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Abbreviations

ADLI	Agricultural Demand-Led Industrialisation
BMZ	Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung (Federal Ministry for Economic Cooperation and Development)
EFFORT	Endowment Fund for Rehabilitation of Tigray
EHPEA	Ethiopian Horticulture Producers and Exporters Association
ELIA	Ethiopian Leather Industries Association
EPRDF	Ethiopian Peoples' Revolutionary Democratic Front
EU	European Union
FDI	Foreign Direct Investment
FeMSEDA	Federal Micro and Small Enterprises Development Agency
GDP	Gross Domestic Product
GNI	Gross National Income
GTZ	Gesellschaft für Technische Zusammenarbeit
ISO	International Organization for Standardization
LLPTI	Leather and Leather Products Technology Institute
PASDEP	Plan for Accelerated and Sustained Development to End Poverty
PPP	Purchasing Power Parities
ReMSEDA	Regional State Micro & Small Enterprises Development Agency
SMEs	Small and Medium Enterprises
SOE	state-owned enterprise
TAMPA	Tigray Agricultural Marketing and Promotion Agency
TVET	Technical and Vocational Education and Training
UNIDO	United Nations Industrial Development Organization
UNU-MERIT	United Nations University - Maastricht Economic Research Institute on Innovation and Technology
VAT	Value Added Tax
WTO	World Trade Organization

Summary

Industrial policy is a contested issue, especially for low-income countries. On one hand, it is widely accepted that these countries need proactive policies to master the transition from low-productivity resourced-based societies with large informal sectors to more productive, knowledge-based and formalised patterns of productive organisation. On the other hand, deliberate interventions aimed to channel resources into preferential activities may well end up reducing allocative efficiency and creating perverse incentives for investors and bureaucrats alike. This is especially true for low-income countries, where political checks and balances tend to be weak.

This report assesses industrial policy in Ethiopia. It is part of a research project on *Industrial policy in low- and lower-middle-income countries* covering nine states in Sub-Saharan Africa, the MENA region and Southeast Asia.

The Ethiopian government has demonstrated impressive dedication and ability to create the preconditions for a market-based and socially inclusive industrial transformation. It is strongly committed to investing in technological learning in order to build new competitive advantages. This becomes evident in ambitious programmes to strengthen the Technical and Vocational Education System and to set up new universities as well as supporting institutions for specific sectors, e.g. for textile, leather and horticultural products. The government has defined priorities for diversification and industrial development. Agricultural demand-led industrialisation and export promotion play a key role in its strategy.

From 2004 onwards, the Ethiopian economy has grown at 11% annually. This growth, however, has mainly been due to favourable agro-climatic conditions, high coffee prices, considerable inflows of aid and remittances, and a boom in construction; it does not reflect increased competitiveness, and it has not yet prompted significant changes in the economic structure. The share of manufacturing in GDP stagnates at 5%, and still virtually all exports are unprocessed or at best semi-processed.

This study takes a closer look at the policymaking process in the leather/leather products and the cut flower industries. The two case studies exemplify different government approaches. In the cut flower industry, the dominant players are quite strong medium-sized and large firms. Their success depends on the ability to choose the right variety of flowers, to adapt available technology packages to local agro-climatic conditions, and to sell a perishable high-value product on the international market. This requires much tacit knowledge which only large specialised firms are able to accumulate. Here the government plays no role in intervening at the company level – the technology being far too complex, and the product too heterogeneous. Instead, the government opted for a more responsive stance, easing regulations and removing obstacles in infrastructure, and leaving the strategic decisions to firms and their highly professional organisation. In the leather and leather products industry, the challenge is different. The sector is stuck in a “low-quality trap” in which problems at all levels of the value chain are mutually reinforcing. The sector can thrive only if all these aspects are tackled simultaneously. As no large private corporations exist in this industry, active public engagement is necessary to overcome the existing coordination failure. Conse-

quently the government implements a comprehensive package of activities to nurture companies along the whole value chain, with a leather technology institute as the focal point.

While this differentiated and pragmatic approach is convincing, the study also identifies major risks of industrial policymaking. The government deliberately employs a carrot-and-stick approach that differentiates between economic activities and firms, up to the point where targets for individual firms are sometimes negotiated on a case-by-case basis in exchange for public support. At the same time, resource allocation for industrial policy is not fully transparent, e.g. it is not clear when firms are eligible to get preferential treatment in terms of access to licenses, land, credit and foreign exchange, on what condition ailing firms will be bailed out, and whether these conditions vary between state-owned enterprises, firms affiliated with the ruling political parties, and independent private firms. Moreover, business and politics are still strongly entwined in Ethiopia. State-owned enterprises still dominate many manufacturing industries and service sectors, and party-affiliated endowments have taken many of the business opportunities left for private engagement. Discretionary allocation of public resources lends itself to political capture by interest groups.

To date Ethiopia is clearly anything but a predatory state whose government pillages the economy. There is no hard evidence of systematic abuses of political regulation and support programmes for illicit personal enrichment of political elites. Relying fully on the wisdom and integrity of an enlightened leadership, however, is not without risks. Power constellations may change, those who have vested interests in SOEs and endowment-owned enterprises may gain political influence, and political power shifts may force political leaders to compromise on their development agenda.

Against this background, the main challenge is to make policy decisions more transparent and ensure the accountability of policymakers. Deepening of the Civil Service Reform Programme, reducing the privileges of state-owned and endowment-owned enterprises, and exposing them fully to fair competition will help to draw a clear line between business interests and public policy. Policymakers should acknowledge that private entrepreneurs are better equipped to recognise market trends and take advantage of new opportunities than government agencies. Thus industrial policy should move away from predefining priority sectors and instead focus on skills development and on creating incentives for entrepreneurs in order to develop innovations and disseminate new business models throughout the country. The prospects for such a policy shift are good, as the Ethiopian government has a clear development agenda and increasingly recognises the need to combine a market-friendly policy environment with determined supply-side policies for technological learning.

Introduction

Productivity growth is a precondition for increasing people's living standards and maintaining competitiveness in the globalised economy. Low total factor productivity is the key reason for persistent poverty in developing countries. The productivity gap separating poor and rich countries has never been as deep as it is today. Poor countries in particular thus need to emphasise productivity growth to alleviate poverty. The challenge is not only to develop more productive ways of doing business in already established activities but also to accelerate the structural transformation from low-productivity activities in agriculture, petty trade and skill-extensive services to new activities that are knowledge-intensive and exploit the advantages of inter-firm specialisation.

Undoubtedly the main driver of structural change is the private sector. Still, governments have an important role to play in setting policy frameworks that allow for competition and encourage innovation and technological change as well as in correcting market failures. It may be important to encourage new activities that do not emerge spontaneously, e.g. because several interrelated investments need to be made simultaneously that exceed the possibilities of individual entrepreneurs, or to support activities that while unlikely to pay off right away for an individual investor, are still likely to produce manifold linkages and spillovers in the future. Governments may in this way accelerate structural change towards more competitive and higher value activities. This is what industrial policy is about.

While the theoretical case for industrial policy is not in doubt, there is no consensus about the right degree of intervention. The controversy is mainly about *selective* interventions that favour some sectors over others and thus interfere with the price mechanism, the main signalling device of market economies. Critics argue that governments are usually not very good at identifying coordination failures or anticipating future knowledge spillovers, and their decisions may well end up reducing allocative efficiency and creating perverse incentives for investors and bureaucrats alike.

It is now widely accepted that industrial policy *may* work well in countries with strong merit-based public services and political checks and balances. Opinions, however, diverge widely with regard to the role of industrial policies in low- and lower-middle-income countries where financial resources are often severely limited and some core institutions still need to develop administrative capacities and better incentive systems. According to all available governance indicators, most low- and lower-middle-income countries lag far behind with regard to government effectiveness, transparency, and accountability. Hence, even if it is clear that these countries face particularly severe market failures, there is a big question mark as to the ability of governments to intervene in markets in a way that increases public welfare.

In any case, the appropriate policy mix is unlikely to be the same as in rich countries, because both the requirements and the capacity for public intervention are substantially different. Yet most empirical case studies of industrial policy focus on the old industrialised countries or the famous success stories of technological catching up (such as Korea, Taiwan, Singapore, Malaysia, Brazil, and Chile). Much less is known about the quality and the outcomes of industrial policies in low- and lower-middle-income countries.

The aim of this report on industrial policy in Ethiopia is to help fill this gap. It is part of a comparative research project on “Industrial policy in low- and lower-middle-income countries” funded by the German Ministry for Economic Cooperation and Development (BMZ) and supported by GTZ. Besides Ethiopia, the comparative research included Cambodia, Egypt, Mozambique, Namibia, Nigeria, Syrian Arab Republic, Tunisia, and Vietnam.

For the purpose of the project we define industrial policy as any government measure, or set of measures, to promote or prevent structural change in ways that the government views as desirable. Two implications of this definition need to be highlighted. First, industrial policy has a normative perspective. Most policy documents address a range of goals, including productivity growth, employment creation, social inclusion, and environmental sustainability. Second, policies may target not only the manufacturing sector but also promising activities in agriculture or services.

As part of this project, a background report has been written that takes stock of the industrial policy debate and discusses the peculiar challenges of such policies in less developed countries.¹ For a comprehensive discussion of the pros and cons of industrial policy, the reader may refer to that report. This country case study therefore concentrates on the Ethiopian experiences only.

It should be noted that, as in other low-income countries, availability of reliable data is a major problem in Ethiopia. One factor of particular importance for the purpose of this report is that some relevant information, e.g. on the governance structures and privileges of those firms that are indirectly controlled by political parties, is not systematically disclosed. Likewise, monitoring and evaluation of policies is hardly ever done. This analysis and assessment of policy processes and impacts therefore relies to a large extent on qualitative information gathered from expert interviews and grey literature, such as unpublished government and donor reports. Support from GTZ, particularly Sabine Becker, in accessing policymakers and other stakeholders has been extremely helpful. Moreover, the author is indebted to Kibre Moges from the Ethiopian Economic Policy Research Institute, Mulu Gebreyesus from UNU-MERIT and Eiko Kauffmann from GTZ for valuable comments on an earlier draft.

The report consists of four parts. The first part provides an overview of historical, political and socio-economic preconditions of industrial policymaking in Ethiopia. Part 2 discusses the government’s industrial policy, looking at the underlying philosophy of industrial policymaking and the resulting strategies and assessing practical policy formulation and implementation. Part 3 illustrates the making of industrial policy in two economic sub-sectors, drawing lessons and exploring why the government pursues different approaches in the two cases. Part 4 then draws overall conclusions on industrial policy in Ethiopia.

1 Altenburg (2010).

1 Initial conditions and challenges for industrial policy

1.1 Socio-economic situation²

With its 80.7 million inhabitants, Ethiopia is the third most populous country in Africa, with a rapidly growing young population. It is one of the world's least developed countries, ranking in place 180 out of 187 on the Human Development Index. Ethiopia's GNI per capita is as low as US\$ 280 (2008). In 2007, 39% of the population were estimated to live below the poverty line of US\$ 1.25 a day (PPP) – a considerable improvement compared to the 61% reported in 1995. Lack of basic education is a big problem,³ but, again, the government is undertaking strong efforts to improve this situation. The percentage of the relevant age group that has completed primary education increased rapidly, from 22% in 2000 to 46% in 2007.

Ethiopia is still largely agrarian. 85% of the workforce is engaged in the rural economy, mostly in agriculture.⁴ Agriculture accounts for 43% of GDP (down from 50% in 2000). Agriculture is dominated by smallholders, the majority cultivating less than 0.5 ha and producing mostly basic staples for the subsistence of their households. Farmers do not have property rights on the land they cultivate. While abolishing private land ownership was a measure to overcome the legacy of a highly polarising feudal system, it also constrains investments in agricultural productivity. Despite some geographical disadvantages – dependence on irregular rainfalls, increasing soil erosion, aridity in some regions and pervasive tropical diseases in others – many regions of Ethiopia do have substantial agricultural potential, with different climate zones and relatively good availability of water. Agricultural productivity, however, is stagnating, and food security is a major concern. Several million people are once again dependent on food aid.

Manufacturing has stagnated at about 5% of GDP over the last 20 years. The decreasing share of agriculture has been compensated for by a similar increase in services. Manufacturing industry is largely limited to simple agro-processing activities (sugar, grain milling, edible oil production, leather tanning) and production of basic consumer goods (beer, footwear, textiles and garment). Industries that might help accumulate technological capabilities and create dynamic inter-industry linkages – such as chemical, electrical and electronics, metal-processing and other engineering industries – are almost non-existent. Likewise, production of agricultural inputs is insignificant. Overall, the technological level of firms is very low, even by regional standards; e.g. only 4% of firms use technology licensed from foreign companies, and likewise only 4% have ISO certification (compared to 12% in both cases in Sub-Saharan Africa) (World Bank / IFC 2006).

2 Unless otherwise indicated, data have been taken from World Bank country tables: http://ddp-ext.worldbank.org/ext/ddpreports/ViewSharedReport?&CF=1&REPORT_ID=9147&REQUEST_TYPE=VIEWADVANCED&HF=N&WSP=N, accessed 17 Dec. 2009.

3 The youth (15–24 years) literacy rate in the early 2000s was 62% for boys and 39% for girls (UNESCO, cited in: www.unicef.org/infobycountry/ethiopia_statistics.html#52), accessed 17 Dec. 2009.

4 It should be noted that a minor proportion of the rural population is engaged in non-agricultural activities such as cottage industries and petty trade.

The main export products are agricultural. Coffee, oilseeds, khat, pulses, flowers, skins, meat and meat products account for about 80% of all exports, with coffee by far the most important item. Some high-value horticultural products have recently been picking up. Manufacturing exports were as low as US\$ 105 million in 2007, accounting for less than 10% of total exports. Basically all manufacturing exports are agriculture-based (clothing, canned and frozen meat, semi-processed hides, footwear, beverages, and oilcakes). On the import side, Ethiopia imports most capital goods and manufactured consumer goods, and the country is heavily dependent on fuel imports. In recent years, imports grew much faster than exports. Currently, exports finance less than 22% of imports (European Union 2009). Ethiopia therefore has a huge and rapidly growing current account deficit.

When Eritrea ratified its independence in 1993, Ethiopia became a land-locked country. Although the port of Djibouti is not far off, and shipment through Djibouti is quite reliable, transport to the port is a significant cost factor. Adding to this is the administrative cost of trading across borders. In this regard, Ethiopia ranks particularly low (152 out of 181 countries) on the Doing Business Index (World Bank / IFC 2008).⁵

Since the end of the civil war and establishment of the current government in 1991, Ethiopia has shown steady progress. The economy recovered slowly during the 1990s. After a drought-related recession in 2002/03, economic growth took off, with an average of 11% during the subsequent five years. Per capita GDP increased from US\$ 107 in 2003 to US\$ 201 in 2007 (World Bank 2009). This growth has been fuelled by inflows of official development aid, including soft loans from China and India, by remittances from the diaspora, and by foreign direct investment (FDI). Furthermore, Ethiopia has recently benefited from a series of good harvests. As a result of development aid and other inflows, public investment – primarily in roads, dams, education, and health – has grown much faster than private investment. This has spurred employment growth, but also provoked a foreign-exchange crisis.

Overvaluation of the birr has recently driven up inflation. It also undermines incentives for industrialisation, because it benefits imports of simple consumer goods and increases the price of exports. Inflation is now expected to come down, but the current account deficit remains a major concern. In 2009 foreign exchange reserves were down to five weeks of imports (European Union 2009), causing the government to ration foreign exchange, mainly for private investors, and to force coffee exporters to put their stocks on the market. Such interventions are likely to have a negative effect on future private investments.

1.2 Historical and political background

Ethiopia has undergone profound political changes. The country is building on a rich and impressive history of cultural development. As the country (except for a short period of Italian occupation) has never been under colonial rule, it started relatively early to build sovereign national institutions. Already in 1909, Menelik appointed 9 ministers and started to build up a modern civil service (Taffesse 2008, 373). The Imperial phase, which ended

5 Several interviewed entrepreneurs complained that intermediary goods and spare parts often ‘get stuck’ in customs, and that reimbursement of VAT may take years.

when Emperor Haile Selassie was deposed in 1974, was characterised by a fairly effective administrative system, but it also relied on autocratic rule and a feudal land ownership system. Many rural families did not have access to land to secure their livelihoods.

In 1974 a communist military junta seized power. The Derg regime, named after the committee of military officers that ousted Haile Selassie, initiated 17 years of a centrally planned economy. All private enterprises were nationalised. Private land tenancy was abolished and usufruct rights granted to peasants. Small producers were in part resettled, forced into cooperatives and grouped in villages, with the aim of improving service provision and land use.

Mismanagement and the Derg's violent rule created strong opposition. Separatist guerrilla movements, particularly in Eritrea and Tigray, embarked on a protracted civil war. Under these conditions, a prolonged drought during the mid-1980s led to unprecedented famine. In 1991 the Derg was overthrown by a coalition of rebel forces from different regions and made up of ethnic groups, which formed the basis for the current government led by the Ethiopian Peoples' Revolutionary Democratic Front (EPRDF) under Prime Minister Meles Zenawi.

The new government launched reforms for reconciliation and reconstruction of the country. After two decades of drastically declining real per capita income (World Bank 2007a, 10), Ethiopia now returned to a phase of steady, but modest, income growth. Stabilisation was interrupted by the war with Eritrea in 1998–2000. Only since 2003 has economic growth taken off, posting an average of 11% per annum.

The EPRDF is strongly committed to egalitarian policies. This is reflected in its focus on rural development, control of land ownership, and its commitment to pro-poor spending. 64% of the government's total budget is spent on sectors that are mainly pro-poor, such as education, health, agriculture, water, and roads (European Union 2009).

Also, the government encourages decentralisation. During the Imperial phase, the country was governed by a central government whose elite was mainly formed by Amharas. The EPRDF government, a coalition of different ethnic groups, established a federal system based on ethnic-based territorial units in 1991. The Constitution grants those units a considerable degree of autonomy and even provides for secession of any ethnic unit. Moreover, political parties are organised along ethnic lines, which enhances political representation at the central level (Habtu 2003). All major ethnic groups are represented in government, with Tigrinya people in many of the powerful positions.

The government adopted market-oriented economic reforms. Given the disastrous record of the Derg, the new government recognised the role of private enterprises as the engine of growth. The government privatised many state-owned firms, encouraged competition, and reduced government intervention in trade and factor markets. Ownership of land and strategic industries and services, however, remained with the state. In 2003 the government decided to apply for WTO membership and started negotiations. In the same year, a new competition law was enacted. As a result, the investment climate has significantly improved, as a comparison of the first (2001/02) and the most recent (2006/07) Investment Climate Survey reveals.

While the government enacted market-oriented reforms, it also allowed political parties to use endowment funds to invest in many lines of business (whereas direct participation of

political parties is not allowed). When the war was over, these funds were among the first investors, benefiting from manifold opportunities for reconstruction as well as from certain privileges (see below). The EPRDF uses its influence on those enterprises to advance its industrialisation agenda.

Moreover, the government is not willing to cede control of what it considers to be key instruments for the implementation of its development strategy. It has retained its monopoly in telecommunications and is very hesitant with regard to financial sector reform. In the same vein, the new competition law endorses the principle of free competition, but at the same time sanctions the privileges of remaining state-owned and endowment-owned enterprises and exempts from competition many products and enterprises that are regarded as having “significant impact on development” (USAID 2007). As a result, the WTO accession process has not made any significant progress.⁶ Ethiopia has attracted little FDI, even by African standards (World Bank 2009, i), reflecting both the incipient level of market development and political restrictions in the country’s economic management.

Until 2005 economic modernisation and liberalisation were accompanied by advances in democratisation. General elections in 1995 and 2000 were won by considerable margin by the EPRDF, giving the party a large majority of seats in the national parliament (not least because major opposition groups boycotted the election). Following the 2005 elections, however, democratisation suffered a serious setback. According to the official results, the EPRDF won the elections, although by a considerably reduced margin. The result was contested by opposition parties, and the fact that the National Election Board delayed the publication of results for several months was interpreted as a manoeuvre to manipulate the outcome. Tensions escalated, and riots following the elections led to more than 100 people being killed and many thousand put in jail. The EPRDF remained in power and enacted several laws that restrict the political space of civil society organisations.

This has implications for industrial policy. Some personalities of the old industrial elite figured prominently in the political opposition before the 2005 elections and held leading positions in business membership organisations. Since the 2005 events, the government has shown increasing mistrust of parts of the private sector and taken action to align business membership organisations with the EPRDF government. It refused to extend the license for the Ethiopian Manufacturing Industries Association, and international donors were urged to stop supporting the organisation. A new leadership of the National Chamber of Commerce was installed. Today the Chamber is mainly seen as an instrument to disseminate government policies and mobilise support for them, rather than a politically neutral representation of business interests.

As a result, the current situation is characterised by mixed signals. On the one hand, the government has, since 1991, embarked on a credible agenda of market-based and socially inclusive industrial transformation. It has undertaken strong efforts to invest in social development, education, vocational training, and industrial development; on the other hand,

6 The US, Canada and the EU have tabled a long list of open questions regarding WTO accession. Although the Ethiopian government is working on the responses, observers do not expect a consensus in the near future.

its fear of losing political control and having to abandon the EPRDF's project of industrial transformation has resulted in a more restrictive political environment.

1.3 Enterprise structure

The vast majority of Ethiopia's firms are micro and small. According to the 2003 survey of the Central Statistics Authority, 1.3 million persons were engaged in the micro enterprise manufacturing sector, 94.2% of whom were own-account workers. Only 98,000 persons were employed in "small" (larger than micro) manufacturing enterprises. The micro and small firms sector of the economy is mainly a sector of self-employment. 55% of the micro enterprises in manufacturing activities produced food and beverages, 23% textiles and garments. 85% of the businesses in the small scale manufacturing sector are grain mills.

Employment in informal micro enterprises is growing much faster than employment in the formal sector. Between 1999 and 2005, informal employment (defined as employment in firms with fewer than 5 employees) increased by 144% compared to only 16% in formal employment. By 2005, 71% of urban employment was in the informal sector (World Bank 2009). Thus formalised medium- and large-sized firms absorb only a very small share of the annual increase in the Ethiopian workforce, and the majority of new entrants to the labour market are forced to engage in own-account work.

The Federal Micro and Small Enterprise Development Agency and international development agencies confirm that micro and small firms rarely ever grow into a medium-sized segment, reflecting a lack of entrepreneurial and managerial capability. When micro entrepreneurs are successful, they often prefer to diversify into new activities rather than to develop and expand their respective core activity. It is not clear to what extent this is a strategy to remain below the radar of public authorities. Labour productivity is extremely low, even by the standards of Sub-Saharan Africa (*ibid.*).

As a result, medium-sized and large firms are barely developed. In 2002 Ethiopia had only 49 manufacturing enterprises with more than 500 workers, plus 225 small and medium-sized manufacturing firms which employed between 51 and 500 persons (Ethiopian Economic Association 2005, 26). Most industries are engaged in sugar processing, brewery, cement, publishing and printing, leather tanning, and textiles. Five groups of firms can be distinguished according to their ownership structure:

1. Many large enterprises are still **state-owned enterprises (SOEs)** going back to the socialist Derg regime. The current government created the Ethiopian Privatisation Agency and privatised 287 SOEs between 1997 and January 2009 (MoTI 2009). The government wants to privatise many more firms, but the process so far has been slow, not least because privatisation has often been linked to restrictive conditions, e.g. that the new owners refrain from dismissing personnel. In 2006 the manufacturing sector was "still dominated by public enterprises that account for 72% of total manufacturing value added, 62% of gross value of production, employ 57% of the manufacturing workforce and account for 64% of wages and salaries" (European Union 2006). According to another source, the share of SOEs in the output of medium- to large-size

manufacturers declined from 58% in 2000/2001 to 51% in 2004/05.⁷ As some of the larger SOEs are now going to be privatised, this share is likely to go further down. Moreover, SOEs in most manufacturing activities are now exposed to competition from private firms. Their performance varies. While some are in serious trouble, others outperform their private competitors, partly because they are larger and less constrained by tax administration, customs and trade regulations, access to land, cost of finance, and corruption. The government seems determined to maintain state ownership of enterprises in strategic sectors such as telecommunications, civil aviation, railways, energy, mining, chemicals, insurance, and banking. In the financial sector, private domestic banks have been admitted alongside the still dominant state banks and are rapidly growing.⁸ Likewise in the insurance industry, there are now eight private enterprises competing with one state-owned insurance company.

2. The political parties, which are organised along ethnic lines, control large business groups, so-called **endowment-owned firms**. The ruling EPRDF and its member organisations stand out in this regard. Under the law on political organisation, political parties are not allowed to invest in business. To comply with this law, businesses are owned by endowment funds run by party members or close allies, or those persons hold company shares directly. The business group controlled by the EPRDF is said to be one of the largest conglomerates in Sub-Saharan Africa. Within this group, the Endowment Fund for Rehabilitation of Tigray (EFFORT) is the most powerful. It was established by the Tigray People's Liberation Front in order to generate income for the families of 'martyrs' and to advance the industrialisation of Tigray. EFFORT is engaged in a large number of industries, including building materials, tannery, textiles, garments, pharmaceuticals, industrial engineering, mining, banking, insurance, trading, construction services, and livestock. Although EFFORT operates as a non-governmental public charity organisation, it has never been audited since its launch in the mid-1990s. There is no transparency with regard to management structure, or profits and losses. The companies run by the EPRDF are reported to have made extensive use of the credit facilities of the state-owned Commercial Bank of Ethiopia. Private competitors claim that heavily indebted EPRDF companies have been bailed out, and despite mismanagement in some of them, there have been no cases of foreclosure. Moreover, EPRDF-related companies are said to get preferential treatment with regard to government licenses, allocation of foreign exchange, and contracts with the Ministry of Defence. Given the discretionary character of many government policies, however, it is not possible to verify these allegations.⁹
3. One private investor of Ethiopian and Saudi-Arabian nationality, **Sheik Mohammed Al Amoudi**, alone owns many of the leading firms across all economic sectors. According to Forbes magazine, he is the 43rd richest person in the world and is said to have invested more than US\$2 billion in Ethiopia (Forbes, 11 March, 2009). His investments in Ethiopia range from hotels, gold mines, glass, plastics, soft drinks, a pri-

7 Central Statistics Authority, cited in World Bank (2009).

8 Private banks accounted for 30 and 46 percent of total deposits and credits respectively in 2007, up from 13 and 35 percent in 2000/01 (Addis Ababa Chamber of Commerce 2008).

9 See e.g. several of the sources cited in Zerihun (2008).

vate airline, production and marketing of households furniture and office equipment, to food processing.

4. There is some **foreign direct investment**, mainly from the European Union, India, Israel, the United States, and Saudi-Arabia. FDI is concentrated in agricultural activities, including floriculture, horticulture, meat and, recently, biofuels (Weissleder 2009). In trade and services, foreign investors face considerable restrictions.
5. There are an increasing number of **independent Ethiopian entrepreneurs**. Among them, Ethiopians from the diaspora play a significant role, as many business people emigrated during the Derg and engaged in economic activities in their host countries, where some of them accumulated capital and learned about new international business opportunities. E.g. all tanneries and garment companies and the majority of shoe and textile companies are private Ethiopian enterprises. Overall, however, independent Ethiopian entrepreneurship is still weak, and entrepreneurs complain of unfair competition, alleging that state-owned, endowment-owned, and even foreign enterprises have better access to land, credit, foreign exchange and support services.¹⁰

Ethiopia does not host any major expatriate business community. Businesses are mainly owned by Ethiopians. This is quite unique in Sub-Saharan Africa, where European citizens from the former colonial powers, Indian or Arab minorities often play a dominant role in the private sector. The Ethiopian exception is due to the fact that the country has maintained its independence.

Productivity varies greatly among Ethiopian manufacturing firms (Gebreyesus 2008; World Bank 2009, 17 f.). At the same time, firm turnover is high, especially among micro and small firms. 60% of firms exit in the first three years after entry (Gebreyesus 2008, 113).¹¹ This reflects two phenomena. First, there is a big group of “necessity entrepreneurs” who start own-account activities for lack of employment alternatives and without any clear business idea. Among these necessity entrepreneurs, productivity tends to be far below the level of well-established medium-sized firms, failure rates are high, and owners frequently shift to other activities. Second, some firms are more constrained in their access to credit, land, and product markets than others. Independent Ethiopian entrepreneurs (and micro and small producers in particular) seem to be more constrained than state-owned, endowment-owned, and foreign firms, and this results in lower productivity.

Investment surveys reveal that SOEs and endowment-owned firms are far less affected by problems in the local business environment. While independent private firms identify the anti-competitive or informal practices of others as their leading constraint and mention tax administration, customs and trade regulations, access to land, cost of finance and corruption as relevant problems, both the state-owned and the endowment-owned firms rank these issues much lower (World Bank 2009, 50 f.).

10 This is confirmed by UNCTAD (2004); World Bank (2007a); and Zerihun (2008, 264).

11 Gebreyesus (2008), in his econometric study, finds that this high turnover increases allocative efficiency, that is, productivity grows because more productive firms replace less productive ones. The World Bank (2009) states the opposite, e.g. that Ethiopia is inefficient in its allocation of resources across firms, as the most productive enterprises are not systematically increasing their market share at the expense of less productive ones. The World Bank blames policy factors that distort competition in favour of incumbent firms.

Overall, most modern firms are highly vertically integrated. Subcontracting is rare, and especially micro and small firms have almost no productive links with any of the above-mentioned ownership groups. Large firms perform even simple service activities in-house, such as maintenance of green areas, transport and security. This also holds for agriculture. The reasons for this are not totally clear, but low productivity and lack of reliability of micro and small firms seems to be the main problem. Moreover, key institutions that could help to “lubricate” market transactions are weak (e.g. regarding property rights protection and contract enforcement), which explains why firms are risk-averse and unwilling to engage with business partners (World Bank 2009). In agriculture, farmers have been reluctant to participate in collective activities since the Derg regime established large state farms and pressed farmers into cooperatives. Mention must be made here of a few recently established exceptions, where large firms have engaged with micro and small scale producers, e.g. new outgrower schemes in agriculture in Tigray.

1.4 State-business relations

While the Imperial phase was characterised by autocratic rule and feudal land ownership patterns, it also laid the foundations for a comparatively strong bureaucracy. To work in public administration was regarded the best route to social ascendance. Hence the administration was – and still is – quite well respected in Ethiopia. Nation-building, including the formation of an independent civil service, started much earlier than in most other countries of Sub-Saharan Africa. The relationship between government and citizenry, however, was clearly top-down and authoritarian, with little regard paid to transparency and accountability. The communist Derg, while aiming to build an egalitarian society, reinforced the existing patterns of top-down government. Laws, however, were regularly by-passed by the Derg (Taffesse 2008, 374).

When the current revolutionary government took office in 1991, it made a strong effort to improve the efficiency of the civil service. Although it took over a fairly inefficient public sector, it was at least able to build on a history of public administration. In 1994 the new government established a Task Force for Civil Service Reform which developed an ambitious and comprehensive Civil Service Reform Programme¹². Implementation started in 1996. The reforms tackled the major issues required to design appropriate industrial policies, to improve implementation, and – very important – to create safeguards against political capture. Among other measures, a programme for results-based monitoring and evaluation was initiated; an employee appraisal system was introduced; tools to benchmark public sector performance were established; and instruments to increase transparency and accountability were introduced at the federal, regional, and local levels, including

“external audit, parliamentary oversight, anti-corruption, and the development of the accounting and auditing profession ... Innovative techniques for monitoring fiscal and output performance (were installed such as) expenditure or input tracking surveys, cost efficiency studies, service delivery report cards, anti-corruption and governance surveys.” (World Bank 2007b)

Almost all government institutions are currently undergoing ‘Business Process Reengineering’ to assess and reform administrative routines (Taffesse 2008, 403). In 2001 the

¹² See Taffesse (2008) for an overview and assessment.

Ministry of Capacity Building was created as a powerful new entity to oversee the manifold capacity building programmes at federal, regional, and local levels.

The Civil Service Reform Programme is extremely comprehensive, and implementation has not yet met the government's high ambitions (Taffesse 2008, 408 ff.). This is hardly surprising, given the present budget and human resource constraints, and the fact that deep changes in mindsets are required if bureaucracies are to embrace the principle of a modern and efficient public sector. Moreover, the programme is not free from political interference. Recruitment and career development, according to several interviewees, depend strongly on affiliation with the ruling EPRDF party. It seems that the government, while fully aware of the need to enhance the efficiency of its civil service, still values political loyalty higher than merit. There is a general perception that party affiliation and loyalty have become even more important since the 2005 events.

Still, Ethiopia's government has been more efficient in providing basic health and education services to the population than most governments of similarly poor countries. This also applies to services for enterprise development. 46% of firms have access to a line of credit or loans from financial institutions, compared to 22% on average in Sub-Saharan Africa. It takes 11 days for a standard firm to obtain an operating license in Ethiopia, while the regional average is 20 days (World Bank / IFC 2006). The World Bank ranks Ethiopia 37 (out of 100 maximum points) with regard to government effectiveness; this is a fairly low rank, but higher than most other countries at the same level of per capita GDP, and the Civil Service Reform Programme is likely to push Ethiopia further up in the ranking.

Even more importantly, corruption does not seem to be as pervasive as it is in many other poor countries. While the Corruption Perception Index ranks Ethiopia 126th out of 180 (which is rather low, but, again, better than most other countries at similar income levels), most other sources paint a more favourable picture. According to the World Bank's 2006 Enterprise Survey, only 12% of firms state that public officials expect them to make informal payments to get things done, compared to 41% in the region of Sub-Saharan Africa. With regard to the allocation of donor money, the funds allocated to so-called Programme-Based Approaches (where donors financially support national programmes rather than implementing clearly confined bilateral activities) are monitored, and the results show that allocation follows transparent criteria, with no visible influence of favouritism. Likewise, the fact that GTZ was assigned a US\$ 250 million contract on building several universities is a clear sign of development orientation: Although endowment-owned enterprises are strongly engaged in the production of cement, construction materials, and services, GTZ is free to organise public tenders without any government interference in favour of state-owned or endowment-owned firms.¹³ Moreover, Ethiopia is a voluntary member of the Construction Sector Transparency Initiative, an international multi-stakeholder initiative designed to increase transparency and accountability in the construction sector.

The downside of the government's focus on creating an efficient civil service is that independent entrepreneurship has never been encouraged. Successful entrepreneurs are not seen as important role models in Ethiopian society, and opportunities for advancement are

13 Interview Mr. Helming, GTZ, Addis Ababa, March 2009.

more often sought in the public sector than in entrepreneurship. During the Imperial phase, private investment in import-substituting industries was encouraged, but no performance requirements were imposed on protected industries and little effort was made to develop technological capability and promote exports (Ethiopian Economic Association 2005, 63 f.). Hence the policy helped to advance industrialisation, but not competitive entrepreneurship. During the socialist dictatorship of the Derg, entrepreneurial activities were suppressed and private medium and large enterprises nationalised (ibid). Even in the revolutionary movement that overthrew the Derg regime, most factions had a Marxist formation. Nevertheless, the incoming EPRDF-led government recognised the need for a market economy and adopted a pragmatic economic policy, supported by the USA and the international financial institutions. The role of the private sector as the driver of economic growth has been acknowledged, although the 2005 events revived mistrust between the government and independent Ethiopian entrepreneurs.

In industrial development, business membership organisations play an important role in representing the interests of private enterprises, bringing in perspectives on future development trajectories, and holding governments accountable for the performance of public services. In Ethiopia, however, these organisations are weak and do not represent overall private sector interests. According to one advisor, only an estimated 2% of all registered business are members. Although chambers and associations meet with the competent ministries – and even the Prime Minister – quite frequently, these meetings are rarely concerned with controversial issues. According to some participating firms, they serve as communication channels through which government officials propagate their decisions rather than as a platform to exchange views, solve immediate problems and jointly develop long-term strategies for industrial development. Membership organisations, dependent on government transfer payments, lost much of their independence after 2005. It should be noted, however, that even before the 2005 events, business membership organisations did not play an active role as change agents for industrialisation. The Ethiopian government has been the sole driver of the national modernisation agenda.

Several informants confirmed that certain leading business individuals do have direct access to policymakers, but this access is informal and restricted. Of course, high ranking party members engaged in endowment-owned firms as well as managers of SOEs enjoy privileged access.

2 Industrial policy: Ideology and practice

2.1 The Ethiopian government's overall development perspective

Ethiopia's government recognises the need to support private sector development as the engine of economic growth and productivity enhancement, and it is clearly committed to advancing industrialisation and other high-value activities. The government describes itself as a revolutionary democracy and developmental government. It can in fact be characterized as "developmental" in the sense that its attitude and activities are strongly driven by the desire to lay the foundations for long-term economic development. Probably few developing countries show such a determined and credible commitment to

- industrial development, technical and vocational education and training (TVET) as well as science and development. Substantial investments have been made in new universities, expansion and reform of the TVET system, specialised institutions for sector-specific technology development, and a new Ministry for Science and Technology;
- pro-poor spending. There is a strong policy focus on improving education and health as well as rural infrastructure, microfinance, and to maintain land policies that protect the livelihoods of the poor;
- decentralisation of government power to the ethnic regions and the community (*woreda*) level.

The political elite in the ruling EPRDF is strongly influenced by the successful economic management of latecomer development in Korea and Taiwan. The Industrial Development Strategy, as well as instruction materials for EPRDF cadres and documents circulated by Prime Minister Meles Zenawi, stress the need to build on capitalist enterprises as the engine of growth. At the same time, a clear distinction is made between “rent-seeking” and “developmental” capitalists. Rent-seeking capitalists are those not exposed to competition, including those who accumulate wealth by controlling the state. EPRDF documents refer to Mobutu’s Zaire and to Nigeria as examples of countries exploited by rent-seekers. “Developmental” capitalists, in contrast, are those who create value in a competitive environment. The government perceives itself as a developmental state that dries up opportunities for rent-seeking and actively fosters and supports developmental capitalists. According to the perception of the EPRDF, it is crucial for Ethiopia to reach a ‘point of no return’ when the old rent-seeking elite will have lost its economic basis and developmental capitalists will have gained hegemony. This explains the government’s firm will to avoid the return to power of conservative business groups, which, according to its interpretation, want to reinstall a rent-seeking economy.

It is important to note, however, that the concept of rent-seeking can be interpreted differently, and that this makes a huge difference with regard to policy. Rent-seeking refers to the extraction of uncompensated value from others without making any contribution to productivity. Rents may be obtained by gaining control of land and other pre-existing natural resources; by establishing a position in imperfect markets that allows a firm to set its prices above the equilibrium price without losing profits to competitors; or by lobbying for government regulations that reduce competition in favour of incumbents. Public choice theorists highlight the risks of governments regulating markets in a way that encourages rent-seeking behaviour by firms, e.g. to get privileged access to land or tariff protection. To avoid this, they advocate free enterprise competition.

The Ethiopian government has a different understanding of the concept. While it stresses the need for greater competition in some cases, it falls back on increased government control and regulation in others. It maintains state ownership of land because it sees private land ownership as the main form of rent acquisition,¹⁴ and it grants lavish lease rights to those investors it considers to be “developmental” (e.g. flower farms). Moreover, it inter-

14 The concept of “land rents” is based on the observation that the value of land is largely due to public investments in infrastructure, rather than resulting from amelioration by the landowner. http://en.wikipedia.org/wiki/Rent_seeking, accessed 8 Mar. 2010

venes in distribution systems with the aim of cutting out middlemen (which are thought to abuse of oligopolistic market power), and it prohibits hoarding. Coffee producers and traders, for example, are obliged by law to sell their stocks within a certain period of time after the harvest. In April 2009, when the government faced foreign exchange constraints, it shut the warehouses of 94 coffee exporters and revoked their licenses, accusing them of hoarding, among them the largest exporters.

Papers written by the Prime Minister, EPRDF documents and the Industrial Development Strategy all refer to the lessons that Taiwan and Korea (and in some cases Japan) hold for Ethiopia's development. These include: early focus on productivity growth in agriculture in order to accumulate capital, increase supply for agro-industries, and generate demand for manufactured goods; restriction on ownership of land; a nationalised banking system that has enabled governments to channel credit from rent-seeking to value-creating activities; incentives for export-orientation; 'carrot and stick' policies for enterprises, e.g. setting productivity and export targets; a focus on export-led industrialisation; and control of industries as a 'cash cow' to generate the financial means the ruling party needs to retain political hegemony.

These elements in fact are a powerful factor in shaping Ethiopia's industrial policy. Japanese experts have been invited to advise the country on industrial policy, Koreans to draft its science and technology policy. Agricultural demand-led industrialisation is regarded as the starting point for industrial development (also in terms of ensuring political support by the country's large rural populations): land remains in the hands of the state, as private land ownership is regarded as a principal source of rent-seeking; the financial sector is set to remain under government control;¹⁵ the Board of Directors of the Commercial Bank is appointed by the government, and the bank lends on the basis of "strategic" political criteria; export orientation is strongly encouraged; specific performance targets for major firms are set; and government control of economic sectors – e.g. telecommunications – is maintained as a source of revenue for the government. In 2003/04 the government received 13.5% of its total revenue from SOEs and government-owned property.¹⁶

As Asian experiences show, strategic policymaking of this kind, which defines sector-specific targets, differentiates between rent-seeking and developmental enterprises, and uses incentives to reward and penalise, may help to kick-start development processes if it is well managed. But it certainly creates new sources of rents and, consequently, incentives for illicit enrichment. Rents may accrue to firms for being fortunate enough to have their activities considered as "strategic"; or to firms that are part of the state-owned or endowment-owned enterprises; or to firms that benefit from restricted licensing; or to firms that manage to work around existing import or export bans. If carrots and sticks are used, it is imperative to make sure that clear and transparent rules are in place and to hold policy-makers accountable. In contrast, if decisions are taken in a non-transparent and discretionary way, the result will be to encourage rather than overcome rent-seeking.

15 The three major banks that account for the bulk of financial transactions are state-owned.

16 Based on Central Bank data, cited in European Union (2006).

2.2 Ethiopia's industrial development strategy: A critical review

Ethiopia's development goals are laid down in the Plan for Accelerated and Sustained Development to End Poverty (PASDEP) and its industrialisation goals are set out in the Industrial Development Strategy. PASDEP is the country's second poverty reduction strategy paper, drafted for the five-year period 2005/06-2009/10. It has a much more explicit focus on private sector development, competitiveness, and growth than its predecessor. The Industrial Development Strategy, which was approved in 2002, is regarded as the country's first-ever comprehensive industrial development strategy. It recognises the need for deep institutional reforms of the national institutional system, which is characterised as non-transparent, bureaucratic, anti-democratic, etc. The Plan spells out how "developmental" enterprises are to be supported.

Subsequently, a number of tangible institutional changes have been implemented, including the establishment of new (or strengthening of existing) specialised capacity building and technology institutes for sub-sectors (leather and leather products, textile and apparel, sugar industry, metal, dairy and meat, horticulture), and the elaboration of a detailed sector strategy for the leather industry (Zerihun 2008, 258). Ambitious reforms have been initiated in complementary areas, e.g. to overhaul the TVET system. Likewise, the annual intake capacity of higher education has increased strongly to 48,053, bringing the total number of students in universities to over 180,000 in 2006/07 (MoTI 2009).

Overall, the plan reflects a quite clear strategic orientation and the government's strong commitment to industrial development and structural change. It is more explicit than the respective plans of many other countries, which typically provide standard lists of desirable goals, without offering much practical guidance for policymakers. While many other low-income countries accept whatever private sector development component international donors offer, the Ethiopian government is unmistakably "in the driver's seat" and negotiates with donors to ensure that their offer fits the overall strategy. Given the stability of the government, which has been in power since 1991, Ethiopia's development can build on a long-term strategy.

The Industrial Development Plan mentions a few general principles – e.g. to recognise the role of the private sector as an engine of growth; the importance of state leadership to challenge and support developmental firms; and the need to build on both foreign and domestic investors. Furthermore, it specifies priority areas for *selective* interventions that favour certain sectors over others. What follows presents and critically analyses the main criteria for selective support.

1. The most prominent focus is on *agricultural demand-led industrialisation (ADLI)*. From an inclusive growth perspective, this focus is well chosen. At the moment, 85% of the workforce is rural, with the vast majority engaged in agriculture, and agriculture is hardly connected to manufacturing. Low productivity and income severely constrain rural demand for manufactured products, and only 5% of intermediate inputs demanded by agriculture are produced by the domestic manufacturing industry (Ethiopian Economic Association 2005, 7). The government is making strong efforts to invest in rural infrastructure, primary education and health, rural vocational training centres, increasing the area under irrigation, etc. Dedicated technology and training centres have been set up to support specific industries (e.g. sugar, meat and dairy, leather and leather products) and a number of value chain programmes are underway.

While this strategy, focused on infrastructure and supply-side technical inputs, creates important preconditions for rural development, it has not yet yielded any significant results. Farming and livestock management systems are still mostly archaic, productivity gains are far from satisfactory, and the number of specialised farms producing high-value cash crops (such as cut flowers, fruits and vegetables) remains far too low to improve overall indicators. The underlying key problem is lack of private investment, which in turn is constrained by public land ownership and very small plot sizes. Given these conditions, few investors are willing to undertake major investments in irrigation, mechanisation and agro-industries.

Its profound dependence on agriculture makes Ethiopia particularly susceptible to the adverse effects of climate change. Less regular rainfall could exacerbate rural poverty and nationwide food shortages. Droughts and periodic intensive rain could further deteriorate soil conditions. Strengthening climate resilience through adaptation programmes should therefore be high on the government's agenda. In fact, a National Adaptation Programme of Action was prepared in 2007, and the government is currently developing a national climate change strategy with assistance from the World Bank. To date, however, there is little progress in implementation, and climate mitigation and adaptation are not integrated in the PASDEP or the national strategy for industrial development.¹⁷

2. *Priority for export sectors.* Given the limited size of local markets and the need to generate foreign exchange, there is a clear focus on export industries. Export-led industrialisation is also one of the lessons the government has learnt from the successful development of Taiwan and Korea. Again, the main emphasis is on high-value agriculture (horticulture) and agro-processing industries (leather products). Export industries benefit from favourable land lease rates, soft loans, tax incentives, subsidies for participation in trade fairs and international missions, and other services. Differential interest rates are offered for different products, e.g. horticulture projects qualify for soft loans, whereas the production of pulses for export does not. Following an "East Asian" approach, export targets are agreed upon for individual firms. The case studies in Chapter 3 document political support for two exporting industries.

So far export promotion has had limited success. Between 2003/04 and 2007/08, the total exports of three priority sectors (leather, textiles, agro-processing) increased from US\$ 72 to 168 million. Exports thus remain marginal. What is more, the export share of these three priority sectors actually decreased from 12 to 11% (MoTI 2009).

The policy bias in favour of exports has repeatedly been questioned. Critics argue that efficient import substitutions may have the same positive effects on the foreign exchange account; and, even more importantly, entry barriers may be much lower, as local entrepreneurs do not have to cope with international standards, economies of scale, and high transport costs involved in the export business. Then again, encouraging firms to export may have a number of advantages, especially in terms of technological learning. In fact, Bigsten and Gebreyesus (2009) show that exporting firms in Ethiopia are generally more productive than non-exporters and increase their

¹⁷ See Ellis / Baker / Lemma (2009: 40 ff.).

productivity faster. While part of this is explained by self-selection, the authors also found strong evidence of “learning-by-exporting”. It can be assumed that experiences of exporters exposed to sophisticated international markets create a number of knowledge spillovers for the local economy. According to recent statements by the Prime Minister and the Ministry of Trade and Industry, equal treatment will be granted to efficient import-substituting industries in the future.

Last but not least, the birr is currently over-valued. Firm-level support for exporters is unlikely to yield major results as long as exports suffer from an unfavourable exchange rate. Devaluation would help to increase export competitiveness and to resolve the current foreign exchange crisis.

3. *Labour-intensive industries* are seen as more appropriate than capital-intensive industries due to Ethiopia’s factor endowment. The Industrial Development Strategy talks mainly of agro-processing and garments as potential candidates. However, the strategy paper recognises that low labour productivity seriously constrains export competitiveness. It states that while salaries are two to three times lower than they are in China, productivity is five to seven times lower. Taking Ethiopia’s conditions as a land-locked country into account, the prospects for attracting outsourced tasks in global value chains (typically garment assembly in export processing zones) are dim. What remains are activities that are resource-based *and* use cheap labour, such as the footwear industry.
4. *Four specific economic sub-sectors* are identified in the Industrial Development Strategy (textile and garment industry; meat and leather products industry; agro-processing industry; construction industry). All of them are agriculture-based and/or labour-intensive. Specialised institutes and/or training programmes have been created for each of the sectors.
5. *Cottage and small-scale manufacturing enterprises* deserve special attention. Small enterprises account for the lion’s share of non-farm employment in Ethiopia, but operate at very low productivity levels. The vast majority of cottage industries and small firms can be categorised as *necessity entrepreneurship* (as opposed to *opportunity entrepreneurship*), because they lack basic conditions for business success, e.g. an innovative and promising business idea, capital, as well as technical and managerial skills. To work on one’s own account is mostly a second-best decision in the absence of formal employment opportunities. As it is virtually impossible in the medium term to expand productive formal employment in a way that would fully absorb the currently unemployed or unproductively employed workforce, there is an urgent need to increase productivity *within* the segment of micro and small enterprises. Government support is mainly channelled through the Federal Micro and Small Enterprises Development Agency (FeMSEDA) and the respective centres in the regions (ReMSEDA). These provide entrepreneurial and vocational training (using appropriate technologies for printing, weaving, metalworking, carpet making, etc.) through regional TVET centres and are seeking to increase their outreach by using a train-the-trainers approach.

Critics, however, see the SME policy as a job creation scheme that may be useful to provide poor people a decent source of base income, but does little to nurture innovation- and growth-oriented entrepreneurship. To achieve the latter, more focus

should be given to new business models that create additional markets. Options that have not yet been exploited in Ethiopia include: rewarding innovative business concepts; encouraging graduates from universities and colleges to set up new firms and coaching them with the help of experienced business people;¹⁸ support programmes that help link micro and small firms to larger firms, as suppliers or franchisees; and public procurement *cum* training programmes to upgrade small firms.¹⁹ An approach of this kind would require closer collaboration between FeMSEDA/ReMSEDA and those institutions that promote larger industries, such as the Ethiopian Investment Authority.

Much more can also be done to improve provision of business development services beyond the services provided through the TVET system. As the public system of FeMSEDA/ReMSEDA is unable to reach out effectively to all small enterprises, additional channels of service delivery may be required. Business membership organisations may be encouraged to strengthen their service offer, and private service providers may be built up using a combination of supply-side and demand-side incentives, such as voucher systems (Amha / Ageba 2006).

2.3 Policy formulation and implementation in practice

When it comes to modern industrial policy, governments formulate industrial policies in a participatory process that enables them to elicit information from private stakeholders in order to address specific market failures. This requires both close interaction with these stakeholders ('embeddedness') and independence in decision-making ('autonomy'), in order to avoid serving the interests of particular lobbyists (Evans 1995). Moreover, modern industrial policy is designed as an open-ended process of experimentation or "self-discovery" (Hausmann / Rodrik 2003). Temporary incentives may be provided if they are necessary to trigger private sector responses that may generate positive externalities; but they should be phased out when there is evidence that the private sector does not respond as expected, or when market development takes off and generates sufficient response. In order to take these decisions, close monitoring and evaluation of policy performance is needed, and stakeholders should be invited to provide their feedback. Hence good industrial policies build on an *evidence-based, participatory and transparent institutional learning process*. Moreover, policymakers should make use of private service providers whenever possible, providing incentives if necessary, and encourage competition among service providers, rather than implementing each and every service through government channels.²⁰

Industrial policymaking in Ethiopia has advanced substantially over the last few years. Especially the institutional reforms of the Civil Service Reform Programme are shifting

18 According to interviews at universities, there seem to be almost no company spin-offs from universities, reflecting a lack of interest in entrepreneurship among the Ethiopian elite.

19 In the construction industry, 40% of the volume of any one contract must be given to SMEs, but this regulation does not apply to other sectors.

20 See Altenburg et al. (2008) for an extensive overview of principles of modern industrial policy-making.

the industrial policy system in the right direction. Some agencies under public ministries have already been restructured in a way that makes them more flexible and responsive to the needs of the private sector. The Ethiopian Horticulture Development Agency, for example, was formerly a department of the Ministry of Agriculture and Rural Development, which made it difficult for the agency to react quickly and flexibly to the demands of the private sector. Now it has gained flexibility as an autonomous agency that reports directly to the president and is free to hire its staff independently. A similar example at the regional level is the Tigray Agricultural Marketing and Promotion Agency (TAMPA) in Mekele, which attracts investors very proactively and professionally and shows remarkable flexibility in responding to their needs.

To develop an open policy-learning system, however, Ethiopia still has a long way to go. Although the government has designed quite flexible and appropriate policies for different challenges (see e.g. the different ‘policy styles’ used in the cases of the cut flower and the leather industries, Chapter 3), these decisions are taken within the confines of the government (or the ruling party) and are neither systematically evidence-based nor participatory nor transparent. This may be a reflection of the EPRDF’s dogma of insulating its institutions from rent-seeking interests. Moreover, especially the relationships between government, ruling party, state-owned enterprises and endowment-owned enterprises are quite opaque. Transparent procedures with regard to allocation of credits, land, and subsidies of different kinds are needed to create a level playing field for all companies and build trust among the public and the private sector.

Currently, resource allocation is sometimes done in a way that is not fully transparent to outsiders. For example, the government hand-picked 100 textile firms for a subsidised ISO certification programme, rather than inviting companies to apply on the basis of transparent predefined criteria. Also, Ethiopia does not encourage competition among service providers or take measures to encourage private service markets, e.g. training for service providers or use of voucher systems.

As shown above, business membership organisations are weak, represent only a certain faction of the business community and lack political independence. Moreover, there are few other open spaces for interaction with non-state actors. There are no independent policy think tanks that are asked to bring in their expertise when strategies and programmes are drafted. Moreover, the adoption of the Charities and Societies Proclamation in 2009 is expected to reduce the democratic space for civil society to participate in the policy dialogue. In sum, the government is only partly able to elicit information from the business sector and other social groups about the constraints that exist and the opportunities available.

Industrial policies in Ethiopia are not yet evaluated systematically and independently. No rigorous evaluations of core institutions and programmes are available. Although there are some reporting requirements, reports provide information on activities, rather than impacts, and are usually prepared by the implementing agencies themselves, rather than third parties. Monitoring and evaluation is increasingly built into some programmes (e.g. the TVET system), but the government has not yet taken steps towards fully independent third party evaluations or open stakeholder processes. E.g. it was reluctant to accept a social monitoring component in the donor-financed Protection of Basic Services programme.

3 Case studies

Two case studies have been selected to exemplify challenges and opportunities for industrial policy in Ethiopia: the leather/leather products industry and the cut flower industry. These two sub-sectors exemplify different patterns of public policymaking. While the leather and leather products industry can be regarded as a traditional branch, which the government intends to upgrade through proactive support from a range of dedicated public institutes, the cut flower industry emerged spontaneously, but was then supported by a responsive government that removed hurdles on request of the private industry and its association.

3.1 The leather and leather products industry

Ethiopia has a huge livestock population consisting of cattle, sheep and goats. Hides and skins are one of Ethiopia's most important export products. Already in 1928, the country's first tannery and shoe factory was established. The Derg banned exports of raw hides and skins, forcing tanneries to move up the value chain and to export semi-processed products. These became Ethiopia's main manufactured export product, accounting for 74% of all manufacturing exports in 2002 (Ethiopian Economic Association 2005, 24). Exports of semi-processed leather as well as finished leather products, such as shoes and bags, have grown steadily, reaching an annual average of US\$ 83 million in the period 2004/5 to 2007/8 (ecbp 2009). Today the sector consists of 800 registered hides/skins traders and about 6,000 tanneries and leather goods factories (World Bank Group 2006). Until recently, foreign investment in leather tanning was not allowed, and only in the last two or three years has foreign investment in tanneries and footwear production got underway.

Manufacturing of footwear is a promising option to increase the value added of the leather industry, making use of Ethiopia's low labour costs. The production of leather shoes on a handicraft basis has a long tradition in Ethiopia, but only a handful of modern factories have been established. In the early 2000s, the footwear industry suffered a serious crisis when Chinese imports of cheap synthetic shoes flooded the domestic market, driving many small-scale producers out of business. Larger enterprises, however, reacted to the challenge, importing modern machineries and improving the quality, design, and durability of shoes. Soon after the first wave of Chinese imports, consumers became aware of the low quality and durability of these synthetic products, returning to buy genuine leather shoes from domestic producers. Today mechanised factories are clearly competitive and growing, whereas small producers of low-quality shoes are still struggling to compete with Chinese imports.

In fiscal year 2004/2005, regular exports of leather footwear started with small batches delivered to Italy. Three years later, exports of footwear had increased to US\$ 10 million. Nine large mechanised enterprises dominated the footwear industry in 2009, most of them exporters. In the same year, the first major international investor, a German company, began work on a factory in Ethiopia. In addition, 30 medium-sized and about 600-700 small and micro enterprises are engaged in the production of footwear (ecbp 2009).

The leather and leather products sub-sector is one of the most promising manufacturing industries in Ethiopia. Due to its strong backward linkages with the rural economy, it has considerable potential for poverty reduction. To date it has created about 10,000 jobs in

the formal industry (ecbp 2009), plus a much greater number in informal handicraft and trading activities.

However, the industry faces serious problems, both in the processing stages and upstream in the production of raw materials.²¹ The problems start out with the low quality of hides and skins. Most cattle are not treated against ecto-parasites and diseases, and this leads to quality degradation of the hides. The common practices of branding, backyard slaughtering, as well as inappropriate storage and transport of hides and skins further reduce their quality. Due to their small size and losses, tanneries obtain no more than 22 ft² from one cattle hide, compared to 40 ft² in Europe and the Americas (ecbp 2009). Tanneries cause considerable environmental damage and are currently unable to comply with international environmental standards. Manufacturers of finished leather products are considerably less productive than international competitors. Diseconomies of scale and shipping costs add to their competitive disadvantage. As the industry has until recently not been exposed to international markets and has not built up design capabilities, producers have little understanding of fashion trends in international lead markets.

While the country's large mechanised firms – both tanneries and footwear manufacturers – have made considerable progress in terms of cost and quality, the performance of micro and small-scale producers is much worse. Footwear producers are clustered spatially in a few regions²² – the Mercato area in Addis Ababa being the most prominent cluster. Clustering has a number of potential advantages, as it may help firms to deepen their specialisation and benefit from collective efficiency through joint purchasing, marketing, or learning. A study on the Ethiopian footwear clusters, however, has found very little specialisation and cooperation among firms. Moreover, it has shown that there is very little subcontracting between large and small firms (van der Loop 2003, 32).

To become a major player in international markets and expand productive employment, Ethiopia's leather and leather products industry thus needs to tackle the manifold problems at different stages of the value chain in a coordinated manner. The government, with considerable support from UNIDO, GTZ, and other international agencies, has taken up the challenge and engaged in a comprehensive upgrading programme. The leather and leather products industry has been defined as a priority sector in Ethiopia's PASDEP and the Industrial Development Strategy. The government has worked out a specific five-year development programme for the industry (2006–2010).

Already in 1994, six state-owned enterprises formed the Ethiopian Leather Industries Association (ELIA), which today is an industry association with 43 members, including basically all large tanneries and leather product manufacturers. ELIA organises specialised trade fairs and exhibitions and helps to match export deals with foreign customers.

In 1998 the Ethiopian Leather and Leather Products Technology Institute (LLPTI) was established, with support from the Italian government. LLPTI is now the main service provider for tanneries and the leather processing industry. It provides consultancy and training in areas relevant to the industry, including factory management, marketing and

21 See ecbp (2009); UNIDO / MoTI (2005); van der Loop (2003).

22 According to UNIDO, three clusters exist in Addis Ababa and there is one in Mekele.

branding, effluent treatment, and laboratory testing of quality parameters. In 2009 a benchmarking programme was set up to work more systematically on productivity enhancement. LLPTI also offers standard training modules for the many hundreds of micro and small producers in the country. The Institute is expected to recover 25–30% of service costs from user fees.

To encourage exports, the National Export Development Committee, chaired by the Prime Minister, sets export and productivity targets. These are negotiated with large enterprises – both private and state-owned – on a case-by-case basis, and individual targets are agreed upon. Participating companies benefit from a range of government incentives – e.g. tax holidays for exporters and tax-free import of machinery – and support services. In 2004, the government offered land for an industrial zone. In it the military built semi-constructed plants, which were handed over free of charge to producers on the basis of business proposals (Redi 2009).

Moreover, the Engineering Capacity Building Programme has been mandated to design and implement, in collaboration with the major partners and stakeholders, a leather value chain upgrading programme which addresses problems simultaneously and in a coordinated manner. The programme consists of ten work packages including an ecto-parasite control programme for livestock, investment promotion and matchmaking services to attract foreign buyers, support for international exposure of Ethiopian firms, firm level support for productivity improvement, introduction of quality management systems, and capacity building for ELIA and LLPTI, among others. The programme includes a twinning arrangement between LLPTI and German leather technology centres. In parallel, UNIDO is assisting the government in promoting synergies among the small footwear producers and traders in local clusters such as Mercato. All these activities taken together, the government offers a quite comprehensive and reasonably integrated sector strategy.

3.2 The emerging cut flower industry

The cut flower industry has emerged much more recently, but is now one of Ethiopia's main export sectors. With flat lands on altitudes between 1500 and 2500 metres, where days are warm and nights are cool, with fertile soils and sufficient water supply, Ethiopia offers very good agro-climatic conditions for the cultivation of flowers. Most farms produce roses, but some are diversifying into new products such as *Hypericum*, *Gypsophila*, carnations, lilies, and freesias. In the case of roses, high altitude allows buds to grow larger, which is important to fetch premium prices. Moreover, wages in Ethiopia are low, and the suitable cultivation areas are close to Addis Ababa's international airport. According to data from the Ethiopian Horticulture Producers and Exporters Association (EHPEA), the industry exported flowers worth US\$ 120 million in 2008, up from almost zero in 2003. The area under cultivation was about 1,000 ha at the end of 2008, most of it under greenhouse cover. In 2008, 80–85 flower farms were operating, with some large companies operating more than 100 ha and many small companies with less than 10 ha. Flower production employed over 50,000 people, 80% of them women.²³ The rapid growth of the industry fuelled hopes that flower exports might even overtake coffee as Ethiopia's main export product in the near future. But recently, falling world market prices and increasing

23 All data from EHPEA, interviews with Ato Tsegaye Abebe (head of the association), 26 March 2009, and *HortiHolland* magazine, e.g. March 2009 edition.

freight costs forced several producers to close down, even before the current economic crisis. The crisis hit the sector quite hard as demand for flowers decreased in the main European markets, but the long-term impact on the sector is not yet clear. Long term perspectives may be good, as rising energy prices may affect European greenhouse production – which requires heating – more than Ethiopian production, despite the expected surge in airfreight tariffs.

During the 1980s and early 1990s, some initial efforts were undertaken to produce summer flowers for export, first under the Derg on state farms, then by two domestic private entrepreneurs.²⁴ Success, however, came only with Indian and Dutch foreign investment in the late 1990s and early years of the new millennium. The first rose producer started operations in 1999. After 2001 several other companies entered the market, and take-off started in 2003. Until that year, exports were marginal.

The flower industry – and especially innovation in it – is largely driven by foreign investors. Ethiopian investors, however, have been able to emulate their business models. Among the country's 80–85 producers in 2008, about one quarter were Ethiopian firms. The first successful large-scale producer of roses (Golden Rose) was an Indian investor who contracted specialists from Israel. Later leading Dutch producers entered the market. Especially important was the entry of Sher-Ethiopia, a leading Dutch company and by far the largest developer of greenhouse production in Ethiopia. In contrast, the role of national agricultural research and extension services seems to have been quite insignificant for the development of the industry (Gebreeyesus / Iizuka 2009, 15 f.).

Flower production is a knowledge-intensive business. Growers need to know which varieties fetch good prices, and which ones are suitable for specific regions. For example, the size of rose buds is larger, and colours more intense, at higher altitudes, but production per m² is considerably lower. Moreover, altitude, temperature, rainfall and moisture vary greatly among locations, resulting in highly differential disease risks. Success therefore depends on experimentation with different varieties, cultivation methods, and locations. Particularly for the up-market qualities, control of diseases (Botrytis and downy mildew) is a crucial factor. Farms are therefore experimenting with integrated pest management techniques. Marketing is equally demanding. The easy way is to sell at Dutch auctions, but higher prices can be achieved through direct sales to final customers, although this places higher demands on producers in terms of production programming and logistics.

In sum, flower production is a very promising export activity for Ethiopia, but developing the right technology and marketing channels is a very risky and knowledge-intensive undertaking. Those pioneers who take the risk and discover viable business models pave the way for a whole industry to follow. In terms of economic theory, the pioneers generate informational externalities: Once they have developed a lucrative business, competitors may quickly copy it and thus dissipate the rents that can be obtained from the business innovation. Hausmann and Rodrik (2003, 4) argue that

“there is great social value to discovering that cut flowers, soccer balls, or computer software can be produced at low cost, because this knowledge can orient the investments of other entrepreneurs. But the initial entrepreneur who makes the ‘discovery’

24 For an excellent overview of the history of Ethiopia's flower industry, see Gebreeyesus / Iizuka (2009).

can capture only a small part of the social value that this knowledge generates [... because] other entrepreneurs can quickly emulate such discoveries. Consequently, entrepreneurship of this type ... will typically be undersupplied."

Due to this mismatch between private risks and social benefits, there is a case for governments to encourage the discovery of new business opportunities.

In fact, the Ethiopian government has recognised this and offers generous incentives for flower farms. At the beginning, the sector evolved without specific government support. Exporters were granted substantial benefits – including a five-year tax holiday and duty-free import of capital goods – but no sector-specific support was available. Ethiopia's export promotion strategy, ratified in 1998, does not mention the cut flower industry (Gebreyesus / Iizuka 2009, 13).

When the success of pioneering firms became evident and EHPEA was formed to lobby the government, additional incentives were made available. The Prime Minister took personal interest in the growth of the industry. He meets growers regularly to discuss and take care of their problems, and in urgent cases the head of EHPEA is able to access him directly. One key problem faced by the pioneers was access to large plots of suitable land at a reasonable distance from the airport. At the outset, producers had to lease small plots of land from individual farmers (Gebreyesus / Iizuka 2009, 14). The government then started assisting investors in obtaining appropriate and accessible farmland at a lease price of only US\$ 18 per hectare. The second major problem was uncompetitive airfreight rates. The government helped to arrange an agreement with Ethiopian Airlines and currently subsidises the freight rates. Furthermore, producers were eligible for subsidised credit, but this has recently been discontinued.

A new Ethiopian Horticulture Development Agency was established in 2008 with the aim of providing faster and more coherent services for horticulture exporters. Although the new agency is under the Ministry of Agriculture and Rural Development, it has its own budget and freedom to hire staff without being bound by the general rules of the civil service. The idea of creating such a semi-autonomous unit was to offer one-stop services for investors in order to avoid cumbersome transactions with several layers of bureaucracy. The Horticulture Development Agency reports directly to the Export Committee headed by the Prime Minister.

One important success factor is the flower industry's very active business association. Several interviewees considered EHPEA the most effective business association in Ethiopia. On top of its successful lobbying, the association provides important services to flower producers. It organises a biannual International Trade Exhibition. Moreover, EHPEA took the lead in establishing a Code of Practices for the flower industry. The Code documents compliance with Ethiopian laws on labour and environmental issues, as well as compliance with good agricultural practice. It is supported by many stakeholders, including the competent ministries and several non-governmental organisations, and it is audited internationally. Such standards are increasingly demanded by international buyers and help to preserve the image of Ethiopian producers.

In sum, promotion of the newly emerging cut flower industry has benefited considerably from export incentives and the good relationships between firms, the sector association,

and public authorities, which have helped to remove obstacles. Still, some challenges for industrial policy remain:

First, technological progress is largely driven by FDI. Ethiopian nationals – both private investors and public research institutions – have not yet been able to adopt international best practice know-how and to adapt technologies to their local environments. Achieving technological competence in this regard may become a major competitive advantage for Ethiopia *vis-à-vis* its main competitors, Kenya and Ecuador. Greater investment in dedicated research and agricultural extension services is needed to achieve this. A new industry-led capacity building programme at Jimma University, in collaboration with the Horticulture Development Agency, EHPEA and the Dutch University of Wageningen, is a promising step in this direction.

Second, the competitiveness of the flower industry may be enhanced by increasing capabilities to provide complementary assets. While some basic inputs (like packaging materials) are locally available, producers are heavily dependent on imported inputs, including fertilisers, irrigation equipment, and construction material for greenhouses.

Third, the generous incentives offered to flower exporters come at a considerable cost. In addition to foregone taxes, the lease rate for fertile irrigated land implies an extraordinary hidden subsidy. How long investors will continue to receive such subsidies is an open question. In principle, such subsidies are justified as long as the investors help to discover new business opportunities that can be emulated by others. During a recent visit to Ethiopia, Harvard economist Dani Rodrik raised the question whether it makes sense to continue subsidising new investors in the flower business when more than 50 are already established. This is a difficult question, because it is impossible to establish when an investor generates informational externalities whose social value exceeds the amount of subsidies received. A lot of experimentation is still needed to test new varieties, new cultivation techniques and marketing channels, all of which add to the stock of knowledge available to follow investors. Transparent guidelines are therefore needed as to what type of investment deserves subsidies, and for how long.

Fourth, the cut flower industry holds important lessons for other horticultural crops. The Ethiopian highland offers appropriate climatic conditions for a range of fruits and vegetables, including strawberries, pineapples, passion fruit, papayas, mango, guavas, avocados, green beans, cabbage, asparagus, baby corn, snow peas, and chilli. Many of these crops can be produced all year round, and they thus offer opportunities to export at times when prices in Europe are high. The challenge is to replicate technological and policy learning from the cut flower industry and encourage similar innovations in fruit and vegetable production. To develop large scale production, major infrastructure investments are needed, including cold storage facilities. This will require an active role on the part of the Ethiopian government, as a nation-wide cold chain with regional procurement centres requires simultaneous investments that individual private investors would be practically unable to handle.

3.3 Lessons from the case studies

The two case studies exemplify two different ‘policy styles’, or government approaches towards private sector development. In both cases intervention is justified, because the

two sectors would arguably not have been able to expand high-quality production and exports without public support. Both seem to have been quite successful in forming the basis for activities that may take off in the future as major drivers of growth, although, in both cases, the scale of the operations and the spillovers to the economy are still modest.

However, the rationale for intervention is different in both cases, calling for different approaches. In fact, this is what the government did: It opted for a more responsive stance in the case of cut flowers, leaving the strategic decisions to firms and their highly professional organisation; and it adopted a more pro-active ‘nurturing’ approach in the case of the leather and footwear industry, where the main challenge is to absorb already existing standard technological knowledge, to disseminate it in a sub-sector consisting of many small and medium-sized firms, and – in the absence of a private value chain lead firm – to ensure coordination of upgrading activities throughout the value chain.

In the *cut flower industry*, the partners are quite strong and innovative medium-sized and large firms. Their success depends on their ability to choose the right variety of flowers, to adapt available technology packages to local agro-climatic conditions, and to sell a perishable high-value product on the international market. This requires much tacit knowledge which only large specialised firms are able to accumulate. Here the government plays no role in intervening at the company level – the technology being far too complex, and the product too heterogeneous. The fact that state-owned farms failed miserably in the 1980s confirms this view.

The main tasks of public policy here are to remove specific obstacles that are beyond the reach of individual firms – e.g. to ensure free access to land, or competitive air freight tariffs; to subsidise pioneering firms on grounds of informational spillovers; to create opportunities for specialised capability building with regard to flower cultivation techniques; and to support the transfer of lessons learned from floriculture to other horticultural activities.

In the *leather and leather products industry*, the challenge is different. The main problem here is coordination failure. The sector is stuck in a “low-quality trap” in which problems at all levels of the value chain are mutually reinforcing: Inappropriate techniques at the stages of livestock management, tanning, and transport undermine competitiveness in high-value leather product markets, and low quality of final products translates into low prices and under-investment at all stages of the value chain. The sector can thrive only if all these aspects are tackled simultaneously. In other circumstances, this problem might be resolved by large private sector lead firms. Large footwear or other leather processing companies can, in principle, take care of upgrading their own supply chains, and they are usually much more efficient in doing so than governments. But there is no such firm in Ethiopia yet. Large firms may emerge when the local market has a certain critical size (as in the case of Bata in India) or when the country is attractive for large scale manufacturing for global value chains – this is how footwear production grew in Taiwan and Korea, and later on in China and Vietnam. In all these cases, large corporations played an important role in upgrading the quality and productivity of their respective supply chains – or, speaking in economist’s terms, to correct coordination failure. This is not the case in Ethiopia, and this is what justifies pro-active public engagement.

Creating a thriving leather products industry would generate substantial spillovers to the rural economy, both in terms of direct income effects (by increasing the demand for hides and skins) and in terms of technological learning (through incentives to improve production techniques in the tanning industry, in abattoirs and in animal husbandry). Moreover, livestock management, leather tanning, and processing of leather products are mature technologies that call for less firm-specific tacit knowledge. Thus it is easier for governments to provide services for industrial upgrading, such as training courses for tanneries and footwear producers, or laboratories that test standardised quality parameters.

4 Conclusions

The Ethiopian government has demonstrated impressive dedication and ability to create the preconditions for a market-based and socially inclusive industrial transformation. It is strongly and credibly committed to investing in technological learning in order to build new competitive advantages and leave the history of feudalism and “rent-seeking” behind. Improvements for the vast majority of the rural poor are at the centre of the government’s project for societal transformation. Overall, policy formulation and implementation is relatively effective, given the country’s level of per-capita-income, and the government has shown flexibility and pragmatism in choosing and adapting its industrial policies.

The main risk for Ethiopia’s future development stems from three interrelated characteristics of its industrial policy process:

- The government deliberately employs a carrot-and-stick approach that differentiates between economic activities and firms, up to the point where targets for individual firms are sometimes negotiated on a case-by-case basis in exchange for public support.
- Allocation of resources for industrial policy is not fully transparent, e.g. it is not clear when firms are eligible to get preferential treatment in term of access to licenses, land, credit and foreign exchange, on what condition ailing firms will be bailed out, and whether these conditions vary between state-owned, endowment-owned, and independent private firms.
- Business and politics are still strongly entwined in Ethiopia. SOEs still dominate many manufacturing industries and service sectors, and party-affiliated endowments have taken many of the business opportunities left for private engagement. It is not always clear to what extent political considerations reflect the business strategies of those firms, and vice versa.

The combination of these three characteristics involves risks. Discretionary allocation of public resources lends itself to political capture by interest groups, particularly in an environment where government, EPRDF, and the business elite are closely entwined via dense shareholding and political relationships that are not transparent for the public. There will always be a temptation to employ the current institutional setup to strengthen the ruling party coalition and to employ economic incentives in return for political support, e.g. to make the party-owned endowment funds a source of rent-seeking for its cadres and allies. In any case, the independent private sector faces a considerable disadvantage, which is not a good starting point for a trustful relationship and collaborative policy process.

To date Ethiopia is clearly anything but a predatory state whose government pillages the economy. There is no evidence of systematic abuses of political regulation and support programmes for illicit personal enrichment of political elites. Most SOEs and endowment-owned firms have to compete on a market basis, and public tenders seem to be fairly transparent and not to favour politically well-connected firms in any noticeably unfair way.²⁵ The leadership is credibly committed to its national modernisation agenda and has thus far been able to contain rent-seeking by entrepreneurial groups connected with the ruling party.

Relying fully on the wisdom and integrity of an enlightened leadership, however, is not without risks. Power constellations may change, those who have vested interests in SOEs and endowment-owned enterprises may gain political influence, and political power shifts may force political leaders to compromise on their development agenda. This is why it is important to build checks and balances into the political system, making policy decisions transparent and holding policymakers accountable. Discretionary carrot-and-stick policies may produce good results (as they did in Korea and Taiwan), but they may also open a Pandora's Box. Deepening of the Civil Service Reform Programme, reducing the privileges of state-owned and endowment-owned enterprises, and exposing them fully to fair competition will help to draw a clear line between business interests and public policy.

Three additional observations arise from the previous analysis.

First, industrial policy should move away from predefining sectors and instead develop a system that encourages open-ended entrepreneurial search processes. Windows of opportunity often open up in quite unexpected areas. Private entrepreneurs are usually much better equipped to recognise trends and take advantage of new opportunities than government agencies. Government should help to create a learning environment that engenders entrepreneurs who observe market trends and are ready to take risks, and to support their business projects. An open approach of this kind would avoid biases – e.g. in favour of export industries – and help to find new opportunities. For example, the country's current strong economic growth has greatly increased demand for basic manufactured products, but supply has hardly improved. Many local market opportunities are still untapped: bottled and packaged fruit juice is still mainly imported; many construction materials and agricultural inputs are brought in from abroad; until recently, even matches were not produced in Ethiopia. Encouraging local entrepreneurs to develop such markets may yield quick results, taking into account that entry barriers in the domestic market are low compared to export markets. The government may have an important role to play in improving framework conditions and nurturing local entrepreneurship with a focus on market-expanding innovations.

Second, managing policy reform on so many fronts at one time requires good policy coordination and clearly defined responsibilities. The creation of the Ministry of Capacity Building as a new “super-ministry” seems to have been a bold move. However, there may now be a need to better define powers and responsibilities, e.g. *vis-à-vis* the Ministry of

25 The World Bank's 2002 Country Procurement Assessment Report stated that “endowment-owned firms were reported to enjoy preferential treatment in bids for government contracts” (cited in World Bank 2009); but there is little hard evidence for this.

Trade and Industry. The newly created Ministry of Science and Technology may add to the risk of overlapping powers and responsibilities, given that industrial and trade policy, technology development, and capacity building are nowadays strongly interrelated.

Third, the government may want to rethink its position with regard to private trade and services. The government often characterises middlemen as “rent-seekers”, and the overall thrust is to have public agencies provide services that are strategic for national development – from banking to agricultural extension and business development services for SMEs. While in certain cases it may be good to replace intermediaries who abuse of their market position and to maintain public service monopolies, in many other cases it may be counter-productive. As in manufacturing, private traders and service providers are often more innovative and have stronger incentives to provide value to their customers than bureaucrats. This calls for changes on two fronts: first, to create more space for private service providers to compete with existing public suppliers – the advantages and disadvantages of public vs. private service provision will then become evident, and policymakers can reward those who perform better; second, to proceed with the Civil Service Reform in order to make public service providers more flexible and accountable to their customers.

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