export incentives on the manufacturing sector of the country. As indicated in different studies, the principles of their studies have been focused on export promotion and foreign direct investment, but not sector-based, and not on manufacturing sector export growth. However, manufacturing sector growth is significant as it can grow faster than sectors that emphasize the exports of primary products.

The results of this research will be significant for Ethiopian government decision-makers, for reforming tax structures, and for investors and the export business community by providing insight into the Ethiopian export incentives and their effect on manufacturing export growth. Investors need to build strategic plans that take into account the long-term influence of their decisions on businesses and the economy. It is important to inform prospective investors and people to promote the promotion and adoption of successful macroeconomic policies. Likewise, the study will also have the benefit to present and indicate the weaknesses and strengths of the export incentive scheme of the Ethiopian manufacturing sector. Furthermore, the study may be an input for the concerned bodies that are working in manufacturing growth (export), administration, and control of export in Ethiopia.

The range of export tax incentives offered in Ethiopia is wide. It includes cost-sharing, decreasing the rate of income tax, sales tax zero-rating, exemptions from duties of export, etc. This study analyzed the impact of export incentives in the manufacturing export growth of Ethiopia within time of 2005 to 2019. This paper investigates whether the incentives have a significant effect on the manufacturing export growth in Ethiopia or not. This question is addressed by examining the correlation between the variables through quarterly-based time series econometric analysis.

The rest of the paper is organized as follows: Chapter 2 presents a review of theoretical and empirical literature; Chapter 3 discussed methodology, including data, variables, and the model. Chapter 4 presented the Ethiopian manufacturing sector, and chapter five presented the results and discussion. The last chapter presented the discussions and conclusions of the paper.

2. Literature Review

This section defines the term “incentive” and reviews the theoretical as well as empirical literature which explains the effectiveness of the export incentive policy. The theoretical review will cover the effect of export incentives on export growth, particularly in manufacturing growth, followed by the related empirical literature on the area of study.

2.1.Theoretical Framework

The term, incentive, is defined as “any tangible benefit given from (or at the direction of) government to particular companies or categories of enterprises” (*Sustainable Tourism : Contribution to Economic Growth and Sustainable Development : Issues Note*, 2013). In some industries or areas, business failures resulted from either too much or too little investment (Barbour, 2005). Incentives, such as the influence of symbolic signaling, and the ability to offset inadequacies elsewhere in the investment program have advantages. Investment incentives are offered in the form of either fiscal relief or cash grants. International experience indicates that in investment decisions, these opportunities play only a minor role (Barbour, 2005).

Export incentives are policies used to encourage companies to export their products. This is a grant from the government to the export company (Krugman & Obstfeld, 2007). Widely used export incentives are direct cash payments per export sale that are often used in developing countries due to their higher cost, duty drawbacks or rebates, export funding, tax exemptions, preferential rates for public services, or interest rates on an export guarantee. Do export incentives increase exports or increase welfare? Different theories provide different answers. There is an elongated trade policy debate in international economics concerning the use of the export incentive. Since we all know that "people will respond to incentives" according to the principles of economic theory. Because rational people make decisions by comparing costs and benefits, they respond to each other on the economic side. The study shows that export incentives raise the value of trade and boost consumer welfare and are considered to be the best policy. Uwaoma & Ordu, 2016 explained incentives for the manufacturing industry serve as a catalyst for industrial growth by growing domestic manufacturing imports and help them make decisions by comparing costs and benefits; thus, they respond to each other on the economic side. There is clear evidence to suggest that tax credits will help draw investment and build employment in developing countries (Garsous et al., 2017).

However, the neo-classical economic theory argues that giving tax benefits to one group of investors rather than to another violates one of the central tenets of a healthy tax system of horizontal equity. This imbalance distorts the demand signals facing potential investors and contributes to the inefficient redistribution of resources (Uwaoma & Ordu, 2016). The most common reason for special incentives is that market failures surround the decision to invest in some sectors and/or locations justify interference by the government. When fiscal policies are introduced in developed countries, different studies give various reasons to presume the result. Firstly, A. Estache et al., 1995 stated that limited fiscal flexibility would weaken the effect of tax and holiday rebates and the repeated use of tax incentives may result in complicated, costly, and largely evading capital taxes, resulting in small benefits and significant welfare costs. Second, Klemm, 2010 also noted that the cost of incentives is wide from any direct loss of income due to distortion of the economy, administrative expenses (such as the control of fraud incentives), and behavior of rent-seeking, including the possibility of corruption. Third, Van Parys & James, 2010 explain that fiscal incentives in countries with low public-good endowments. This paper evaluates the impacts and efficiency of tax incentives and argues in favor of their arguments.

Most markets do not fully fulfill perfect competition. This assumption is phrased as a market imperfection or distortion. It is argued in international trade policy analysis that the presence of imperfections or distortions in trade policy can be used to raise national welfare considered as non-friendly to welfare in a perfectly competitive market. This has given rise to a lot of protection or support intervention arguments like the argument of infant industry, optimal trade theory, and strategic trade theory (Suranovic, 2010). The infant industry argument is an argument for protection or support or intervention to assist the infant industry while they compete with firms that are more established and equipped with information and knowledge. There are two infant industry arguments. The infant industry argument on the presence of external markets and capital market imperfections is asserted by most international economic books or literature (see Krugman & Obstfeld, 2007; Feenstra, 2015). In general, there is a list of reasons that range from perfect competition to imperfectly competitive markets formed for and against export incentives. The reasons given for the import substitution strategy remain, facing the same flow and criticism.

2.2.Export Incentives and Export Growth

Governments provide export incentives to keep domestic products globally competitive. According to Hibbert, 1990, the core purpose of export incentives is to increase the overall

country's economic growth by increasing the country's total merchandise exports and by diversifying the structure of these exports, not only in terms of goods but also in terms of the export markets/destinations. Sometimes countries resort to different incentives systems and put different treatments for their exporters to overcome international trade barriers to exports. Such barriers include the existence of high tariffs and other related costs for producing exportable products. According to TOKARICK, 2007, reducing import restrictions in the form of tariffs is a policy alternative that both poor and rich countries implement to increase incentives to export. Export trade incentives can be broadly grouped into three categories such as fiscal incentives, financial incentives, and non-monetary incentives. Each of these incentives is discussed in the ensuing paragraphs.

2.2.1. Fiscal Incentives

Fiscal policies are dealing with government spending and tax policies. The burden of mobilizing resources to finance essential public infrastructure programs must be focused on how the government can raise adequate revenues for its development activities. In the long term, the government can only rely on the effective and fair collection of taxes as a more sustainable means of collecting revenue to achieve its growth targets (Todaro & Smith, 2003). However, the key issue remains whether policymakers in developed countries have been able to boost spending to the point of rising economic growth rates and enhancing the well-being of their people by providing massive tax benefits. Studies in both developed and emerging countries show that tax benefits are an expensive and wasteful way of promoting investment. Most studies indicate that the most important determinants of FDI in developing countries are long-term factors concerning the viability, market size, and market demand (Kurul & Yalta, 2017).

It includes all measures taken to reduce disincentives to export efforts caused by duty or other charges on exports, duties on imports required for the production of exports; duties on imports of materials and components required for the production of manufactured goods as well as a duty on production that add unnecessary costs to the selling price of export products (Hibbert, 1990). This group includes incentives including tax concessions on export earnings; exemption/reduction of export duties; accelerated methods of depreciation for the export industry; temporary admission of materials incorporated in export goods; exemptions, rebate or refund of sales taxes; purchasing tax and internal taxes; and adjustment of export tariffs.

According to Oyejide, 2007, fiscal incentive schemes such as duty drawback and exemptions, manufacturing under bonded warehouse and establishment of export free zones are considered “compensatory” which are targeted to eliminate disincentives raised from the economy’s investment, trade, and regimes of exchange assuring access to inputs on world market rates are equitable to foreign competitors. However, the duty-drawback schemes that countries employ in the attempt to remove export bias due to intermediate input tariffs imported typically do not eliminate the bias. TOKARICK, 2007 stated that this is justified based on the ground that incentives are costly to administer, reduce government revenue, lead to increases in distorting taxes which might discourage exports; and the drawback does not reverse the decrease from increased tariffs of the relative export price.

2.2.2. Financial Incentives

These are designed to make export businesses attractive through compensation for price disadvantages resulting from internal regulations that are not oriented towards export promotion (Hibbert, 1990). Such categories of incentives include direct/indirect cash subsidies, export credit facilities for pre-shipment and post-shipment transactions, special foreign exchange allocation, and remission of the tax normally chargeable on profits. According to Demircuc-Kunt & Refik, 1991 and Harrold & Bhattasali, 1996 financial access through affordable interest rates enables exporters to eliminate their financial constraints. Oyejide, 2007 described financial incentives as complementary and autonomous measures to provide export incentives that are not necessarily linked to any disincentive associated with trade, investments, and exchange rate. Furthermore, Banerjee & Newman, 2003 suggest that financial support helps remedy for distortions in allocation caused by inadequate financial markets and can thus increase export development.

2.3. Review of Empirical Literature

The most convincing evidence that supports incentive is that at least one of the incentive facilities was used for many manufactured exports within successful Asian economies. These countries have provided various incentives including preferential financing, subsidies for promotion, tax incentives, subsidized infrastructure, and incentives for foreign investment (Yanagihara & Sambomatsu, 1997). Burgess, 1995 and Weiss, 2005 have indicated four elements for the successful export push strategies in Asian countries: access to imports at world prices, provision of export financing to encourage the expansion of new export activities, market penetration strategy through the export subsidy, and the creation of international trading companies. These

countries have pursued result-oriented policies; If over a relatively short period, a system did not provide results in the form of increasing exports, it was canceled promptly. Second, exports established results criterion for credit allocations, supported worldwide standards, and accelerated technology diffusion (Oyejide, 2007).

In Africa, countries endeavored to mimic successful Asian countries. For instance, in Kenya, the government provided credit through commercial banks and specialized credit institutions, export incentive provisions such as the Export Compensation Scheme up to 1989, the Manufacturing Bonded Warehouse introduced in 1989, the export promotion zone introduced in 1990 and the import duty exemption schemes for exporters who did not use the scheme of export compensation were introduced (Harrold & Bhattasali, 1996). In Zimbabwe, the government has introduced schemes such as the inward processing rebate scheme (similar to under-bond manufacturing) and the duty drawback scheme. In Nigeria, government export aid and programs are largely based on government assistance and fiscal policies that included incentives such as currency retention schemes, under-bond manufacturing, duty drawback, credit for export, insurance scheme, and an export development fund (Wangwe, 1996).

However, some of the studies note that the efforts of incentive policies did not bear as much fruit either due to the complexity of procedures, long delays in getting some of the incentives, limited access for incentives, or poor implementation of incentive policies and programs (Harrold & Bhattasali, 1996; Opara et al., 2010). Similarly, Oyejide, 2007, confirmed that the implementation of economic-wide incentive schemes in many low-income countries was defective because the required institutions, instruments, and mechanisms were inadequately developed. According to Harrold & Bhattasali, 1996, in countries, including Africa, where Money and financial markets are not well-developed, but highly segmented. Without a distinct export financing system, exporters have no neutral status. These disadvantages of exporters concerning both global competitors and domestic credit-ration beneficiaries, making it tougher to maximize developing countries' export capacity.

The majority of export incentive literature is related to export performance and export-induced factors. However, the subject of competitiveness among exporting industries in various nations cannot be dealt with in all respects, especially in the case of developing countries where such incentives operate as "breathing" for exporting sectors. When other competitive countries compete for the same export markets, the issue of export incentives becomes more complex,

offering many export incentives as well as because export incentives have a positive effect on exporting goods, while at the same time leading the government to lose income. In the previous research Bhagwati, 1988 and Gebreyesus & Kebede, 2017 explained in their research papers about export promotion strategy as a kind of export incentive contributing to export; however, this research has not focused on the relationship and role of export incentives particularly in manufacturing export growth. Furthermore, previous research on tax incentives in African countries has found that tax incentive schemes do not actually improve the flow of FDI to countries and thus do not perform as expected. Many developed countries are unable to collect sufficient taxes to fulfill their budget income needs and to invest in infrastructure development programs that will boost their economies. Although many policymakers are sensitive to the fact that they are losing more money as a result of reward schemes, many are sluggish or hesitant to adjust their tax policies for the best practices and plug revenue gaps in the economy as a result of stronger competition between advanced countries for investments.

In the light of the above, this study contributes by concentrating on the relationship and role of export incentives for the growth of export in the manufacturing sector. In addition, it will try to determine the response of each major type of export incentive and macro-economic policy variables such as manufacturing export incentives, world GDP growth, and effective exchange rate deficit aspects to meet the objectives of manufacturing export growth. In addition, to the best of the researcher's knowledge, few analytical studies have been undertaken so far that indicate the relationship between incentives and manufacturing export growth in Ethiopia. This study is therefore intended to extend the literature in this area.

3. Data and Methodology

The paper focuses on manufacturing sector export growth because the main objective of the manufacturing export incentive is to ensure economic development through the industrial growth of the country via transformation into an industrial-led economy for the manufacturing sector to become competitive in the international market. But the performance of the Ethiopian manufacturing sector has showcased the slow manufacturing output growth, despite the government implementation of different export trade duty incentive schemes. To find out the effect of export incentives on manufacturing growth, this paper used secondary data from four government ministry offices of Ethiopia and one international institution, namely, Ministry of Revenue (MOR), Ministry of Trade and Industry (MOTI), National Bank of Ethiopia (NBE), Development Bank of Ethiopia (DBE), and International monetary fund (IMF). The quarterly time series data from 2005 to 2019 for each variable is employed. Additionally, the study also reviewed government official documents, including proclamations, directives, and other documents describing Ethiopia's export promotion policies and strategies.

The study uses a three-stage analysis that will be carried out including the graphical analysis of the trends of the Ethiopian manufacturing export incentive scheme and manufacturing sector exports growth by an empirical examination. Secondly, this paper uses the correlation examination among the variables in the data set, and thirdly, the time-series econometric analysis is conducted. The time series econometric analysis is used to check the impact of export incentives on manufacturing export growth in Ethiopia over the study period. Regression of the manufacturing export value against a variable that collectively captures the export tax incentive. Diagnostic test results have been used to evaluate the stationarity of the variable and to check for the existence of co-integration among the series.

One dependent variable and three independent variables were used for this study. The dependent variable of the study was manufacturing export growth, which is defined as the export value for the manufacturing sector expressed in terms of dollars (USD) and was collected from MOTI. This export tax incentive, real Global GDP growth, and the real effective exchange rate are believed to affect the dependent variable. An export tax incentive scheme is the aggregate monetary incentive provided to the manufacturing export under a duty drawback scheme,

vouchers scheme, bonded exports factory scheme, manufacturing warehouse scheme, bonded inputs supply warehouse scheme, or an industrial zone scheme. This data was collected from the MOR database. Data related to the global GDP growth rate is collected from the IMF while the real effective exchange rate (REER) index is collected from the Ethiopian Development Research Institute (EDRI) and NBE.

The analytic model has been formulated assuming that the effect of export incentives on the dependent variables is carried out in a production function framework as is as follows:

$$MVAL = f(EXTI, RGDP, REER) \text{ ----- (3.1)}$$

Where, the MVAL is the manufacturing export value of the country in USD; EXTI is the amount of the export tax incentive scheme; RGDP is the world real growth domestic product (GDP), and the REER is the export weighted real exchange rate index. Therefore, from the equation (3.1), the following econometric model can be derived to examine the effect of the export tax incentive on manufacturing growth (export):

$$M_VAL = \alpha + \beta_1 EXTI + \beta_2 RGDP + \beta_3 REER + e \text{ ----- (3. 2)}$$

Where, MVAL is the amount of the manufacturing export value in USD at constant prices; EXTI is the amount of export tax incentive in E; RGDP is the world real GDP growth rate; REER is the export weighted real exchange rate index; α is a constant term, and e is the error term.

4. Ethiopian Manufacturing Industry Export Growth

Ethiopia has been one of the most rapidly rising economies in Africa since the 2000s. However, the industrial sector of Ethiopia is yet far from being a motor of growth and structural transformation. In employment generation, exports, output, and inter-sectoral links, the manufacturing sector has a minimal role. The structure and performance of the manufacturing sector in Ethiopia in some ways reflects the broader sub-Saharan countries' experience (Bhorat et al., 2019). There have been two different features in Ethiopia's manufacturing sector: firstly, poor industrialization in terms of sector GDP share, exportation revenues, industrial intensity, and competitiveness. Secondly, small enterprises and resource-based sectors (especially food industries) dominate the industrial structure and are cluster around the capital (Oqubay Arkebe, 2018). Data from the past 25 years and the evidence for the paradox of slow development in manufacturing industry outputs (particularly manufactured export items) despite strong industrial policy measures further analyzes Ethiopian manufacturing structure and performance analysis in the last 25 years. While production performance was unimpressive, there is an indication that a tipping point could have happened in the mid-2010s. The productive sector could have begun to emerge from the doldrums, there are some positive signs (Oqubay Arkebe, 2018).

Ethiopian export promotion depends on the country's Industrial Development Strategy (IDS). One of the IDS' key concepts is that sustainable and rapid industrial growth can only take place if the industry is internationally competitive (Gebreyesus & Kebede, 2017). Additionally, Strategy for encouraging high-value agricultural exports (e.g., horticultural goods and meat) and labor-intensive industrial products such as textiles and clothing, leather products (Mulu Gebreeyesus, 2013). In some cases, incentives are defensive, discouraging associate degree existing local industry from an effort to gather incentives offered elsewhere. Incentives may also be proactive as states attempt to diversify their economies (Oqubay Arkebe, 2018).

5. Result and Discussion

5.1. Export Incentive Schemes of Ethiopia Manufacturing Sector

Ever since the overthrow of the military regime in 1991/92 Ethiopia has been undertaking a series of economic reforms adopting structural adjustment programs (SAP) under the support and supervision of the World Bank (WB) and the International Monetary Fund (IMF). Under this new policy regime, the central element is a market-oriented strategy as well as recognizing the major role of export that is export can play in the Ethiopian economic growth as part of its core strategic development which is ADLI (agricultural development led industrialization) adopted export promotion strategy (Welteji, 2018; Nega & Moges, 2012). Accordingly, numerous initiatives and strategies have been developed to increase and diversify the export and investment of countries in the major exporting and potential exporting regions, ranging from macro-economic to sector-specific policies.

The government of Ethiopia provides various export and investment incentives, particularly to non-traditional exporters, to boost and increase exports. Frequently used incentives offered to exporters are export trade duty incentive schemes and export credit guarantee schemes. In addition to export incentives, the government also provides different investment incentives such as an income tax exemption, customs duty exemption, and the granting of loans for up to 70% of the investment required while only 30% of the investment is made by the investor. Moreover, through illuminating bureaucratic processes, the government has made life easier for those who want to attract investment and export trade licenses. It is remarkable that it now takes a maximum of three hours for the Ethiopian investment commission to acquire a license to supply all the necessary documentation.

The Export Trade Duty Incentive Scheme was developed in Ethiopia in July 2002. This scheme refunds the duty paid on the raw materials used for the manufacture of outputs for export and fulfills certain requirements. According to the Ethiopian Export Trade Duty Incentive Schemes proclamation (2012) No. 768/2012, there are six kinds of schemes stated in the proclamation: the duty drawback scheme, the bonded export factory scheme, the voucher scheme, the bonded input supply warehouse scheme, the manufacturing warehouse scheme, and the industrial zone scheme (this scheme has still not been practically implemented yet). Based on current incentive

beneficiary data, more than 90% is under the voucher scheme while the remainder is split between the duty drawback and other bonded schemes.

The duty drawback incentive scheme (DD) is one of the export trade duty incentive schemes, which provides a 100% refund for indirect taxes and duties paid on imported or locally manufactured inputs used for the manufacture of exported goods. This duty incentive scheme benefits any person or organization engaged in the export or re-export of products (the reason for re-export may be due to injury, short delivery, or wrong specification) eligible under certain conditions. These requirements are that, first, within one year, the product manufactured using the imported or locally generated input should be exported and the refund duty should be at least 1000 birr. Second, exporters should send any supporting documents and declare them upon export to the customs commission. The document includes the exporter's identity, the type of duty paid receipts, and the amount of input used. Thus, the exporters satisfying the conditions referred to above are entitled to obtain a refund of the duty paid on the input used. Since the execution of the duty is expected to be paid by the MOFED according to the decree, this duty is currently carried out by the Manufacturing Incentive Directorate in the MOTI along with the Ethiopian Customs Commission. The sum to be refunded is calculated using the input-output coefficients to be prepared by the MOFED unless this body supplies the input-output coefficients to be submitted by the exporters as one of the supporting documents referred to above. It will be amended and will be included.

Under the voucher scheme (VS), a document called a voucher that has a monetary value equivalent to the amount of taxes and duties payable for input that the exporter acquires is given to an individual or organization. Instead of a voucher being given, there is no reimbursement for domestic manufactured inputs used to produce exported goods, unlike a duty drawback. Several requirements are requiring all exporters who appear to be the beneficiaries of the scheme thoroughly filled in. A critical requirement is that a qualified certificate prepared by the MOTI should be given to the person or organization. See Proclamation 246/2001 for specifics of the various conditions.

The bonded export factory scheme (BEF) involves those who have been engaged exclusively in the manufacture of export products, who have obtained a certificate of eligibility from the MOTI, and a manufacturing plant meeting the Ethiopian Customs Commission criteria. In this scheme,

the raw materials are entered directly into the factory where manufacturing takes place without paying taxes and custom duties, and the recipient can export manufactured goods within one year after manufacturing, otherwise, the recipient is subject to payment of taxes and duties plus 50% of the taxes and customs duties as a penalty. The method of control of this scheme is that the factory compound is subject to customs control; any operation to be brought into or taken out of the factory is carried out with the approval of the customs authority. This scheme is the latest to be adopted by the 768/2012 proclamation as an export tax incentive.

The bonded manufacturing warehouse scheme (BMW) is the fourth kind of scheme, which allows the exporter to have a warehouse that meets the customs authority's norm. In this warehouse, whatever raw material is required for the production of exported products is purchased and processed, and locked up by the two parties, the person for the manufacturing exporter industry and a person from the Ministry of Revenue (government official). The exporter may then remove this raw material for use at the request of that material when two parties are present.

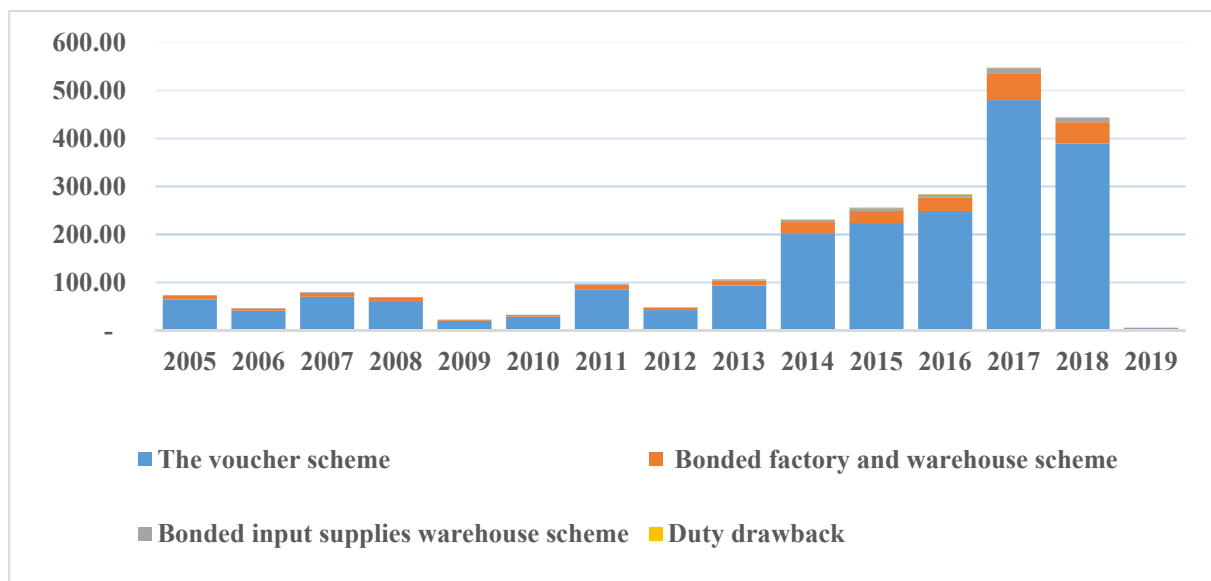
The bonded input supplies warehouse scheme (BISW), for persons who have obtained a certificate of eligibility from the Ministry of Trade and Industry and who have warehouses meeting the requirements set by the Ministry of Revenue, is the last system that has been properly implemented. Input supplies purchased by the recipients of the bonded input supply warehouse scheme shall be shipped, under customs control, from the customs post office to such warehouses without being subject to duty payment. Input supplies imported under the warehouse scheme for bonded input supplies can supply their inputs to producers within a year. If it is not delivered to a producer within one year of being transferred to an input warehouse for bonded supplies, the beneficiary shall be obliged to pay 50% of the customs duty in addition to the customs duty payable on input supplies provided, however, that the Commission of the Ethiopian customs may extend that period for one additional year, taking into account the nature of the inputs. Proclamation No. 768/2012 implements this method.

The input can also be used and exported within one year, as in the case of both schemes here. Consequently, the beneficiaries of this program are not licensed to use the voucher system. Furthermore, a manufacturing exporter who does not meet or complete any of the requirements listed under these systems appears to lose the privileges and will be expected to pay the duty

accordingly. In the case of a duty drawback, no refund will be made, but in the case of a voucher and a bonded warehouse manufacturing system, the exporter will be required to pay interest on the tax and duty. In addition, manufacturing exporters who in some way exploit and abuse incentives are subject to court discipline to the penalty. For instance, if an individual exporter supplies a false document or refuses to supply the true document, the exporter is liable to imprisonment and fines. However, due to the credibility of the exporter, the duration of imprisonment and the duration of the fine vary. Another scenario may be that the sale of raw material brought free of duty for export production is subject to imprisonment and fine payments.

In June 2004, in addition to the schemes offered under the export trade duty incentive for exporters, the government of Ethiopia recognized the need for various foreign experts, issued a cost-sharing directive to share their costs with salaries paid to foreign experts. Figure 5.1 shows that, since its launch, the trend of revenue forgone through the incentive scheme for the manufacturing sector has had a growing pattern. In 2005, it was over 64.7 million U.S. dollars and reached over 157.1 million US dollars in 2017. The amount of revenue foregone in the form of drawbacks during the entire study period is over 6.11 million U.S. dollars with a total amount of revenue of over 4.88 million U.S. dollars. The least functional export trade incentive scheme in Ethiopia is the bonded manufacturing warehouse scheme as there are very few beneficiaries who have been entitled to this scheme in the entire study period.

Figure 5.1 Trends of the Export Incentive Schemes of Ethiopia



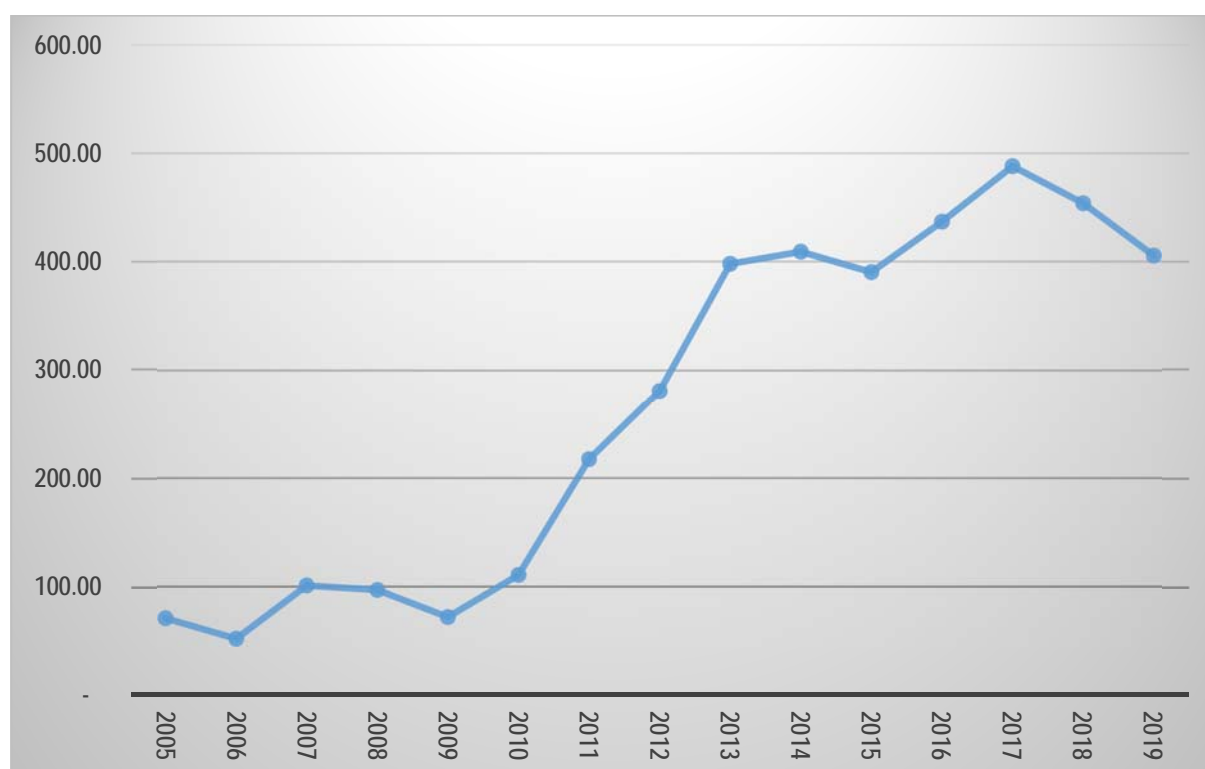
Source: Ethiopian Customs Commission, 2020

5.2. Trends of Manufacturing Export Growth and Export Incentives

Figure 5.2 illustrates that despite variations over the study period, the trend of manufacturing export growth in the country shows a distinct pattern. As can be seen, the country's manufacturing export growth has increased from 70.94 million USD in 2005 to 405.59 million USD in 2019, an increase of 22.31% on average annually. The maximum value of manufacturing exports in 2017 was USD 487.54 million, and the lowest value was USD 52.11 million in 2006. On the other hand, the estimated average manufacturing value-added share to GDP during the period is only 4.5%, and the highest share reported in 2017 accounting for 6% and the lowest share is 3%.

Figure 5.2 Trend of Manufacturing Export Growth

(Unit: Million USD)

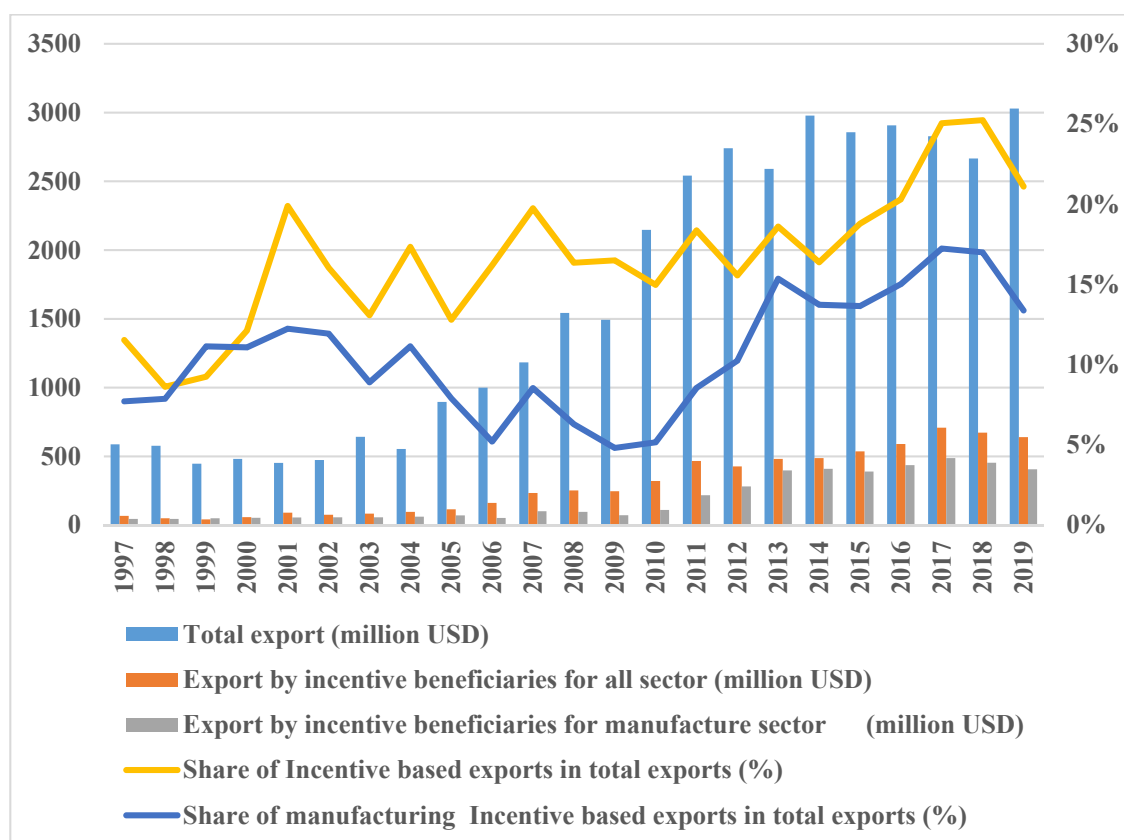


Source: MOTI, 2020

After the implementation of export trade duty incentives at the beginning of the 2000s, incentives and exports have started to be used by exporters in compliance with the principles and regulations set out in the proclamations. Although the proclamation has its drawbacks, the recipients of incentives have led to the exports share increase. As can be seen in Figure 5.3, the exports share by the beneficiaries of export duty incentives in the country's overall exports has been up and

down since the introduction of the incentive scheme. Before applying export incentives, the average share of total exports for all exporters was 13.49%, and only the manufacturing sector was 10.25%. Whereas, after export duty incentives were properly functional in 2005, the average export ratio of exporters using export trade duty incentives scheme increased significantly, reaching 18.40% for all export incentive beneficiaries; however, the share of manufacturing sector export incentive beneficiaries was almost equal to 10.81% despite the impact of the economic crisis in 2008 up to 2010. It can therefore be deduced that export incentives have led to an increase in the share of export incentives provided to users of export trade incentives, but that share is not quite satisfactory as many exporters have not used export incentives. Excessive data specification criteria and monitoring systems by government authorities that are backward and manually oriented are the reasons for the inability of exporters to efficiently use incentives, creating an obstacle to the use of incentives.

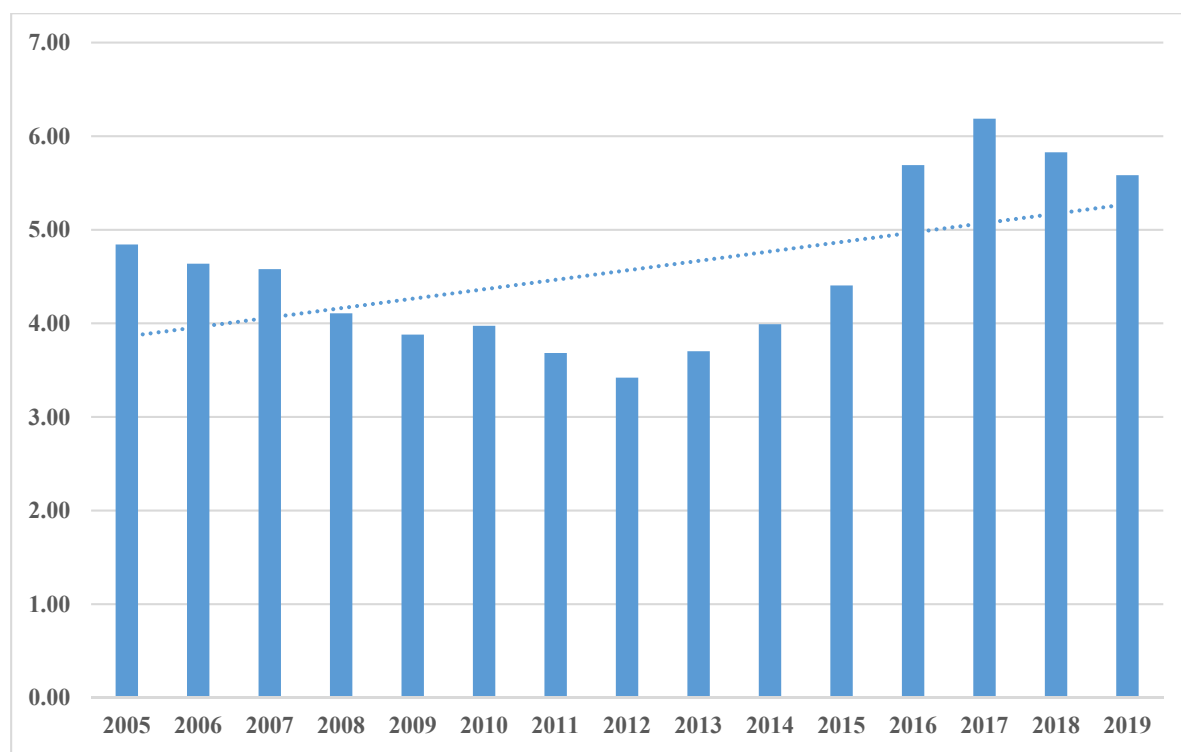
Figure 5.3 Share of Export by Incentive Beneficiaries to Total Export



Source: MOR, MOTI, and the author's compilation.

As of 1990, the rise in the share of exports of goods and services to GDP (the percentage of GDP) in Ethiopia was 4.65%. Over the past 25 years, its highest value was 18.33 in 2004 while its lowest value was 2.58 in 1992. As can be seen from Figure 5.4, 4.56 % is the average level of the manufacturing value added to GDP during the study period. When we compare the average percentage of exports to GDP before and after the implementation of proclamation no.249/2001 on export duty incentives, it can be understood that after the implementation of incentives, the average percentage of exports to GDP is greater than the average percentage of exports to GDP before the adoption of incentives, which is 7.3 %. Therefore, it indicates the introduction of this export incentive scheme through the above proclamation contributes to the growth of exports which in turn contributes to the growth of the share of exports in the GDP of the country.

Figure 5.4 Trends in Manufacturing Export in Ethiopia (%GDP)

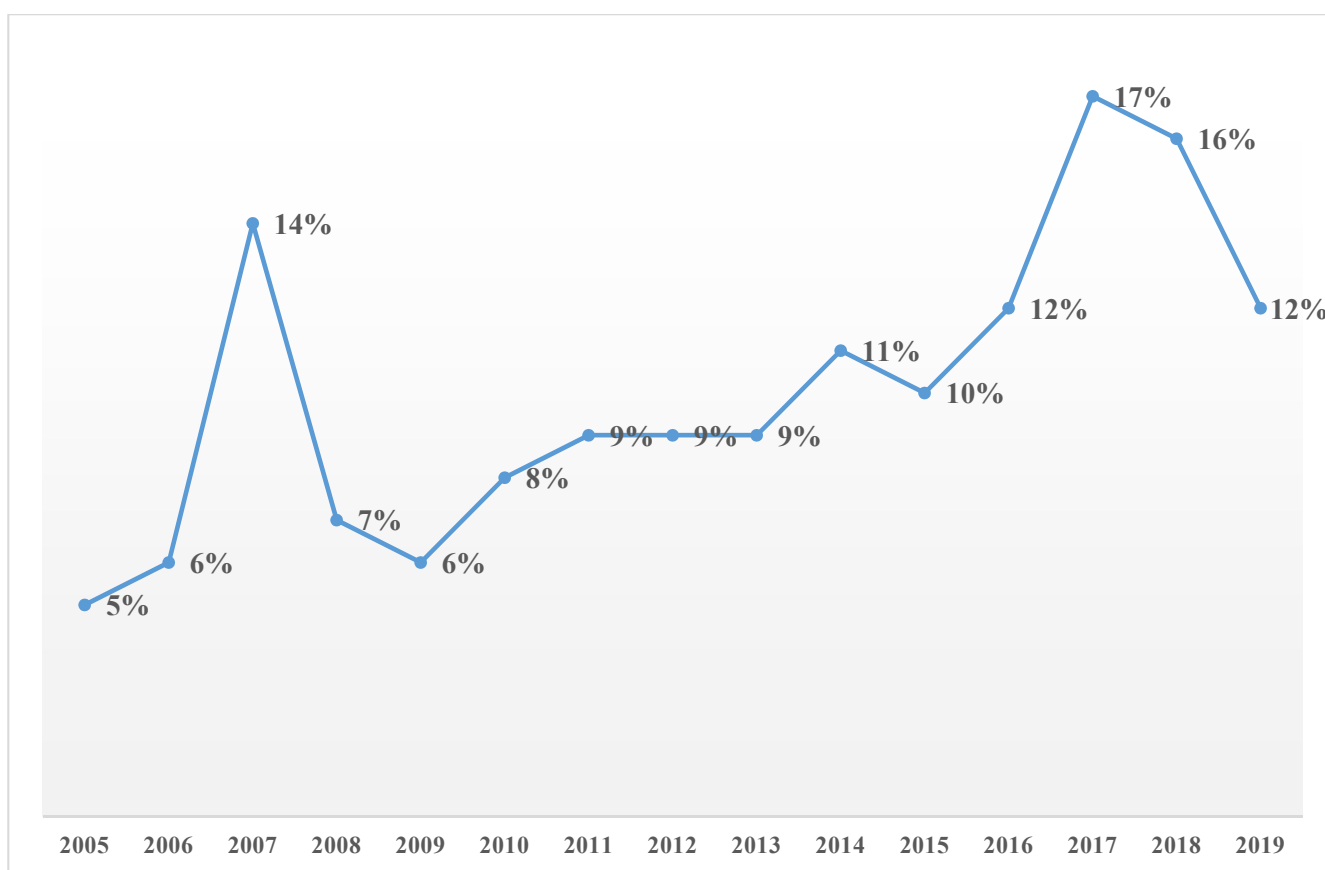


Source: MOTI, 2020

Ethiopia exports predominantly primary goods, mostly agricultural products. The level of the value-added manufactured export item is very minimal. The trade liberalization policy the country pursues allowed the establishment of different private firms that are engaged in the export of semi-finished and finished products including leather products, garment, and textile products, steel products, and Agro-processing products. However, the contribution of these items to export

earnings is insignificant compared to the traditional export items. Figure 5.5 shows the trend of manufactured export performance from 2005 to 2019. As illustrated, with an average share of 10 %, the share of manufacturing exports from overall merchandise exports is tiny. The share of the value of manufacturing exports in the country's GDP is very small, not exceeding 6%. This illustrates that exports from the country are highly dependent on non-manufactured/primary commodities.

Figure 5.5 The Share of Manufactured Exports to Total Export in Ethiopia



Source: National Bank of Ethiopia, 2020

5.3. Regression Analysis

As depicted in Table 5.1, the manufacturing export value has a strong positive correlation with the export tax incentive (EXTI), a positive correlation with the real effective exchange rate (REER), and the world GDP growth rate. This implies that while the strengthening of manufacturing export incentives to the manufacturing export is significantly correlated with increased manufacturing export products, the share of manufacturing export earnings to world GDP growth is marginal. Export tax incentives have a positive correlation with the exchange rate

(REER) and the world GDP growth rate, and this indicates that improved export tax incentives have led to a weak positive interaction with improvements in world GDP growth and the exchange rate.

Table 5.1 Correlation Results among the Study Variables

	MVAL	EXTI	RGDP	REER
MVAL	1			
EXTI	0.705595903	1		
RGDP	0.175038987	0.27742253	1	
REER	0.613433874	0.44043222	-0.46895361	1

As explained by Gujarati, 2003, if its variance and mean are constant over time, the time-series data have to be stationary and the covariance between the two time periods depends on distance or lag. Therefore, the stationarity of the variables is tested using Augmented Dickey-Fuller (ADF) approach, and the results in table 5.2 show that all variables are stationary at first difference. As shown in table 5.3 and 5.4, the Dickey-Fuller test for the predicted error and the Engle and Granger test for the accurate critical value is conducted. The study also conducted the Johansson system co-integration test, as shown in Table 5.5, and it was found that the model MVAL has co-integrating equations ($P=0.05$). The existence of co-integration among the series suggests that variables have a long-run relationship and calls for the error correction model (ECM) to estimate short-run relations.

Table 5.2 Augmented dickey fuller Test at First Difference

Variable	Test Statistic	Dickey-Fuller critical value			the p-value for Z(t)
		1%	5%	10%	
dfMVAL	-6.836	-3.569	-2.924	-2.597	0.0000
dfEXTI	-7.210	-3.569	-2.924	-2.597	0.0000
dfRGDP	-4.060	-3.569	-3.569	-2.597	0.0011
dfRGDP	-3.762	-3.569	-3.569	-2.597	0.0223

Table 5.3 Dickey-Fuller test for the predicted error

Dickey-Fuller test for unit root Variable: error		Number of obs = 58 Number of lags = 0		
H0: Random walk without drift, a = 0, d = 0				
	Test Statistic	Dickey-Fuller critical value		
		1%	5%	10%
Z(t)	-5.745	-2.617	-1.950	-1.610

Table 5.4 Engle-Granger test for cointegration

Engle-Granger test for cointegration		N (1st step) = 60 N (test) = 59		
	Test Statistic	1% critical value	5% critical value	10% critical value
Z(t)	-5.745	-4.961	-4.290	-3.954

Table 5.5 Johansen Test for Co-integration

Johansen tests for cointegration

Trend: Constant

Number of obs = 58

Sample: 2005q3 thru 2019q4

Number of lags = 2

Maximum			Trace		Critical value	
rank	Params	LL	Eigenvalue	statistic	5%	1%
0	20	-519.62194		31.8801*1*5	47.21	54.46
1	27	-512.8795	0.20745	18.3952	29.68	35.65
2	32	-507.66824	0.16448	7.9727	15.41	20.04
3	35	-504.41457	0.10613	1.4654	3.76	6.65
4	36	-503.68189	0.02495			

Maximum			Eigenvalue		Critical value	
rank	Params	LL		Maximum	5%	1%
0	20	-519.62194		13.4849	27.07	32.24
1	27	-512.8795	0.20745	10.4225	20.97	25.52
2	32	-507.66824	0.16448	6.5073	14.07	18.63
3	35	-504.41457	0.10613	1.4654	3.76	6.65
4	36	-503.68189	0.02495			

The regression output in Table 5.6 shows that export tax incentive has a statistically significant positive long-run impact on manufacturing export value. However, the real GDP growth has a negative non-significant impact in the long run. This reveals that a unit increase in incentives would lead to an increase in the manufacturing export value by a factor of 1.091557. The 1% increase in real-world GDP growth will increase the export value by a factor of 1.062318 in the long run. As seen in the table, the real effective exchange rate (REER) also has a statistically significant positive long-run effect on the value of manufacturing exports. This means that a stronger Ethiopian birr is affecting the export manufacturing sector. Export tax benefits have a positive long-term effect on the value of exports in Ethiopia. In general, manufacturing export incentives explain much of the change in the export performance of the country over the study period.

Table 5.6 Results for the Determinants of the Manufacturing Export Value

Source	SS	df	MS	Number of obs	=	60
				F(3, 56)	=	42.39
Model	67755.205	3	22585.0683	Prob > F	=	0.0000
Residual	29835.8912	56	532.783771	R-squared	=	0.6943
				Adj R-squared	=	0.6779
Total	97591.0962	59	1654.08638	Root MSE	=	23.082

MVAL	Coefficient	Std. err.	t	P> t	[95% conf. interval]	
EXTI	1.091557	.3866302	2.82	0.007	.317044	1.866071
RGDP	11.32731	2.90934	3.89	0.000	5.499205	17.15542
REER	1.062318	.1773195	5.99	0.000	.7071048	1.417532
_cons	-140.5456	27.20474	-5.17	0.000	-195.0433	-86.04796

The long-term determinants of the manufacturing export value by independent variable have been presented. Here the regression output is determined for the short run. As shown in Table 5.7, a change in the export tax incentive has a statistically significant positive impact on manufacturing export growth while both changes in the world GDP growth and the real exchange rate have a negative and non-significant impact on the manufacturing export value in the short run.

Table 5.7 Result for the Determinants of the Manufacturing Export Value

Source	SS	df	MS	Number of obs	=	58
Model	630.637252	4	157.659313	F(4, 53)	=	7.10
Residual	1176.90566	53	22.2057671	Prob > F	=	0.0001
				R-squared	=	0.3489
				Adj R-squared	=	0.2998
Total	1807.54291	57	31.7112791	Root MSE	=	4.7123

D.MVAL	Coefficient	Std. err.	t	P> t	[95% conf. interval]	
EXTI D1.	.7160585	.1470685	4.87	0.000	.4210764	1.011041
RGDP D1.	-.9099234	1.406702	-0.65	0.521	-3.73141	1.911563
REER D1.	-.2365486	.1502423	-1.57	0.121	-.5378966	.0647993
error L1.	-.0017097	.0829439	-0.02	0.984	-.1680742	.1646547
_cons	1.7357	.661262	2.62	0.011	.4093768	3.062024

In general, in line with A. Fanta, 2013 who found financial and fiscal incentives, both the long-run and short-run export value and volume are affected. Based on the above empirical analysis results on the effect of incentives on manufacturing growth in Ethiopia, the existence of manufacturing export incentives has a significant effect on manufacturing export performance both in the long run and in the short run. However, the effect of export weighted real exchange rate and the world real GDP growth are limited in the long run.

6. Discussion and Conclusions

This paper aims to examine the impact of export tax incentives on the growth of the manufacturing export sector in Ethiopia by using data from 2005 up to 2019. The results show that the country's export earnings have increased consistently since the introduction of incentive schemes. Provided that the country's export earnings are mainly from a few primary commodities such as coffee, cereals, oilseeds, pulses, hides, and skins, the country's export diversification policy appears to have borne fruit during the study period.

The study found that the export incentive beneficiary trend in Ethiopia has increased since the export tax incentive scheme has been implemented, and the amount of revenue forgiven for the entire study period is over USD 2.3 billion, more than 90% of the beneficiaries under the voucher scheme. The least functioning export incentive scheme in Ethiopia is the bonded export factory scheme in which there are only three beneficiaries. The study also found the share of exports of recipients of export incentives in the manufacturing sector was almost equal to 10.81, despite the impact of the economic crisis from 2008 up to 2010. It can be deduced that export incentives have led to an increase in the share of export incentives provided to users of export trade incentives, but that share is not quite satisfactory as many exporters have not used export incentives. Excessive data specification criteria and monitoring systems by government authorities that are backward and manually oriented are the reasons for the inability of exporters to efficiently use the incentives, creating an obstacle to export growth.

The study found that during the study period, there was no significant improvement in manufacturing value-added exports. Exports of manufactured goods accounted for an average of 10 % of total exports and increased at an average annual rate of 25%, implying that exports to the country are mostly dominated by non-manufactured exports. The finding also indicates that the consumer accessibility of the country's commodity has increased. However, the percentage of total goods export revenues to GDP is just about 10%. This means that, unlike the emerging Asian countries, the role of exports in economic growth in Ethiopia is negligible.

The study found that the relationship between manufacturing exports growth and manufacturing export incentives is positive, and the time series econometric analysis revealed that export incentives influence the manufacturing value in both the long run and the short run. Besides the

incentives, world real GDP growth and the real effective exchange rate affect manufacturing export growth in the long run, but both do not influence export value in the short run. The absence of a causal relationship between the GDP growth rate and the manufacturing export value in the short run implies that Ethiopia is not an export-oriented economy, particularly for the manufacturing sector. The real effective exchange rate affects the amount of export in the long run, which is consistent with (A. B. Fanta & Teshale, 2014) who found a significant long-run effect of exchange rate on export growth. In general, export tax incentives have helped the country to expand the manufacturing export sector. However, the country's export still relies on primary goods, and the share of manufactured export is very small. This, in my view, would be corrected by accelerating industrialization; otherwise, it would be naive to expect manufactured export to dominate export earnings in the absence of a robust industrial sector.

Appendix

Table A.1. Share of Export by Incentive Beneficiaries to Total Export

year	Total export (million USD)	Export by incentive beneficiaries for all sector (million USD)	Export by incentive beneficiaries for manufacture sector (million USD)	Share of Incentive based exports in total exports (%)	Share of manufacturing Incentive based exports in total exports (%)
1997	587.15	67.76	45.32	12%	8%
1998	577.35	49.8	45.49	9%	8%
1999	447.38	41.45	49.83	9%	11%
2000	481.78	58.44	53.38	12%	11%
2001	453.17	90.17	55.50	20%	12%
2002	473.42	75.97	56.52	16%	12%
2003	642.12	84.05	57.21	13%	9%
2004	553.37	96	61.70	17%	11%
2005	896.63	114.9	70.94	13%	8%
2006	999.39	161.94	52.11	16%	5%
2007	1,183.27	233.73	101.11	20%	9%
2008	1,542.86	252.41	97.06	16%	6%
2009	1,493.64	246.59	72.00	17%	5%
2010	2,147.31	321.57	110.91	15%	5%
2011	2,542.30	467.04	217.60	18%	9%
2012	2,741.30	426.83	281.15	16%	10%
2013	2,591.04	482.12	397.93	19%	15%
2014	2,977.92	487.98	409.13	16%	14%
2015	2,856.66	536.78	390.24	19%	14%
2016	2,907.33	590.46	436.73	20%	15%
2017	2,827.47	708.55	487.54	25%	17%
2018	2,666.22	673.12	453.60	25%	17%
2019	3,029.57	639.47	405.59	21%	13%

Source: Ethiopian Ministry of Revenue, Ethiopian ministry of trade & industry, and author's compilation

Table A.2 Government Revenue Forgiven through the Export Incentive

Year	Total	VS	BEF and BMW	BER	DD
2005	924.62	843.72	66.57	14.42	-
2006	586.26	534.96	42.21	9.15	-
2007	998.75	911.36	71.91	15.58	-
2008	871.60	795.34	62.76	13.60	-
2009	282.76	258.02	20.36	4.41	-
2010	409.55	373.71	29.49	6.39	-
2011	1221.52	1114.64	87.95	19.06	-
2012	605.27	552.31	43.58	9.44	-
2013	1335.15	1218.32	96.13	20.83	0.57
2014	2893.00	2639.86	208.30	45.13	6.59
2015	3194.91	2915.35	230.03	49.84	10.85
2016	3554.64	3243.61	255.93	55.45	7.40
2017	6853.73	6254.03	493.47	106.92	10.51
2018	5563.77	5076.94	400.59	86.79	3.78
2019	63.49	57.94	4.57	0.99	3.85

Source: Ethiopian Ministry of Revenue and author's compilation

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