Ethiopia Private Sector Development
accelerating employment growth

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The case for a focus on private sector development: higher productivity employment

- To reduce poverty by 50% by 2015, growth must accelerate to 8% per year – above historical averages – 4-5%
  - Not only higher growth, but more labor intensive growth

- Increase in public investment from 6 to 12% of GDP has created BOP pressure and contingent liabilities

- Private investment trending at 9 to 11% of GDP – far below potential – can be

- Needed: a shift from low to higher productivity employment, fueled by private investment
  - increasing productivity (removing barriers)
  - Increasing investment (nurturing growth)
**Urban employment trends worrying**

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Tigray</td>
<td>55.1</td>
<td>40.4</td>
<td>42.4</td>
<td>-23%</td>
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<tr>
<td>Afar</td>
<td>60.9</td>
<td>53.7</td>
<td>53.1</td>
<td>-13%</td>
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<tr>
<td>Amhara</td>
<td>57.3</td>
<td>50.8</td>
<td>49.2</td>
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<tr>
<td>Oromia</td>
<td>62.7</td>
<td>48.4</td>
<td>48.6</td>
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<td>Somali</td>
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<td>54.7</td>
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<td>Benishan</td>
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<td>51.3</td>
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<tr>
<td>SNNPR</td>
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<td>55.4</td>
<td>55.1</td>
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<tr>
<td>Gambella</td>
<td>56.4</td>
<td>62.4</td>
<td>Not available</td>
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<tr>
<td>Harari</td>
<td>54.3</td>
<td>49.6</td>
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<tr>
<td>Addis_Ababa</td>
<td>46</td>
<td>47.9</td>
<td>47.9</td>
<td>4%</td>
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<tr>
<td>Dire_Dawa</td>
<td>49.8</td>
<td>45.8</td>
<td>44.4</td>
<td>-11%</td>
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From PSD pessimism to guarded optimism

• Rapid increase in FDI applications in 2004 and 2005, mostly manufacturing

• Public enterprises account for about 53 percent of value-added in industry, down from 86 percent in 1996. A gradual shift from public to private within limited overall growth.

• Tourism, construction and services contributing strongly.

• Early signs of a robust response to AGOA

• Shoe industry recapturing domestic market
Challenge is to increase productivity to drive growth
Policies
An efficient investment climate creates conditions for productivity growth

**Institutions**
- Bureaucracy and regulatory structures
- Skill and education of labor force
- Strength of financial institutions
- Rule of law
- Control of corruption and crime

**Policies**
- Macroeconomic stability
- Tax rates/administration
- Access to and cost of finance
- Time to clear customs
- Availability of business support services
- Tariff levels
- Access to land
- Availability of export facilities

**Investments**
- Power
- Telecommunications services
- Roads
- Ports
- Waste disposal
- Air freight
- Internet access
Decomposing the Productivity Gap

- **Investment Climate**: 16
- **Age & Industry Distribution of Firms**: 16
- **Structural Factors (Market Size & Geography)**: 27
- **Difference due to Total Factor Productivity**: 59
- **Difference due to Skills per worker**: 21
- **Difference due to Capital per worker**: 9
- **Ethiopia’s Labor Productivity**: 11

China’s Labor Productivity = 100
### Key Obstacles by Region, 2002 ICA

<table>
<thead>
<tr>
<th>Obstacle</th>
<th>Addis Ababa</th>
<th>Amhara</th>
<th>Eastern Region</th>
<th>Oromia</th>
<th>Southern</th>
<th>Tigray</th>
<th>Average</th>
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<tbody>
<tr>
<td>Access to Land</td>
<td>Black</td>
<td></td>
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<tr>
<td>Competition from Imports</td>
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<tr>
<td>Tax Administration</td>
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<tr>
<td>Business Regulations</td>
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<tr>
<td>Lack of Demand</td>
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<tr>
<td>Access to Credit</td>
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<tr>
<td>Corruption</td>
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<tr>
<td>Inadequate Infrastructure</td>
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<tr>
<td>Region Average</td>
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**Key:**
- Severe: > 15%
- Moderate: 7.5 – 15%
- Mild: 0 – 7.5%
- Good: 0%
National Level: Constraints Faced by Business

Note: Figure shows the percentage of respondents identifying constraint as the leading constraint they face.

Source: Ethiopian FACS Survey 2002.
Key Investment Climate Obstacles, 2004 focus groups

- Getting land for construction
- Overall tax regime
- Business licensing and permits
- Accessibility and price of credits, collateral
- Access, price and reliability of utilities
- Garbage disposal and other municipal services
- Receiving construction permits
- Availability of skilled labor
- Access, price and reliability of communications
- Certification of goods and services
- Low demand for goods
- Customs for import
- Customs for exports
- Labor regulations
- Business registration
- Non-Tax inspections (fire, sanitary etc)
- Environmental regulations

Severity of problem: 0 no problem, 10 very severe problem
Substantial improvement in business registration process

![Graph showing improvement in business registration process](image)
Substantial progress in administrative reform

• **Significant tax reforms introduced 2002**
  – Broaden the tax base and improve the efficiency of tax administration
  – New legislation on value-added and income taxes
  – Introduction of a taxpayer identification number
  – Establishment of the Ministry of Revenue
  – Large taxpayer office and strengthening of personnel
  – Reduction in presumptive tax regime assessments

• **Reengineering and automation of customs**
  – Asycuda, risk management / selectivity
  – Dramatic reduction in customs processing time

• **Tax administration remains an impediment**
  – Particularly for smaller firms at provincial level
Other administrative barriers remain

- **Contract enforcement**
  - 420 days, 15 procedures to enforce a contract

- **Property registration**
  - Ethiopia ranks among 10 worst worldwide, 15 procedures

- **Tax administration at Provincial level**
Financial sector

• **Important regulatory reforms**
  – Supervision, private entry, reduction in NPLs, microfinance

• **But extremely low financial deepening combined with liquidity**

• **Lack of competition**
  – Private banks source of profits – trade finance (fees, short-term credit)
  – State banks source of profits - state infrastructure program
  – Without competition no innovation (new products), no technology investment
  – Lack of consumer finance – housing/mortgage, consumer, credit cards – undermines growth and helps explain liquidity

• **Lack of equity market raising risks**
  – Undercapitalized firms using credit in place of equity (raising attrition rate)
  – Commercial banks taking equity risks (raising NPLS)
Privatization / level playing field

- Public enterprises account for about 53 percent of value-added in industry, down from 86 percent in 1996.

- Yet pace of privatization below expectations
  - New modalities, but no clear increase in pace of transactions

- Competition policy
  - Significant cases in pipeline
  - Private / civil society Commissioners not named
  - Capacity building of Secretariat behind schedule

- Regulatory framework for private participation in infrastructure
Despite significantly lower labor productivity, state firms enjoy several advantages.
## Private Sector Perceptions of Progress

<table>
<thead>
<tr>
<th>Clear improvement</th>
<th>Mixed progress</th>
<th>Insufficient progress</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Business licensing and permits</td>
<td>Construction permits</td>
<td>1. Access to land</td>
</tr>
<tr>
<td>2. Telecommunications services</td>
<td>2. Availability of skilled labor</td>
<td>2. Overall Tax regime</td>
</tr>
<tr>
<td>3. Customs for exports</td>
<td>3. Low demand for goods</td>
<td>3. Access to credit</td>
</tr>
<tr>
<td></td>
<td>7. Environmental regulations</td>
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<td></td>
<td>8. Inspections (fire, sanitary, etc)</td>
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</table>
Conclusion – policy performance

• Rapid reduction of key administrative barriers
  – Federal tax, customs, business entry

• Some administrative barriers remain
  – Contract enforcement, property registration, provincial tax administration

• Insufficient progress on privatization
  – Transaction volume far below action plan agreed in PRSC

• Poorly functioning factor markets
  – Financial sector
  – Land lease market and property rights
Investment
Fairly rapid increase in investment applications in 2004 and 2005

Registered Investment by Sector and Ownership

Source: Ethiopian Investment Commission

- Agriculture
- Construction
- Education
- Electricity Supply
- Health
- Hotel and tourism
- Machinery Leasing
- Manufacturing
- Mining & Quarrying
- Other Businesses
- Real Estate

SECTOR | Year

Type_licen
Public
Foreign
Domestic
But very poor track record converting applications to investments

Registered Investment Under Implementation or Operation by Sector and Ownership

Source: Ethiopian Investment Commission
Permanent Employment Associated with Investments in Operation or Implementation

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>Year</th>
<th>Count of Perm_Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>2001</td>
<td>10</td>
</tr>
<tr>
<td>Construction</td>
<td>2002</td>
<td>20</td>
</tr>
<tr>
<td>Education</td>
<td>2003</td>
<td>30</td>
</tr>
<tr>
<td>Electricity</td>
<td>2004</td>
<td>40</td>
</tr>
<tr>
<td>Health</td>
<td>2005</td>
<td>50</td>
</tr>
<tr>
<td>Hotel and tourism</td>
<td>2001</td>
<td>60</td>
</tr>
<tr>
<td>Machinery</td>
<td>2002</td>
<td>70</td>
</tr>
<tr>
<td>Leasing</td>
<td>2003</td>
<td>80</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>2004</td>
<td>90</td>
</tr>
<tr>
<td>Other Businesses</td>
<td>2005</td>
<td>100</td>
</tr>
<tr>
<td>Real Estate</td>
<td>2006</td>
<td>110</td>
</tr>
</tbody>
</table>

Type_licen

- Public - Operation
- Public - Implementation
- Foreign - Operation
- Foreign - Implementation
- Domestic - Operation
- Domestic - Implementation
Leading to low FDI levels, even relative to GDP, even relative to SSA

Foreign Direct Investment as % of GDP

Source: WB Global Development Indicators 2005
As a result, few high-value exports
Increasing investment: Sector dynamics

Dynamics of a growing sector:

• Low initial entry barriers, many similar investments

• Market supporting institutions (contracting, property rights) reduce commitment failure and increase confidence in collaboration / alliances / outsourcing functions

• Greater specialization raises average productivity levels

• Competition spur innovation

• Sector collaboration, problem solving, lobbying and growth:
  – attracts specialized infrastructure providers (skills, logistics, standards, tooling, cold storage, etc.) to overcome progressive constraints at each level of growth

Assumption – access to finance, low transaction costs, property rights
Tourism

• **Significant tourism potential based on cultural heritage, historical/religious sites, and physical landscape.**

• **Potential is largely untapped**
  – annual visitors still less than 200,000 (40% tourist) … 1 million+ for Kenya
  – Increasing quality timeliness of air transport
  – Largest sources of tourists – Africa and Europe

• **Need a shared vision**
  – Governance structure
  – Targeted public, private, and collective investments
  – Collective investments in branding, marketing, package tours

• **Infrastructure investment needed**
  – Lack of international-standard hotels outside of Addis.
  – Much of existing supply is state-owned, Government interested in privatization
  – A need for international management experience
  – Adequate volume for present flow, but inadequate for growth
  – Limited revenue capture from sites – lack of complementary investments
Construction

- **Industry booming, but local firms unable to penetrate most attractive segments.**
  - **Constraints:**
  - **Input/output markets:**
    - Demand for cement is currently 2 to 3 times greater than supply.
    - Procurement methods - quality enforcement, transparency.
  - **Financing constraints:**
    - Lack of mortgage financing, limited construction equipment leasing, lack of efficient project financing. Enterprises thinly capitalized with low investment in productivity enhancing / specialized equipment.
  - **Productivity constraints:**
    - Project management / civil engineering skills in short supply, impacting project planning, bid preparation, quality control and project financial management.
    - No effective building standards are effectively enforced on private projects.
    - Inefficient construction methods, low productivity does not overcome low labor costs.
    - Collaboration among enterprises limited, no M&A.
    - Competition based on price. Little differentiation of business models/value proposition.
Electricity

• Government plans to increase electricity access from 13% to 20% by 2012

• Substantial hydropower resources.
  – Gilgel Gibe hydroelectric plant (184 MW) commissioned.
  – Three other hydro plants with a total capacity of 870 MW are under construction.
  – Six new projects being studied
  – Transmission line work being done.

• Potential for off-grid power generation

• Public-private contracts / access to finance
Education

- **Wages in Ethiopia display increasing returns to education.**
  - Primary education wage premium 27%
  - Secondary school wage premium 95%
  - University education wage premium 32%

- **Public sector investment spurring private demand**
  - Enrollment rates rose 12 percent a year—with gross enrollment reaching nearly 60 percent in 2004
  - With rapid expansion, quality now a concern

- **Potential driver of private education**
  - Increasing demand for quality
  - Secondary enrollments will increase pressure to expand tertiary
  - Increasing demand for more specialized skills
Conclusion at sector level

• Pockets of vitality, need critical mass to drive growth

• High entry, but high attrition rate

• Fiscal, credit and land incentives have helped overcome some investment climate problems – a short-term strategy

• Low levels of social capital, lack of common investment in specialized infrastructure, policies, technologies

• Lack of systematic problem solving (exception – floriculture)

• Focus on export sector has caused missed opportunities
The need for a new growth strategy
Elements to consider

• **Revitalized industrial policy**
  – To create sector dynamism

• **Broadening market focus and drivers of demand**
  – From export products to foreign and urban dynamism as a growth driver
  – From industry to industry and services

• **Increased emphasis on urban employment**
Revitalizing Industrial policy

- **Old Industrial Policy**
  - Factor driven / Supply-oriented
  - vertical industries
  - Tariff protection
  - directed credit
  - tax incentives
  - Broad infrastructure investment

- **Institutional examples**
  - Throughout developing and developed world
  - Few successful cases (e.g. Korea) linked closely to export market discipline

- **New Industrial Policy**
  - Scaling up existing pockets of vitality – self-discovery
  - Incremental solving of sector problems preventing critical mass in sectors
  - Innovation clusters and search networks – matching sector problems (technology, market) with global solutions
  - Reducing risks of innovation
  - Collaboration of private enterprise in identifying common-use infrastructure
  - Emphasis on social capital and trust within sectors, and between public and private sector
  - Emphasis on deep sectoral understanding
  - Continuous monitoring, disengagement

- **Institutional Examples:**
  - Fundacion Chile / ProChile, Finland, Indian Spice Board, NASSCOM, Danaharta Malaysia, Toyota
Market focus: beyond export manufacturing

- **Most of the private sector is in services**

- **Many emerging pockets of vitality are urban**
  - Construction and housing
  - Hotels, restaurants
  - Consumer goods and services
  - Commercial real estate

- **Potential for dramatic productivity gains**
  - Atomistic, disorganized markets unable to increase productivity
  - Example: meat
    - Low level of packed, supermarket meat sales
    - Small share of meat slaughtered at commercial abattoirs
    - Weak market power of retail, high distribution costs, many middlemen, low prices to farmers
    - Inability to push quality improvements to producer level (hides and skins)
  - Increasing wholesale/retail distribution can unlock demand and capital
    - Lower cost food, higher wages to large share of employment

![Ethiopia: Sectoral Composition of GDP](image)
Policy focus

• Continue administrative reform especially at provincial level

• Focus on quality of market-supporting institutions
  – Contracting and coordination failures
  – Rule of law
  – Property rights
    • Registry of security interests to enable leasing
    • Tradability of long-term leasehold

• Gradual opening sectors to improve factor markets is critical
  – Gradual opening of financial sector to foreign entry, with capital controls
  – Entry of FDI into wholesale/retail and transport

• Continued emphasis on privatization

• Institutionalizing new industrial policy
World Bank Program and Strategic Directions
World Bank Group Inputs to Government’s Private Sector Agenda

- Investment Climate Assessment
- Privatization & Competition
- Capacity Building
- Value Chains/Clusters
- Finance, Tourism
- PRSC policy framework

- Removing Constraints
- Catalyzing Growth
- Strengthening Economic Governance
- Productivity Growth
- Higher Paying Jobs
- Poverty Reduction
Integrated Bank Group Strategy

• **World Bank / Donor partnerships**
  – Analytical report on private sector strategy (catalyzing growth, removing constraints, strengthening governance)

• **Nile Basin Initiative**
  – Growth corridors
  – Regional integration

• **Increasing IFC and MIGA engagement**
  – Potential investments in financial services, construction materials, tourism
  – Political risk insurance, increasing role throughout Africa

• **Financial sector development**
  – Housing finance, leasing

• **FIAS Administrative Barriers**