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FIELD REPORT

ETHIOPIA:
RECOMMENDATIONS FOR ACTION IN THE PRIVATE SECTOR

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ETHIOPIA - PRIVATE SECTOR
RECOMMENDATIONS FOR ACTION JANUARY 1992

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Executive Summary

1. Background and Purpose

The success of the TGE's new economic policy will depend most fundamentally on the private sector's response to the opportunities for growth and diversification which will emerge from the process of economic liberalization and restructuring. Private sector expansion will be critical for absorbing the large numbers of demobilized soldiers, and for cushioning the social consequences of retrenchment, which will inevitably occur as a result of privatization and other reforms scheduled for the coming years. Expanding the productive base will be essential to any attempt to restructure and revitalize the government's revenue base.

The private sector review conducted in January 1992 sought to provide a quick overview of the current status of the private sector, and formulate a reasonable menu of options for proceeding with an assistance program for the sector.

The issues of macroeconomic stability, exchange rate, monetary policy, interest rate policy and the budget deficit (the net of government revenue and spending) are pre-requisite conditions which should be addressed prior to privatization. These issues are less important to private sector development than to privatization but are, nevertheless, important.

2. Findings

On Private Sector Development

2.1 <u>Private sector (formal and informal) firms are small, but account for most economic activity</u>.

Fifty percent of medium and large scale formal enterprises (MLSEs) are private sector firms. On average a private MLSE reported less than Birr 130,000 in fixed assets and employed 40 people in the mid 1980's. At this same time the average industrial sector SOE reported Birr 2 million in fixed assets and employed 360 workers. The number of informal sector establishments is well over 100 times larger than the number of private MLSEs. But the average value added of these informal firms is less than one tenth of the value added for private MLSEs. The informal sector probably accounts for 90% of total private sector production in the country, 89% of manufacturing activity, and contributes a total of 15% to GDP (this latter estimate does not include the non-monetary or subsistence sector).

2.2 Formal and informal manufacturing concentrate on consumer goods.

In the formal sector, food, beverages, and textiles accounted for 60% of manufacturing output in 1987/88 (compared to 66% in 1983). The informal manufacturing sector tends to emphasize even more these same three industrial segments. Over 50% of urban informal sector establishments were concentrated in food and beverages and another 28% in the textile sector in 1990. Over 63% of formal sector establishments are located in Addis Ababa, while a 1985 survey found that only 33% of informal sector establishments were.

2.3 There are effective business support institutions.

One of the more effective and active seems to be the Addis Ababa Chamber of Commerce (AACC), with 25,858 members. The AACC provides training, export and local market information for members through formal workshops and its newsletter, and lobby on members' behalf. Besides the Chambers, there are plans to legally constitute at least two new business/professional associations: one of consultants and another of building contractors.

2.4 Private sector growth has been uneven.

Most of the MLSEs established in the 1980's were SOE's. In terms of small scale enterprises (SSEs), growth seems to have greatly accelerated in 1990's. A World Bank report states that the MOI granted 145 licenses in 1988. In 1991-2, the Ministry of Industry (MOI) received 4,000 applications for licenses by private entrepreneurs and the Ministry of Agriculture (MOA) received 3,000.

2.5 Key constraints to business entry and/or growth are:

- Lack of foreign exchange.

  Many business persons consulted consider this the most serious constraint. Local private operations, like SOE's, are extremely import intensive; several businessmen pointed out that on average firms require 60%-70% of imported inputs to operate. The private sector does not receive any official allocations of hard currency, though it is allowed to import without limit under the "franco valuta" system. But the system leads to excessive costs and fosters black marketing and export under invoicing. Except for joint ventures, private companies are not allowed to remit profits or service fees.

- Finance and access to credit.

  Private firms depend entirely on their own funds, informal lending groups ("Ikubs"), and moneylenders. SSEs self-financed on average between 59% to 84% of total investment. The World Bank estimates that the cost of credit to private entrepreneurs was 2-4% higher than for SOE's in 1991, and this is excluding additional fees often levied on these firms, including a 2% insurance fee on assets, and illegal side payments. On the other hand corporate account holders get 2% on deposits over Birr 100,000.

- High effective corporate tax rates.

  The marginal business income tax rate was recently reduced from 89% to 59%, but this is still too high. Under the present system, the incentives for accurate financial disclosure are minimized and lenders' confidence reduced, leading to high loan security requirements. High marginal tax rates for individuals discourages worker initiative. High tax rates are also discouraging pension funds, a potential source of capital for privatization. The present tax code does not recognize pension funds and taxes them and any interest earnings at very high marginal rates.

- Licensing structure.

  It takes MOI less than 48 hours to issue a temporary business license. But the entrepreneur cannot begin operating until he/she has the permanent license, which takes some time. The licensing process in the Ministry of Agriculture (MOA) is more cumbersome, due to difficulties in sorting through land ownership issues; of 3,000 applications for business licenses received by the MOA since early 1991, 6 have been approved by January 1992.

- Labor code regulations.

  For example, under the existing labor code, union membership is mandatory; firing is extremely difficult; and there is no free market for skilled labor. All university graduates must apply for a job in government. The courts rarely if ever find in favor of management.

- Regulations on trucking and haulage.

  Though in most parts of the country, these regulations are no longer enforced, they are still in the books and present a potential disincentive to cross-regional and intra-regional trade.

- Price controls.

  Have led to excessive speculative activity, the so called "air to air" trade, whereby people trade their licenses to purchase certain subsidized goods which are subsequently resold through markets at market clearing rates (eg basic foodstuffs, household goods, etc).

- Lack of market information and market infrastructure.

- Confusion between the role of national and regional investment agencies.

  The role of OIJV vis à vis regional/provincial authorities must be clarified. There is no longer a single "one-stop" agency where investors can seek assistance.

On Privatization

2.6 Commitment to privatization is strong, but there is little consensus regarding the role and objectives of a privatization program.

The TGE has expressly stated that it will only privatize those firms "the state cannot operate profitably." But some senior government officials, such as the Minister of Industry, understand that privatization should seek to move enterprises quickly into private hands. Part of what the Mission can and should do immediately is to help the TGE clarify conceptually what it seeks to achieve through privatization. This can be done through dialogue and training (see part 3).

2.7 The current policy and regulatory environment presents serious obstacles to any privatization initiative.

Until the policy issues discussed in the preceding section (e.g. the tax code, credit allocation policies, foreign exchange constraints, etc.) are resolved, it will be difficult to either make the current SOE's profitable or interest investors, foreign or domestic, in acquiring any state assets.

2.8 Government lacks technical expertise in setting priorities for divestiture.

Areas where the TGE might be able to use expert technical assistance from abroad:

(a) Cataloguing SOE's and establishing viable privatization candidates;

(b) Identifying which SOEs should/could be privatized without much restructuring and which would require more extensive rehabilitation;

(c) Evaluating and determining how much the state should be willing to invest in rehabilitation before it divests;

(d) Evaluating the likely employment and other social impacts of divestiture in a particular sector;

(e) Establishing reasonable price ranges (valuation); preparing company audits, prospectuses and negotiations with prospective investors.

2.9 A private sector supply response to privatization opportunities is likely.

There is a fairly substantial class of wealthy Ethiopian entrepreneurs living in the country and abroad. Ethiopian entrepreneurs are moving already to raise capital to finance acquisitions. Foreign investor interest is bound to be more guarded, even though they enjoy more guarantees and concessions under the joint venture law. But some foreign investor interest has already been expressed in textiles.

2.10 There is no single unit in government for coordinating privatization activities.

It is not yet clear whether the final word on a particular privatization proposal will come from the ministry with direct operational responsibility for the SOE's, from the Ministry of Finance as the official owner of the enterprises, or from another body. Nor is the role of regional governments clear. These are all practical operational questions which the TGE will have to answer before it embarks in any type of program. Officials interviewed have expressed an interest in learning how other countries have organized their privatization process. This could be a topic for an initial training session on privatization.

2.11 Privatization is likely to place additional strain on the banking system.

As many of the SOE's are loss making and have, in aggregate large bank borrowings the issue of their indebtedness must be resolved prior to their privatization or otherwise the banking system will be placed under considerable pressure. The recent IBRD banking sector review addresses this issue and recommends the recapitalization of those banks with considerable bad debt/doubtful loan portfolios. This issue is likely to be significant as without a healthy banking system finance will not be able to be provided to the newly privatized companies.

Further, bank management information and accounting systems are antiquated and require upgrading so as to enable the banks to monitor risk, exposure and treasury operations effectively.

2.12 Transport sector liberalization

In line with recent moves to liberalize and deregulate the transport sector donors should be allowed to sell their used vehicles to the private sector rather than to the government. This will stimulate the transport sector and should, in aggregate, lead to a better maintained national fleet of vehicles than if the vehicles were sold/transferred to the government. It would, further, have the advantage of reducing the "patronage" of the government since it would have fewer assets at its disposal.

Observations on Mission Portfolio

2.11 Key programs being prepared at this time will or could support entrepreneurial development and privatization activities, either directly or indirectly.

Moreover, a review of the types of actions currently being undertaken or contemplated by other donors, such as the EC and the World Bank, suggests that perhaps no donors, other than USAID will be in a position to fund as wide a variety of private sector support activities in the foreseeable future (6-18 months). To capitalize on opportunities created by the new economic policy and ensure programs use and support private sector most effectively, the Mission should consider the following:

o To what extent could activities proposed under Mission programs affect the momentum of the privatization program?

By relieving key operational constraints and thus improving SOE profitability, at least in the short-term, the ERRP or Title III program activities (such as the one focused on increasing the capacity utilization for the textile company), could conceivably derail, or at least delay privatization initiatives. This possibility argues for ensuring that the Mission carries out a sustained dialogue and training process with TGE officials to help clarify privatization objectives and expand and maintain commitment to the privatization process.

- <u>How can the private sector be involved more actively in implementation</u>?

  Given the need to rationalize public expenditures, and the severe budgetary constraints faced by the TGE, channeling assistance directly to the private sector becomes a key tool for reducing the recurring cost burden on the government and for insuring the sustainability of activities. Options for involving the private sector more directly in the implementation of Mission activities could include:

  (a) The use of private contractors, not just ERA, in ERRP;

  (b) Using local consultants as much as possible for all studies commissioned as part of existing programs;

  (c) Relying on the AACC and other business support institutions as one of the NGOs charged with monitoring and evaluating the effect of the programs on the private sector.

- <u>What is the best way to diversify the private sector portfolio to reduce political risks</u>?

  The Mission is inclined to put much of its private sector development priorities in the area of privatization. But it may want to consider balancing interventions in this potentially negative/explosive area (in the sense that they may lead in the short term to serious social dislocations) with more positive actions -- interventions which "empower" local entrepreneurs to grow and expand.

3. Recommendations

The agenda for action suggested below is indicative of the types of options available to the Mission, given the preceding findings. Table 1 below lists all proposed activities, indicating the most appropriate timing for each. It also indicates what types of resources the Mission has at its disposal to provide expertise and/or finance in these areas, including its own programs and buy-ins to existing centrally or regionally run projects.

3.1 Conduct and assessment of SOEs in Industry, Transport and Trade.

These are the Ministries most enthusiastic about reform. These Ministries control some of the better performing parastatals. On the basis of such an assessment of SOEs, a typology (in terms of strategic/non-strategic, viable/non-viable enterprises) will be created in each sector and prime privatization candidates identified.

3.2 Appraise the competitive environment and structure of private businesses in sectors of strategic interests.

These sectors would include industry especially textile, food processing), construction, transport and retail activities. The inventory would focus on formal establishments. It is important to know what the structure of these businesses are, their investment and employment patterns, credit needs and their views on the business climate, not just for designing direct assistance package, but for evaluating the viability and worth of SOEs operating in these sectors.

3.3 Conduct an assessment of business training and support institutions.

Knowledge of the local training needs in and options available to conduct training in business planning, marketing, accounting, and other critical areas necessary for business development may become critical as the Mission proceeds to support increased private sector participation in retail trade, transport and other areas. It may be useful for enhancing the viability of increasingly autonomous SOEs.

3.4 Assist in the feasibility study of re-establishing the stock market, in coordination with the World Bank, which is already working intensively in financial sector reform.

3.5. Fund a private sector advisor.

The country is in a critical juncture in terms of key policy issues which will affect private sector development prospects for the coming years. Insuring the momentum is maintained, and providing the TGE with sound advice at critical times will require fairly intensive follow-up and ready access to expert advice which only a private sector advisor located permanently in Addis could effectively provide. This position could eventually be funded from the National Policy and Planning Support project.

3.6 Provide immediate support for the design of new investment, bankruptcy and labor codes.

Both codes are currently in the process of being drafted.

3.7 Provide technical assistance in marketing to OIJV and AACC.

The Mission could have a long-term interest in strengthening these organizations as potential implementing agents for privatization activities.

3.8 Provide access to specialized TA in venture capital fund management to the CEE and other emerging groups of local investors.

There is at least one venture capital company in Ethiopia that is being formed. The success of this institution and emergence of others like it will be critical to the success of the privatization program, and private sector development in general.

3.9 Provide short-term training in privatization for key MOI and Ministry of Trade and Transport officials.

One training activity to be provided immediately would be a seminar on privatization. The seminar would provide TGE officials with an overview of the potential approaches/ techniques for conducting privatization, valuation techniques, the stages in a privatization program, modalities for implementing privatization programs. The seminar could also present and discuss case studies of privatization transactions elsewhere, and provide an overview of lessons learned from privatization initiatives elsewhere in Africa. This component could be undertaken as part of the scope of the SOE assessment (see 3.1).

3.10 Bank training.

The World Bank would like to see a move towards project-based lending from collateral lending, and there may be a role for USAID/Ethiopia here, given AID programs and expertise available in the area. But no such training should be contemplated until, at the very least, the tax code and consequent financial disclosure issues are resolved.

3.11 Bank Management Information Systems

In addition to bank training USAID should consider funding consultants for upgrading bank MIS and accounting systems.

3.12 Fund a feasibility study for the development of a leasing company.

Leasing world wide has provided considerable medium-term funding to private sector companies for the acquisition of plant, machinery and transport equipment. This objective here would be to establish such a leasing company in Ethiopia. It would also have the additional advantage of broadening and diversifying the banking sector and would allow foreign investors to bring know-how to the Ethiopian financial sector which has, in the past, been closed to foreigners.

TABLE E-1

ACTIVITY		DESIRABLE PRE-CONDITIONS	START DATE	SOURCE OF EXPERTISE OR FINANCE
3.1	SOE Assessment	Seminar on privatization (activity 3.3.1)	Immediate	PAD (IPG-PW), ERRP
3.2	Targeted Private Sector Assessment	None	Immediate	PES, PEDS, ERRP, Title III
3.3	Private Sector Training Needs and resources	None	In coordination with 3.1.2	PES, PEDS, HRDA
3.4	Feasibility of Stock Market and other Capital Mobilization Instruments	Clarify TGE position on private sector participation in finance sector; reduction of tax rate; investment code and labor codes acceptable to private sector	3rd quarter 1992	PES, PEDS, Financial Markets
3.5	Private Sector Advisor	None	Immediate	PES, PD&S, NPPSP
3.6	Labor Code & Invest. Code Review	None	Immediate	PEDS, PSS, Implementing Policy Change
3.7	TA in Marketing to OIJV and Chamber of Commerce	PS Assessment and SOE assessment underway; Labor Code and Investment Code acceptable to Private Sector.	2nd-3rd quarter 1992	PES, PSS
3.8	TA to CEE and other venture capital groups	Clarify TGE position on private sector participation in finance sector; reduction of tax rate; investment code and labor codes acceptable to private sector	2nd-3rd quarter 1992	PES, PSS
3.9	Privatization Training	None	Immediate	PAD (IPG-PW) NPPSP
3.10	Finance Sector Training	Reduction of tax rate; investment code and labor codes acceptable to private sector	3rd quarter	NPPSP
3.11	Bank MIS systems	None	Immediate	NPPSP
3.12	Leasing company evaluation	None	Immediate	NPPSP

1. BACKGROUND AND PURPOSE OF THE PRIVATE SECTOR REVIEW

1.1 Background

In November 1991 the Transitional Government of Ethiopia (TGE) published its Economic Policy Statement (referred to here as the NEP). The intent of this new policy framework is to

(a) Gradually reduce the role of the state in production, trade, transport, and other sectors;

(b) Encourage the development of the private sector by liberalizing the current regulatory environment; and

(c) Shift from administrative control and direct state intervention in all areas of economic activity to decentralized market-based allocation mechanisms.

The success of the TGE's program will depend most fundamentally on the local private sector's response to the opportunities for growth and diversification which will emerge from the process of economic liberalization and restructuring.

Further, private sector expansion will be critical for absorbing the large numbers of demobilized soldiers (over 350,000), and for cushioning the social consequences of the formal labor retrenchment which will inevitably occur as a result of privatization and other reforms scheduled for the coming years. Additionally, expanding the productive base will be essential to any attempt to restructure and revitalize the government's revenue base. Similarly, the government's ability to mobilize resources for sorely needed social relief programs, will depend on the extent to which is can effectively and swiftly rationalize budgetary expenditures, which includes reducing the fiscal drain of state-owned enterprises (SOEs).

For over 17 years, private sector entrepreneurs in Ethiopia have been either ignored (in the best of times), or directly harassed and threatened. Government officials consulted during this brief TDY, even those most interested in private sector development and privatization opportunities, showed a remarkable degree of naivety or ignorance regarding the indigenous private sector regarding its size, resources and views on the policy environment.

Donors as well, having focused primarily on disaster relief and/or accepted government development priorities for the parastatal sector, have only a limited reservoir of knowledge regarding private sector operators in the country. As a result, there is very little understanding of what types of policies or expertise is needed, and what indigenous resources are available, so as to foster private sector development. The development of sound programs for supporting macroeconomic and sectoral reform policies and privatization activities depends critically on understanding the changing role and structure of private firms in the country.

1.2 Purpose of the Review

The private sector review conducted in January 1992 sought to provide a quick overview of the current status of the private sector, and formulate a reasonable menu of options for proceeding with an assistance program for the sector. In particular this report:

- o Summarizes key findings regarding the local private sector, including key private sector players and the environment for business in the country;
- o Summarizes key findings regarding TGE privatization policy and priorities, including opportunities for expediting the privatization process;
- o Reviews USAID/Ethiopia's development program and strategy for addressing private sector growth constraint issues;
- o Identifies desirable and possible interventions in the short (next three months) and medium term (over the next 18 months) for enhancing the capacity of the private sector to respond effectively to economic liberalization;
- o Outlines scopes of work for the key short term actions (Annexes A and B), and identifies some vehicles for supporting these actions through existing and planned Mission and centrally funded (IQC) facilities.

Interviews were held with key private sector actors, government officials and donor representatives (Annex C provides detailed memoranda on these meetings). Documents and reports on the economy and the private sector were reviewed (see Annex D for the bibliography).

2. FINDINGS

This section is organized around the following topics:

- o Findings on the state of the private sector, its role in the economy, performance, and constraints to development and expansion;

- o Findings focused specifically on privatization, including and evaluation of the TGE's approach and commitment to the process and potential opportunities for supporting privatization initiatives;

- o Observations regarding the role of private sector within the Mission's current and planned portfolio of activities.

2.1 The Private Sector in Ethiopia: Current Role and Perspectives for Development

The findings highlighted in this section come from secondary and primary (interview) sources. It should be noted that there is a dearth of published and accessible data on the private sector in Ethiopia. The secondary sources consulted in this visit were the World Bank's Industrial Sector Review (1985, referred herein as ISR[1]), as well as its more recent Financial Sector Review (1991, referred to as FSR). This latter report contains an analysis of a recent survey of 42 formal sector firms. Also of use was the ILO's Informal Sector Employment in Ethiopia (ILO), a survey of over 3,000 informal sector firms carried out in 1990.

There is no one single centralized directory of business owners, or a "Who's Who." This makes it difficult to establish an accurate frame for canvassing private sector representatives. The membership directories of the city Chambers of Commerce are a good place to start, but not all Chambers survey members annually, (as the Addis branch does), and none has these rosters computerized. The Central Statistical Authority (CSA) carries out periodic surveys of firms (Annual Survey of Manufacturing Industries), but these limit themselves to gathering data on employment and turnover and focus exclusively on medium and large scale enterprises (MLSEs).[2] The Ministry of Industry (MOI) has a potentially rich data base of firms, since it must receive applications from small scale enterprise owners wishing to obtain an operating license (until recently obtained from HASIDA, now consolidated into the MOI's Private Sector Division). But to our knowledge this data base is not, as yet, computerized and is not easily accessible.

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1 There is supposed to be a newer 1989 version; however the assessment ream could not obtain a copy in-country.

2 These are defined as firms employing more than 10 people and "where work is performed by power driven machines."

2.1.1 The Nature of the Private Sector in Ethiopia

o **How large is the private sector, how important in the economy?**

Obtaining reliable information on the size of the private sector is important for ascertaining its absorptive capacity. Research indicates the private sector plays a large role in the Ethiopian economy. Existing quantitative information on the private sector tends to concentrate on industry sector, particularly manufacturing. In 1981 the CSA surveyed 408 MLSEs. Of these, 50% were private sector firms. According to CSA statistics, on average a private sector firm reported less than Birr 130,000 in fixed assets and employed 40 people. In contrast, an average industrial sector SOE reported Birr 2 million in fixed assets and employed 360 workers.

Extrapolating from a series of HASIDA and CSA studies quoted in the ILO report, and based on the ILO's own survey results and the Chamber of Commerce's rosters, there are probably at least 27,000 informal sector[3] manufacturing firms country-wide and perhaps as many 600,000 informal enterprises (urban and rural) of all types.[4] Thus in terms of the number of establishments existing in 1990, the informal sector is well over 100 times larger than private MLSEs. But the average value added of these informal firms is very low: estimated at between Birr 4,500-11,000, in 1991--less than one tenth of the value added for private MLSEs.

Using ILO figures on average value added and total number of urban and rural informal sector firms, the informal sector probably accounts for

* 90% of total private sector production in the country,
* 89% of manufacturing activity, and
* contributes a total of 15% to GDP.

This does not include the non-monetary (subsistence) sector. Including this sector as part of the private sector, it is possible total private sector activity accounts for 90% of Ethiopia's GDP.

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3 Defined in Ethiopia as these firms which have no HASIDA or MOI license.

4 Not all of these are full time businesses. For Example, a study quoted in the ILO report suggested that of an estimated 500,000 rural establishments, on average 75% could be classified as perennial, 10% seasonal and 17% casual.

World Bank data suggest the capacity of the formal sector (private and public) to generate employment is very limited. Total employment in the MLSE sector has consistently been less than 1 percent of the population between 15 and 64, or less than 20% of the annual increase in the labor force (estimated at 400,000). But the World Bank report does not differentiate between public and private firms, nor between sectors.

- **How is private sector activity distributed by sector, by region?**

Information on sectoral distribution of private sector activity is critical for assessing the competitive environment of particular sector and evaluate the effect of privatization actions: e.g. ensure that privatization would not result in the substitution of inefficient SOEs for inefficient private monopolies. Information on regional distribution could be valuable for establishing targeted regional development targets and ascertaining the relative absorptive capacity of private sector in different regions.

The distribution of private sector activity varies by industry, being highest in agriculture and lowest in basic services such as community services, transport and communications. But quantifying sectoral private sector activity is difficult given the data uncovered so far.

Again the most detailed information is the one for the formal manufacturing sector. Traditionally, the formal manufacturing sector has been dominated by the consumer goods industries, specifically food, beverages, and textiles. These three segments accounted for 60% of manufacturing output in 1987/88 (compared to 66% in 1983). But there is no information in any report regarding the distribution of recent new entrants (since 1990) by industry, nor on how formal private sectoral distribution may vary from SOE distribution.

The informal manufacturing sector tends to emphasize even more these same three industrial segments. According to the ILO report, over 50% of urban informal sector establishments concentrated in food and beverages and another 28% in the textile sector. Comparing results of the ILO study in 1990 with a smaller HASIDA survey in 1985/6, shows that the distribution of firms by sector has remained virtually unchanged over this 5 year period.

Data on regional distribution exist for only one year, both for the formal and informal sector. The 1985 ISR found that over 63% of formal sector establishments were located in Addis Ababa, while the 1985 HASIDA survey found that only 33% of informal sector establishments were. But there is no way to tell, at least from the available research, if and how this regional distribution may have changed.

- **What have been private sector growth and development patterns?**

Data on entry and growth patterns helps in analyzing the distribution of the burden of the structural adjustment process on business. This information may also make it easier to evaluate the effect of programs to facilitate access to critical inputs such as foreign exchange and credit, spare parts, technical assistance, marketing infrastructure on indigenous entrepreneurial growth. Most importantly in the case of Ethiopia, programs to deal with retrenchment, a potentially explosive social issue faced by the TGE as it seeks to restructure and privatize the parastatal sector, may be more palatable and efficient if retrenched personnel can be re-oriented (through the provision of training or credit, etc.) toward areas where there are clear private sector expansion opportunities.

ISR, FSR and ILO data indicate the formal manufacturing sector has grown very slowly. Though there is no readily available information on number of new entrants into the formal private sector, synthesizing a number of reports suggests that most of the new MLSE have been SOEs. The last 10 year plan of the Mengistu government planned 216 industrial projects, 25% of which were for improvements to existing enterprises. Most of these new firms were established with Soviet or Eastern European assistance. Since the mid 1980s manufacturing received a considerable boost from these state investments, including the Mugher cement factory (East German), the Kombolcha textile factory (jointly financed by Italy, East Germany and Czechoslovakia), the Nazareth truck factory (financed by the USSR), breweries in Harar and Bedele, several new flour mills and a new pipe assembly plant.

Since 1985, limits on the amount of capital which could be raised by local business people have been increasingly relaxed and recently have been eliminated. Since late 1991, the private sector has been allowed to import machinery under increasingly liberalized conditions. Anecdotal information suggests these changes have fostered a fair amount of investment; several large entrepreneurs interviewed made multi-million dollar investments in the construction sector in latter part of 1991, particularly hotel and office facilities. There is also some interest in investing in plantation production.

But there is little beyond these anecdotes; there is virtually no time line data which would allow us to ascertain the total number of new entrants. A World Bank report states that the MOI granted 145 licenses in 1988. We know that between 1991 and 1992, the Ministry of Industry received 4,000 applications for licenses by private entrepreneurs. The Ministry of Agriculture received 3,000. Thus the growth in the number of new entrants seems to be considerable, though probably most of these are very small firms.

o **What is the role of women entrepreneurs in the economy?**

Data on women entrepreneurs are scarce. None of the surveys reviewed have disaggregated data by gender. There is a need to explore data sources and consolidate information on the structure and constraints of women owned firms. These data are critical for understanding the role of women in business, and evaluating the impact of specific interventions in the private sector on women.

o **What are the most important private sector support institutions, and how effective are they?**

Such institutions can serve as ideal and cost effective means through which to channel assistance to the private sector. The Ethiopian Chamber of Commerce (ECC) is the largest and most visible of all such organizations. The ECC's outreach potential, though its 9 local branches and their own sub-branches is substantial. But even in the early part of 1991 the Ethiopian Chamber lacked formal linkages with the city branches and politics and turf battles seemed to dominate inter-branch relations. It is likely that such differences have been accentuated by recent regionalization initiatives. The largest city branch is the Addis Ababa Chamber of Commerce (AACC), with 25,858 members.

Both Chambers interviewed provides a wide range of services free of charge to all members, funding them from registration and annual subscription fees.[5] The AACC provides training in a wide range of areas, from basic accounting to personnel management, for low, medium and high-level executives. The ECC provides basic accounting and managerial training for new entrepreneurs through the ILO run "Improve Your Business" (IYB) program, currently being sponsored by DANIDA, SIDA and NORAD. Both the Ethiopian Chamber and the Addis Branch provide export and local market information for members through formal workshops and its newsletter.

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5 **Registration with the Chamber is an obligatory step to obtain an operating license.**

Finally the Chambers perform a critical function in the area of advising and informing government policy making. The Addis Chamber (which seems the strongest of all Chamber organizations) provided critical input into the TGE's New Economic Plan; they also expect to have input into the new labor and investment codes. Most entrepreneurs questioned gave high marks to the AACC (the reputation of the Ethiopian Chamber seems to be lower), though all interviewees agree that the Chamber has a long way to go in terms of actually influencing policy.

Besides the Chambers, recent interviews revealed that there are plans to legally constitute new associations of consultants and building contractors.

- **How efficient is the Ethiopian private sector, compared to SOEs?**

This information is critical for the formulation of a coherent industrial support policy, and for examining the consequences of alternative options regarding the pace and timing of economic adjustment policies, including privatization. The last known estimates of resource efficiency among firms, formal or informal, are in the 1985 ISR. The ISR estimated the Domestic Resource Costs[6] (DRCs) for 19 SOEs. All manufacturing sector SOEs, except for leather, had DRCs greater than one. Cement had a DRC of 2, and 50% of the other firms evaluated had DRCs over 5. This inefficiency may exist for a number of reasons, including under-utilization of resources, incorrect technology choice (e.g. too capital intensive), or a combination of various factors. Unfortunately, no in-depth assessment has been performed on any of the MLSE, private or public, making it difficult to establish the critical factors affecting efficiency and competitiveness in an industry sector, or the efficiency differences between public and private enterprises within a sector.

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[6] The DRC measures the cost of domestic resources that are necessary to save or earn one unit of foreign exchange. If the economic value is of the domestic factors required to produce a unit of output is less than the foreign exchange savings (or earnings) generated by domestic production then the process is profitable. A DRC greater than one indicates that it is not profitable for the economy to be producing this good and it is more efficient to import it and use the savings to produce other goods.

The same ISR report suggested capacity utilization among formal MLSEs was higher than that of SSEs (all of which are private). And value added per worker for SSEs was 5% to 40% of that for MLSEs in 1985. On the other hand the report acknowledged that these differences were more likely to reflect the positive impact of the Zemecha campaign on production, rather than any systematic differences in allocative or productive efficiency among firms. The more recent ILO data suggests that the value added per worker for informal sector firms may be higher than that for formal SSEs (on average between 5% and 30% higher).

Besides the above findings, the Team was not able to uncover updated information[7] on value added per worker or capacity utilization rate differences between public and private firm s over the last 12-18 months.

o **What factors have been affecting private sector growth and performance?**

Constraints to business establishment and growth have been documented in a global manner by a number of studies, but there have been no attempts to consolidate the information from these various sources or systematically analyze inter-and intra-sectoral differences in constraints. Again this information is valuable not just for designing appropriate interventions but for determining the optimal timing for these interventions.

ILO, ISR and FSR data suggest key constraints center around finance and access to credit, either start-up or working capital. Private firms depend entirely on their own funds, informal lending groups ("Ikubs"), and moneylenders. According to the 1989 ISR, SSEs self-financed on average between 59% to 84% of total investment. The report states that of the 145 SSEs licensed by HASIDA in 1988, the AIDB (the Agricultural Bank), the sole source of formal sector credit for these firms at the time, approved loans for only 13 enterprises. The 1991 FSR estimates that the cost of credit to private entrepreneurs was 2-4% higher than for SOEs, and this is excluding additional fees often levied on these firms, including a 2% insurance fee on assets, and illegal side payments (bribes) to loan officers.

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7 **The only systematic attempt to consolidate information on industry performance was by the MOI. The MOI recently provided updated information on 10 public sector enterprises that it manages. However, all the reports are in Amharic and could not be evaluated.**

Other constraints documented by the ILO survey of informal sector firms included lack of raw material inputs and suitable premises. Premises often have to be rented (from the local Kebele) or from the Ministry of Housing, or the entrepreneurs had to construct their own locale at own cost. Moreover there were often complaints of additional bribes solicited by municipal officials for installation of services. Formal sector firms surveyed by the World Bank in the FSR also mentioned bureaucratic procedures, particularly those connected with customs procedures.

Apart from the studies quoted above, recent interviews with private entrepreneurs suggest the following policy issues are most important in affecting private sector performance:

(a) Lack of foreign exchange.

Perhaps the single most onerous constraint, based on formal and informal interviews with private entrepreneurs held here, is the lack of access to foreign exchange. It is this which makes it impossible to obtain spare parts and/or raw materials, reducing operating efficiency and hindering their capacity to expand. Local private operations, like SOEs, are extremely import intensive; several businessmen pointed out that on average firms require 60%-70% of imported inputs to operate.

The private sector does not now receive any official allocations of hard currency,[8] though it is allowed to import without limit under the "franco valuta" system. In December 1991 the TGE reinstated and broadened this system of imports, abolishing the high surtaxes associated with the system; herein private importers had only to pay the standard tariffs on the imports (which range from 5% to 120%). While this has helped ease the strain to some degree (bringing down the price of some spare parts, such as tires, as much as 200%), no one is happy with the system. Entrepreneurs point out that in order to secure access to a steady supply of dollars or other hard currency to use in the "franco valuta" system, they are forced to under-invoice exports. Moreover, those businesses which generate foreign exchange are not allowed to retain any foreign exchange given but only the equivalent in Birr, effectively imposing a tax on exports.

The entrepreneurs questioned were most adamant about avoiding devaluation. All agree that devaluation would be highly inflationary, and would hurt a wide number of people. What

[8] **Apparently, some donors have already said that they will make available foreign exchange to the private sector under new projects.**

they are looking for is some flexibility from the TGE in terms of increased access to foreign exchange, either by being allowed to keep their own foreign currency accounts (keeping some proportion of hard currency earnings from exports to finance their raw materials and input needs), or limited auction system. But until the issue is resolved, and businesses are able to access foreign exchange regularly through official channels, much trade will occur in the black market and businessmen will be unwilling to invest in growth and expansion.

(b) High effective corporate tax rates.

Though the previous government had been discussing a series of reforms to the tax structure with the IMF and IBRD, as part of a wider incentive framework for facilitating productive investment and business growth, and a new investment code and labor code are currently being drafted, apparently there are currently no plans to re-draft the tax code. All business people questioned highlighted this as a critical area for reform, particularly the current marginal tax rates. Although the marginal business income tax rate was recently reduced from 89% to 59%, this is still too high.[9]

Under the present system, the incentives for accurate financial disclosure are minimized; companies are encouraged to keep two sets of books to minimize their tax liability. This lowers lenders' confidence, leading to high loan security requirements, and to an unwillingness by banks to trust a loan prospectus prepared outside the bank. Reduction of the tax rate may not only lead to greater compliance, and thus help in the longer run to improve revenue, but also to greater willingness to disseminate accurate information on company operations. The TGE is reluctant to consider changes to the tax code, fearing loss of revenue. High individual marginal tax rates also discourage individuals from hard work and initiative.

The present tax code also makes pension formation difficult if not impossible. The government taxes the fund and any interest earnings at the same high marginal rates. Coupled with very low deposit rates in the commercial bank (2% for amounts over Birr 100,000), only large corporations such as Shell-Ethiopia, can attempt to establish a viable pension mechanism for their workers.

9 This lower rate applies only to incorporated enterprises. Individual entrepreneurs still pay 89%. In contrast consider that in Kenya the corporate tax rate is 35% and in Uganda where it is 40%.

(c) Unclear/unfair regulations and laws for protecting investors.

The investment code has been discussed solely in terms of foreign joint ventures. But a new investment code[10] should consider the merit of extending the benefits to the rest of the economy. One aspect to be evaluated is the provision in the income tax code for carrying forward losses. Also under the joint venture law, foreign investors are allowed in principle to remit profits and earnings from service fees. Not so foreigners and other investors who choose not to or do not qualify under the joint venture law. Moreover, some investors have pointed out that even under the existing joint venture law, the clause which says that permission to remit profits is "subject to foreign exchange regulations" is one that makes them extremely nervous.

(d) A labor code which restricts labor markets artificially and inflates costs.

Under the current labor code, union membership is mandatory; firing is extremely difficult; and there is no free market for skilled labor. All university graduates must apply for a job in government. The courts rarely if ever find in favor of management.

(e) Credit allocation policies.

The FSR noted that the private sector is virtually locked out of all access to short-term commercial bank credit, and even when it does get it faces significantly higher interest rates and fees than other borrowers. And there is no medium-term credit. Many potential solutions are being discussed, but a program to address the credit constraint must be part of a wider policy reform program. There is always the danger that donors, in their desire to help rehabilitate the private sector rapidly, may be tempted to earmark an increasing amount of resources into short and term lending for private sector use. Or the danger that, as in other countries, donors will begin pumping funds into the banking system, to cover the foreign exchange requirements for imported raw materials and machinery. The results of these lending programs in other countries have been mixed at best. In the absence of wider actions to redress critical financial market development bottlenecks, including the adverse effect the high tax rates have on accurate financial disclosures and therefore on banker's lending confidence, simply channeling or earmarking

10 Apparently, a new investment code is being drafted in the Ministry of Finance.

more credit through the system to the private sector will rarely be an efficient mechanism for providing sustainable assistance.

Finally, it is difficult to assess how serious the credit crunch is, vis à vis other constraints. Recent interviews with entrepreneurs illustrate this. For example, several entrepreneurs who have invested in building luxury hotels in Bole had been able to obtain fairly substantial amounts (up to Birr 2 million) in medium-term loans (5-7 years) for financing construction. Although they were paying higher interest rates than SOEs (9.5%) and still had to put up substantial collateral guarantees (which SOEs need not do), credit was available at a price.

However, what was constraining their operations was access to foreign exchange; all were facing significant delays in construction because they could not obtain basic building materials and equipment (glass, kitchen equipment). On the other hand, another investor, an entrepreneur with over 45 years experience in business in the country, pointed out that as a private entrepreneur he had been asked to provide a "premium" (bribe) of 10% of the total loan amount before the loan could be approved. He decided to withdraw the application and financed the entire operation himself.

(f) Licensing regulatory structure.

The current licensing system is much improved. It currently takes MOI less than 48 hours to issue a temporary business license, and over 4,000 of these licenses have been issued over the last 12 months. Nevertheless, this license is only a temporary one. The entrepreneur can use it to apply for a loan, and obtain additional permits, but cannot begin operating until he/she has the permanent license. The applicant must take the temporary license and obtain additional permits and inspection certificates from a host of other regulatory bodies before it can go back to MOI and get the permanent license. There are no figures on how long this process takes. Apparently the most cumbersome of the other regulatory bodies, in the terms of the length of time it takes to obtain the necessary permits and certificates, is the Municipality of Addis Ababa; it has been called "the Bermuda Triangle," since correspondence and applications left there often disappear without a trace.

The licensing process in the Ministry of Agriculture (MOA) seems to be far more cumbersome and time consuming. The reason seems to be connected to the difficulties involved in sorting through and deciding upon issues related to land ownership. Of the 3,000 applications for business licenses received by the Ministry of Agriculture over the last 12 months, only 6 have been approved.

(g) Regulations on trucking and haulage.

Haulage regulations and underdeveloped physical infrastructure artificially restrict the size of markets, especially for rural and peri-urban producers, reducing incentives for entry and growth. Though in most parts of the country, these regulations are no longer enforced, the fact remains that they are still in the books, and present a potential disincentive to cross-regional and intra-regional trade. The Addis Ababa Chamber of Commerce has prepared and submitted to the TGE and the World Bank recommendations regarding haulage tariffs and transport regulations.

In line with recent moves to liberalize and deregulate the transport sector donors should be allowed to sell their used vehicles to the private sector rather than to the government. This will stimulate the transport sector and should, in aggregate, lead to a better maintained national fleet of vehicles than if the vehicles were sold/transferred to the government. It would, further, have the advantage of reducing the "patronage" of the government since it would have fewer assets at its disposal.

(h) Price controls.

Although the TGE has gone a long way in dismantling many of the price controls, many distortions remain. They make it difficult to obtain raw materials and inputs and/or operate profitably. For example, cotton price controls continue to restrict supply and cause costly capacity under-utilization in the textile mills. Price controls on flour and bread restrict the ability of flour mills to operate profitably as well. Moreover, controls lead to a high degree of speculative activity, the so called "air to air" trade, whereby people trade their licenses to purchase certain subsidized goods.

Other Constraints:

(i) Relative lack of market information and market infrastructure.

Market information, learning to obtain it and use it effectively, is a critical ingredient for encouraging domestic entrepreneurial growth. And marketing is a lost art for much SOE management after more than a decade of central quotas. The AACC and the ECC have been playing an active role, providing export and local market information for its members through formal workshops and its newsletter. But the Chambers acknowledge that access to **timely** and accurate information about markets, especially export markets, is in short supply. This makes it difficult for entrepreneurs to assess their competition, identify areas of opportunities, prepare accurate project feasibility documents. Marketing information is also in short supply for institutions such as OIJV, which need it to supply accurate advise and negotiate with prospective investors.

(j) Current confusion between the role of national and regional investment agencies.

Under the guarantees provided by the Charter and other proclamations, each province has the right to decided upon issues such as investment and joint venture approvals. The OIJV told the Team that it would maintain decision authority over national investment projects and the provinces would have a say over investments in their territory. But it is not yet clear what is meant by "national" vs "regional" interests. Nor is it clear whether the provinces will be creating smaller versions of OIJV. In any case, it is clear that under the present autonomy policies, OIJV no longer has the authority to act as the "one-stop shop" that it is supposed to be. This development has created additional confusion, and will only further discourage investment. The new investment code may be able to clarify these issues.

2.2 Privatization: Opportunities and Constraints

The Team discussed privatization options with a number of local authorities. Below is an overview of key issues to consider when designing a privatization action plan, based on a review of current government pronouncements and documents, interviews with senior government officials and SOE managers, and potential local investors. It bears remembering that privatization issues must be examined within the wider context of private sector development, its impact on the banking system's financial condition and it necessity to develop new institutions to provide finance, eg leasing and capital markets development. If the climate is not right for private sector development and growth, actions to encourage a swift and effective privatization process will be limited.

2.2.1 While there is consensus among TGE officials regarding the need to "privatize," there is no consensus regarding the role and objectives of a privatization program.

Interviews suggest that the commitment to some sort of reform of the state enterprise sector is real. What has yet to be articulated clearly, perhaps because TGE officials themselves have limited knowledge of the options available, is what, aside from political capital in the international community, they hope to get from the privatization process. A privatization program can seek foremost to: reduce the fiscal burden, increase state revenue, enhance allocative efficiency, or increase productive efficiency.

Establishing clear priorities matters, as it affects the pace and manner in which one proceeds with the privatization process (sequence of reforms). For example, if the fiscal burden were designated as the most pressing problem, policy reforms to impose a hard budget constraint, including the elimination of all subsidies, and strict bankruptcy enforcement, would have to be implemented before considering divestiture options. Similarly, massive privatization, through sales to private persons would be the most likely route if the government's key priority were to increase state revenue. A commitment to allocative efficiency would emphasize first reforms in the external policy environment (deregulation, introduction of competition), while a stress in productive efficiency would focus on increasing first managerial autonomy (right to hire and fire, set prices, etc.). The question remains: what do TGE officials wish to achieve though "privatization"?

In its Economic Policy During the Transitional Period *(NEP)*, the TGE expressly states that it will only privatize those firms "the state cannot operate profitably." This would suggest that Government would be far more interested in restructuring than in any massive privatization. Indeed, most officials interviewed seemed to focus far more on restructuring, i.e. introduction of partial reforms in SOE operations short of ownership change, than on transfer to the private sector. On the other hand, some senior government officials, such as the Minister of Industry, understand that privatization should seek to move enterprises quickly into private hands. And of course SOE managers, such as the heads of ETIMEX and the Textile Corp., would rather see a restructuring and rehabilitation of their company, than outright sale to a private investor. Thus different parts of Government are sending different signals. Clarification of the signals is imperative before any program is set in motion.

As the Mission considers whether to assist the TGE in the process of privatization, it should realize that not everyone in the potential "clientele group" understands the concept of privatization in the same manner. Part of what the Mission can and should do immediately is to help the TGE clarify conceptually what it seeks to achieve through privatization. This can be done through dialogue and training.

2.2.2 The current policy and regulatory environment presents serious obstacles to any privatization initiative.

Until the same policy issues discussed in the preceding section (e.g. the tax code, credit allocation policies, foreign exchange constraints, etc.) are resolved, it will be difficult to either make the current SOEs profitable or interest investors, foreign or domestic, in acquiring any state assets. Moreover, pension funds can be a source of capital for the privatization program, but present tax rates discourage their formation. In short, interviews suggest that there is a significant pool of domestic and expatriate Ethiopian entrepreneurs with sufficient capital, expertise and interest to make at least a limited divestiture program work. But such a supply response will not occur until investor confidence is restored and this is unlikely to be restored under the present policy conditions.

2.2.3 Privatization priorities need to be established.

According to senior TGE officials interviewed, the government is in the process of examining SOE finances and ascertaining the book value of the enterprises. There is also a plan to take each of the individual companies operating as part of the sectoral monopolies (e.g. the individual factories operating under the National Textile corporation, the Beverage Corporation, etc.) and turning them into autonomous units. Each would then have a Board of Directors (to be appointed by the Ministry of Finance in all probability, as the "owner" of all SOEs) with the power to appoint management. These units would have the power to make hiring and firing, marketing and production decisions. Only after this occurs would TGE begin moving towards full divestiture. But there seems to be no systematic attempt yet to collect in one data base information about potential divestiture candidates, their performance and their assets.

The TGE seems to lack concrete plans for moving to the divestiture stage. The Minister of Industry acknowledged that the government lacks technical expertise in setting priorities for divestiture: how to establish which companies are viable privatization candidates; how to identify which SOEs should/could be privatized without much restructuring and which would require more extensive rehabilitation; how to determine how much the state should be willing to invest in rehabilitation before it divests; how to evaluate the likely employment and other social impacts of divestiture in a particular sector; how to arrive at a reasonable price (the difference between the book value and the business value of a company).

Given the fairly substantial task ahead, and the limited resources at TGE's disposal, one of more useful exercises TGE can undertake is precisely this type of prioritization. Moreover, in light of the fact that the Minister of Industry seems totally committed to divestiture, that on average industrial sector corporations are less inefficient than the state-owned farms,[11] and that the question of land ownership rights (which is not likely to be resolved any time in the near future) is less likely to be a major bottleneck in the sale of industrial establishments, this type of exercise could begin with the 10 sectoral SOEs operated by MOI. Other areas which offer an opportunity for this type of exercise are transport and retail trade, sectors in which the Mission has strategic interests, and enterprises operated by the Ministry of Trade, another founding body in which senior officials seem committed to divestiture.

2.2.4 The TGE has little knowledge about privatization options.

As noted in the first point there are many different views regarding what privatization means, and what the goals of a privatization process should be. Most officials interviewed focus solely on either direct sale or restructuring. But there are several other options besides these two, including management buy-outs and leases, which may warrant consideration in specific sectors or firms. Each privatization option or technique has its strengths and limitations, and each needs to be considered in the context of TGE priorities, managerial expertise, capital availability, investor interest, the present state of the enterprises, management-labor relations, and a host of other technical and social factors. Again, TGE officials have expressed an interest in learning more about the types of privatization options available. A donor such as USAID could help provide technical assistance and training to strengthen TGE's ability to evaluate and select the most viable options.

2.2.5 A private sector supply response to privatization opportunities is likely.

While Ethiopia is usually described as a country of great poverty, it is also true that it is endowed with an active and dynamic local entrepreneurial class, a class which successfully established and ran a wide variety of sophisticated enterprises before the revolution. Moreover, a substantial number of Ethiopians who left the country during the troubled Mengistu years have be come successful entrepreneurs abroad and amassed a significant amount of savings, judging from the amount of remittances flowing into he country to finance black market and franco valuta trade. Entrepreneurs interviewed during this visit expressed a cautious interest in purchasing some of the SOEs which may be put up for sale. There are indications that Ethiopian

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[11] There is no hard data available to back this up, but all local authorities agree this is generally the case.

entrepreneurs are moving already to raise capital to finance acquisitions. A group of 250 Ethiopians have formed and capitalized the Corporation of Ethiopian Entrepreneurs, essentially a venture capital company, whose funds would be available to finance such purchases. There are other options available which could also help raise capital locally for such purchases. Ethiopia used to have a small stock market 17 years ago. The possibility for helping to re-establish such a local capital market could be explored. But again, though some limited investment has begun, it is unlikely that the local supply response will be large until the regulatory issues highlighted above are resolved.

Foreign investor interest is bound to be more guarded, even though they enjoy more guarantees and concessions under the joint venture law. But some foreign investor interest has already been expressed in textiles. It is easy to see why investment in the textile plants may be very attractive. Ethiopia has a substantial textile import quota to the US, a quota it has never been able to come close to filling. In contrast countries such as Mauritius are quickly reaching their limit,and investors there have begun transferring their operations to Madagascar and other countries. By buying a factory, an investor in essence buys into this quota. Though they may now be unprofitable, due to difficulties acquiring spare parts and raw materials, four of the 16 textile mills are practically brand new and have state of the art equipment; they could perhaps be made to operate profitably with a minimum of investment once these policy issues are resolved. Moreover, difficulties obtaining inputs arise because of lack of access to foreign exchange, a constraint a foreigner would not face. Several of the beverage factories are also very new, and produce for a market of 50 million people, making it another potentially attractive investment.

2.2.6 There is no single unit in government for coordinating privatization activities.

At the present time, each ministry is setting its own privatization agenda, and the pace of its divestiture process. It is not yet clear whether the final word on a particular privatization proposal will come from the ministry with direct operational responsibility for the SOEs, from the Ministry of Finance as the official owner of the enterprises, or from another body. The process of regionalization/decentralization may also introduce additional confounding factors. What will the role of provincial/regional authorities be regarding SOEs for sale in their jurisdiction?

Nor is it clear whether "asset sales" and other privatization actions will be coordinated by one central body or by each individual ministry. When an investor wishes to obtain information on a privatization candidate, to whom will he refer?; and is the operating ministry the best body to put in charge of direct negotiations with the investor? Perhaps the TGE should think of creating a special committee, or coordinate with OIJV, which currently deals directly with investors in this process. In any case, these are all practical operational questions which the TGE will have to answer before it embarks in any type of program. Officials interviewed have expressed great curiosity in terms of how other countries have organized their privatization process. Perhaps one of the more useful initial training sessions USAID/Ethiopia could help finance could be focused on the organizational aspects of divestiture programs, past experiences and lessons learned.

2.2.7 Privatization is likely to place additional strain on the banking system as a result of bad past lending practices.

As many of the SOE's are loss making and have, in aggregate, large bank borrowings the issue of their indebtedness must be resolved prior to their privatization or otherwise the banking system will be placed under considerable pressure. The recent IBRD banking sector review addresses this issue and recommends the recapitalization of those banks with considerable bad debt/doubtful loan portfolios. This issue is likely to be significant as without a healthy banking system finance will not be able to be provided to the newly privatized companies.

Further, bank management information and accounting systems are antiquated and require upgrading so as to enable the banks to monitor risk, exposure and treasury operations effectively.

2.3 The Mission's Portfolio: The Role of Private Sector

The Mission is in the process of designing its development portfolio. Though the three key programs being prepared at this time will not conform a private sector program *per se*, many of the activities contemplated will or could support entrepreneurial development and privatization activities, either directly or indirectly. Moreover, a quick review of the types of actions currently being undertaken or contemplated by other donors, such as the EC and the World Bank, suggests that perhaps no other donor will be in a position to fund as wide a variety of private support activities.

For example, several components under the Emergency Recovery and Reconstruction Programs (ERRP) will directly or indirectly address some of the private sector constraints highlighted in the preceding pages, especially regulatory issues in transport and retail. The ERRP will focus on encouraging Government to abandon its retail monopolies and introduce private traders; relieving credit allocation bottlenecks (by dictating that a portion of credit must go to help finance private traders); and relieving foreign exchange constraints (by assisting private producers access imported inputs, spare parts and commodities). Moreover the program would also help to improve road infrastructure, which should also help revitalize inter-regional trade and increase marketing opportunities for entrepreneurs. ERRP would also provide assistance to undertake a series of studies which would begin addressing some of the knowledge gaps discussed above, including options for alleviating foreign exchange constraints and the effects of devaluation, assessments of industrial SOEs, including current performance, evaluation of potential privatization options, and the impact of privatization on asset management and staffing patterns.

A second Mission program being proposed, the Transition Program toward Sustainable Food Security in Ethiopia under Title III, would also address several private sector development constraints. Title III would provide assistance to encourage the TGE to move away from generalized food price controls, encourage private sector traders to play a greater role in agricultural marketing (by encouraging increased CBE credit flows to private traders, encouraging a reduction in the role of the EDDC), and help improve the operating efficiency of key industrial sector SOEs--textiles and food processing (flour mills). By improving SOE production of textiles, the program then expects to benefit private sector garment makers and traders. Moreover, by improving SOE operations, the Mission then hopes to be able to follow through with divestiture.

A third Mission activity, the 2 year US$6 million National Policy Planning Support Project has not yet been designed. But its funds could be used to support research, training and technical assistance (TA) in a variety of policy areas, among which could be included privatization and business deregulation.

This brief review of the Mission portfolio raises a number of issues to consider in finalizing program design and undertaking implementation:

- <u>To what extent are the reforms proposed in the Mission programs addressing symptoms rather than causes</u>?

Some actions already contemplated to relieve key bottlenecks and improve private sector operations -- providing spare part imports or committing the CBE to increased credit allocations to private entrepreneurs -- address symptoms rather than the fundamental causes of efficiency bottlenecks. Thus, while the activities contemplated by the Mission will bring momentary relief, they may not always bring a sustained improvement in the allocative and operating efficiency of public and private sector firms targeted for assistance.

For example, in the case of foreign exchange, Mission policy programs focus on relieving the shortages of spare parts by providing a one time allocation for a particular input. But why not tackle at some point the basic design of the current foreign exchange allocation system? In the case of the textile industry, a policy change which allows producers who export to keep foreign exchange accounts, which they can then apply to acquire raw materials and inputs directly as required, would be far more simple and efficient as a means to relieve spare parts and raw materials shortages, and therefore raise its capacity utilization, than the scheme contemplated under Title III.

In the case of CBE credit allocation decisions to private traders and producers, it is important to remember that the current tax code discourages accurate financial disclosures, making it difficult for lenders to build up confidence in a new class of borrowers, or to reduce collateral and insurance requirements. In the absence of these more fundamental policy changes, the programs are unlikely to achieve any sustainable gains in terms of expansion of CBE's private sector client base.

- <u>To what extent are reforms proposed under Mission programs inducing sustainable efficiency gains</u>?

As noted earlier, at the very least reforms should seek to improve allocative and production efficiency. This requires devolving increasing decision-making power in terms of procurement, pricing, marketing, to enterprise (public or private) management. Programs which tie their hands in terms of credit and foreign exchange use may not achieve significant or sustainable efficiency gains.

- <u>To what extent could activities proposed under Mission programs affect the momentum of the privatization program</u>?

ERRP or the Title III program activities which increase the effectiveness of SOEs (such as Title III which is to increase capacity utilization for the textile company, or ERRP which will help strengthen ERA), could in theory end up derailing or at least delaying privatization initiatives. By making the enterprises appear to profitable in the short-term, the impetus for privatization may disappear or be considerably weakened. This possibility argues for ensuring that the Mission carries out a sustained dialogue and training process with TGE officials to help clarify privatization objectives and expand and maintain commitment to the privatization process.

- How can the private sector be involved more actively in implementation?

Given the need to rationalize public expenditures, and the severe budgetary constraints faced by TGE, channeling assistance directly to the private sector becomes a key tool for reducing the recurring cost burden on the government and for insuring the sustainability of activities. There are several options for involving the private sector more directly in the design and implementation of Mission activities:

(a) **Giving local contractors a greater role in road construction and maintenance.**

When the ERRP paper discusses road maintenance and building activities, no mention is made of the role private contractors might play. Yet, according to interview data, there are 8 fairly large private contractors who have managed to survive, two of them with extensive experience in road building and maintenance. There are over 600 smaller, primarily building, contractors, which can serve as subcontractors. The Mission may want to consider ways of encouraging ERA to use, at least on a subcontract basis, some of these firms. Or for insuring private contractors are given an opportunity to bid for the pubic works projects contemplated by USAID or other donors. In this fashion, the program could help strengthen a sector which will be critical in job creation, and which has a fairly high local input content.

(b) **Using business associations as implementing agents.**

The AACC seems quite strong and enjoys a wide membership base. It has already built up a solid reputation among members for its lobbying and training efforts. The Mission may want to incorporate the Chamber as one of the NGOs to which it entrusts the studies and monitoring activities mentioned in the ERRP and Title III program. There may be other associations as well which could be included, such as the new contractors association.

(c) **Strengthening local private consultants.**

The consultancy field seems to be growing stronger. Mission choices regarding the direction of TA and training can help support the growth of this service industry. For example, in addition to channeling National Policy Planning and Support funds solely for Ministry official training in privatization, why also not build up the capacity of private consultants in privatization techniques, valuation, marketing, and other technical areas which will in all probability be in high demand in the near future? And a stronger consultancy field, coupled with policy reforms encouraging accurate financial disclosures, will enable banks to reduce the amount of time spent in preparing dossiers and thus contribute to increased banking sector efficiency in the future.

- <u>To what extent do project and program impact indicators permit the tracking of industry level and firm level performance improvement</u>?

Macroeconomic and policy reform indicators are important measures of change, but the real test is the degree to which a more competitive environment is being induced by policy reform. The Title III logframe suggests some sound indicato rs of increased private sector activity. In addition to those already contemplated, indicators of the competitive environment could also include: the average length of time businesses in an industrial sector have been in operation, the number of business failures reported, the average capacity utilization, business turnover, percentage of product marketed within a district or exported, etc. This data can be collected on a regular basis from at least those firms directly participating or benefitting from A.I.D. interventions. Periodic surveys, as the one described in Annex B, can also serve to create and update this type of data for entire industrial sectors in which the Mission has a strategic interest. The Mission can work with business associations and local experts to develop their skills data gathering, and to analyze and disseminate this information on a regular basis.

- <u>What is the best way to diversify the private sector portfolio to reduce political risks</u>?

The Mission, in response to TGE priorities, is inclined to put much of its private sector development priorities in the area of privatization. The Mission may want to consider balancing interventions in this delicate (and potentially negative, in the sense that they may result in the short term in serious social dislocations) intervention with more positive ones, interventions which "empower" indigenous entrepreneurs to grow and expand. Options in this regard may be creating self-sustaining dialogue fora between private and public officials by strengthening business associations, support for the development of mechanisms to achieve cost savings for members through associations, activities which facilitate access to foreign markets, basic business skills training, etc.

- <u>How to leverage other donor resources for private sector development</u>?

The ERRP describes in some detail how coordination will occu r in relief and economic recovery. Equally important is to find ways to leverage for private sector assistance. Several of the donor representatives interviewed were keenly interested in the work USAID/Ethiopia is doing and eager to find ways to collaborate in activity development and support. The UNDP, for example, under its Fifth Country Programme, has formulated a private sector support sub-program. Key areas of interest are: the legal and institutional framework (the investment code, tax code and labor codes are of specific interest and would be willing to supply expertise); small scale enterprise development; and private capital mobilization. No specific activities are fully fleshed out in any of these areas yet, so that both agencies--the Mission and the UNDP--have a unique opportunity to find ways of leveraging off each other's activities early on in the design process. Another UNDP agency, the ILO is already funding advisors on privatization for the Ministry of Industry.

3. RECOMMENDATIONS

The agenda for action suggested below is not meant to be exhaustive, but rather indicative of the types of options available to the Mission, given the preceding analysis. The first part outlines a series of activities in research, training and TA, as well as dialogue. The last section indicates how these activities can be phased as certain pre-conditions for increased private sector involvement emerge.

3.1 Research and Dialogue

Many of these activities will provide fundamental inputs for additional actions in private sector development and privatization areas. They can and should be undertaken as soon as possible, as they are not necessarily dependent on specific policy conditions for their success, will build up the Mission's expertise and therefore credibility in the area of private sector/privatization support, and improve the Mission's ability to conduct policy dialogue in this area.

3.1.1 Conduct an assessment of SOEs in Industry, Transport and Trade.

Before any productive technical assistance in the area of valuation or privatization approach can be provided, the TGE must have a clear picture of the total asset base. On the basis of such an inventory of SOEs, a typology (in terms of strategic/non-strategic, viable/non-viable enterprises) can be created in each sector and prime privatization candidates identified. As noted in preceding sections, such a comprehensive inventory does not yet exist, though the Minister of Industry has taken a major step by consolidating production and the most recent profit and loss statement information for each sectoral monopoly under his jurisdiction.

The Mission should proceed with this assistance as soon as possible, so as not to lose the momentum in the ministries. This activity should be tied to basic training for senior MOI and Ministry of Trade and Transport officials in privatization, so that they understand the reasons behind and the expectations for this assessment (see point 3.3.1). The International Privatization Group-Price Waterhouse (IPG-PW) specializes in this type of assessment and can be accessed through the PAD project managed by PRE (see section 3.4 below). A scope of work for this activity, as well as other activities related to privatization support is contained in Annex A.

3.1.2 <u>Appraise the competitive environment and structure of private businesses in sectors of strategic interests</u>.

These sectors would include industry (especially textile, food processing), construction, transport and retail. As noted in section 2.1 above, while the ILO has invested significant resources in surveying informal (non-registered) firms, ther e is a substantial knowledge gap about the structure, performance and prospects for the formal SSEs and MLSEs. It is important to know what the structure of these businesses are, their investment and employment patterns, credit needs and their views on the business climate, not just for designing any type of direct assistance package, but for evaluating SOEs operating in these sectors: establishing their viability as business concerns and arriving at a fair market value.

This type of exercise, in essence a comprehensive survey or inventory of sectors of strategic interest, could be carried out in conjunction with the SOE assessment. It should also be carried out in coordination and collaboration with the Chamber of Commerce and other relevant support institutions, since this information will be critical inputs for their own lobbying and training program activities. The use of local consultants should be encouraged. A scope of work for this activity is found in Annex B and expertise could be accessed through PEDS or PES.

3.1.3 <u>Conduct an assessment of business training and support institutions</u>.

Knowledge of the local training needs in and options available to conduct training in business planning, marketing, accounting, and other critical areas necessary for business development, may become critical as the Mission proceeds to support increased private sector participation in retail trade, transport and other areas. Moreover, this training could be critical for enhancing the viability of increasingly autonomous SOEs. The Chamber of Commerce already carries out regular training sessions for employees and management using individual local private trainers. It would be interested in participating in this assessment. This study need not take place immediately, though it could take place as part of the wider private sector study described in point 3.1.2 and Annex B.

3.1.4 Evaluate the feasibility of a leasing company to provide medium-term asset based finance

A leasing company would be a effective non-bank institution through which medium-term finance could be made available to the private sector. Importantly, the lending is asset based and the institution does not have to rely upon liens and recovery of a sum of money to obtain repayment as the lessor is the owner of the equipment.

3.1.5 Assist in the feasibility study of re-establishing the stock market.

Action in this area should of course be undertaken in coordination with the World Bank, which is already working intensively in financial sector reform. But most importantly, before undertaking such a study, the Mission should consult with the local entrepreneurial community, and such authorities in the finance sector as Mr Debebe, since it is possible the local private business community may have already taken the initiative to examine issues in this area. In this case the Mission could come in, as required by the local entrepreneurs, with limited specialized technical assistance.

3.2 Technical assistance

3.2.1 Fund a private sector advisor.

USAID/Ethiopia is acutely understaffed at the moment. While the REDSO/ESA private sector officer could provide some interim support, he has limited time to give to any one Mission. Moreover, the country is in a critical juncture in terms of key policy issues which will affect private sector development prospects for the coming years. Insuring the momentum is maintained, and providing the TGE with sound advice at critical times will require fairly intensive follow-up and ready access to expert advice of the sort which could only be provided by a private sector advisor located in Addis. This person should have expertise in privatization and corporate finance issues, particularly as they apply to developing countries and Africa in particular. He/she need not be an expatriate, unless the Mission feels that such a person would carry more weight.

3.2.2 <u>Provide immediate support for the design of the new investment and labor codes</u>.

Both codes are currently in the process of being drafted. Though it is not clear whether the Mission or any other actor, such as the Chamber of Commerce, will have an opportunity to comment before they are finalized, here is a unique opportunity to help the TGE lay a rational foundation for private sector development. In the investment code, issues such as tax breaks (for example extending to the rest of the economy the tax breaks and reduced rates presently available to joint ventures), customs procedures, expropriation and repatriation guarantees should be explored. In the labor code, fundamental changes in management's right to hire and fire, guidelines on fringe benefits and minimum wage, among other issues should be examined. The contents of both codes should be compared to that of other countries in a position to compete with Ethiopia for investment dollars. The tax implications should be assessed. In order to maintain local private sector ownership of the dialogue process, perhaps the Mission could help fund an investment and trade expert to work with the AACC to prepare the official private sector response. Such expertise can be easily accessed through PEDS or PES.

3.2.3 <u>Provide technical assistance in marketing to OIJV and AACC</u>.

The Mission could have along-term interest in strengthening these organizations as potential implementing agents for privatization activities. Both organizations could be instrumental in the success of the divestiture program, by helping to identify investors (foreign and local) for SOEs being put up for sale. A key area where both have asked for support is in marketing. Both organizations acknowledge their weakness in this area, and particularly access to updated data bases on market trends, key players. Both institutions' lack rudimentary equipment in which to enter and catalogue this information. The Mission could consider targeted assistance in marketing, once basic policy issues affecting investment and privatization policy have been clarified. In the short-term however, the Mission could finance short term TA and training to ensure the data base on entrepreneurs and SOEs generated from the studies described in 3.1.1 and 3.1.2 is installed and easily accessible and usable by these organizations. It could also finance subscriptions to basic publications.

3.2.4 Provide access to specialized TA in venture capital fund management to the CEE and other groups of investors.

As noted earlier, there is at least one new venture capital company in Ethiopia. The success of this institution and emergence of others like it will be critical to the success of the privatization program, and private sector development in general. The Chairman of the CEE is confident that at this point capital is not a problem: what they lack is technical expertise in venture capital fund management and organization, having been isolated and out of the mainstream of finance for many years. Though the PES project and the Venture Capital Project can provide this assistance readily, there are critical policy issues which need clarification, including the legality of such an institution, given the TGE's stated refusal to consider private sector participation in the financial sector.

3.3 Training

3.3.1 Provide short-term training in privatization for key MOI and Ministry of Trade and Transport officials.

Some of this training could take place immediately, while other types of more technical sessions could be scheduled according to the priorities established during the SOE assessment process. One activity the Mission could undertake immediately would be to finance a seminar on privatization. The seminar would provide TGE officials with

* an overview of the potential approaches/techniques for conducting privatization,
* valuation techniques,
* the stages in a privatization program,
* modalities for implementing privatization programs.

The seminar could also present and discuss case studies of privatization transactions elsewhere, and provide an overview of lessons learned from privatization initiatives elsewhere in Africa. This component could be undertaken as part of the scope of the SOE assessment (see Annex A).

As the privatization program proceeds, additional training sessions could be designed for local private consultants (in the area of business valuation, for example) and MOI, Trade, Transport and other relevant TGE officials charged with evaluating and approving privatization proposals for specific SOEs.

3.3.2 Bank training.

At the present time all lending is collateral based. The World Bank would like to see a move towards project based lending. There may be a role for USAID in this type of training, though the content of such programs would have to be coordinated carefully with the Bank, which is taking the lead in this sector. But no such training can be contemplated until, at the very least, the tax code and consequent financial disclosure issues are resolved. Moreover donor funds for technical assistance and training for bank officers in project lending should be balanced with TA and training to help the CBE develop and mobilize a longer term deposit base, and perhaps make the banking sector more competitive by opening it up to private sector participation. There also should be TA for local consultants in the area of feasibility study formulation, and actions needed in the area of establishing internationally accepted professional standards for local consultants and accountants.

3.4 Finance Sources and Time Table for Implementing the Activities

The table below lists all proposed activities, indicating the most appropriate timing for each. It also indicates what types of sources the Mission has at its disposal to provide expertise and finance in these areas. The Mission should bear in mind that apart from its existing programs, it has several options available for acquiring experts in corporate finance, privatization and business development through buy-ins to existing IQCs such as:

a) Private Sector Services (PSS) - an IQC managed by REDSO/ESA for general private sector activities.

b) Private Enterprise Development and Support (PEDS) - for general private sector research, specialized TA in finance, private sector training needs, and other related areas. Managed by PRE. In the past has helped finance private sector assessment, SMSE research and support, etc.

c) Private Enterprise Support (PES) - offers much of the same support provided under PEDS, including venture capital assistance, assistance to chambers of commerce. Managed by AFR/ONI.

d) Privatization and Development (PAD) - International Privatization Group - Price Waterhouse (IPG-PW) offers specialized assistance in privatization issues, providing technical expertise in all areas related to divestiture (valuations, privatization strategy design), training and hands on assistance in privatization transaction implementation. Managed by PRE.

e) Financial Markets - Another project under PRE.

f) Implementing Policy Change - Under the S&T Bureau, provides general support in the area of policy analysis, policy reform.

TABLE 1

ACTIVITY		DESIRABLE PRE-CONDITIONS	START DATE	SOURCE OF EXPERTISE FINANCE
3.1.1	SOE Assessment	Seminar on privatization (activity 3.3.1)	Immediate	PAD (IPG-PW), ERRP
3.1.2	Targeted Private Sector Assessment	None	Immediate	PES, PEDS
3.1.3	Private Sector Training Needs and resources	None	In coordination with 3.1.2	PES, PEDS, HRDA
3.1.4	Feasibility of Stock Market and other Capital Mobilization Instruments	Clarify TGE position on private sector participation in finance sector; reduction of tax rate; bankruptcy, investment code and labor codes acceptable to private sector	3rd quarter 1992	PES, PEDS, Financial Markets
3.2.1	Private Sector Advisor	None	Immediate	PES, PD&S, NPPSP
3.2.2	Labor Code & Invest. Code Review	None	Immediate	PEDS, PSS, Implementing Policy Change
3.2.3	TA in Marketing to OIJV and Chamber of Commerce	PS Assessment and SOE assessment underway; Labor Code and Investment Code acceptable to Private Sector.	2nd - 3rd quarter 1992	PES, PSS
3.2.4	TA to CEE	Clarify TGE position on private sector participation in finance sector; reduction of tax rate; bankruptcy, investment code and labor codes acceptable to private sector	2nd - 3rd quarter 1992	PES, PSS
3.3.1	Privatization Training	None	Immediate	PAD (IPG-PW)
3.3.2	Finance Sector Training	Reduction of tax rate; bankruptcy, investment code and labor codes acceptable to private sector	3rd quarter	NPPSP

SCOPE OF WORK
PRIVATIZATION PROGRAM STRATEGY

Purpose:

The objective of this consultancy is to provide USAID/Ethiopia and the Transitional Government of Ethiopia (TGE) with assistance in the implementation of a privatization workplan. The contractor will provide expertise and materials to improve TGE understanding of privatization options as well as help it create a sound data bases with which to establish privatization priorities and evaluate privatization options. Specific tasks in the scope of work which follows are intended to serve as guidelines for the consultants to follow in the course of undertaking the initial study and training sessions. The contractor will identify additional tasks or delete existing ones as appropriate once the fieldwork is underway.

Scope of Work:

The contractor will:

1. Become familiar with the contents and findings of the initial private sector review prepared in January 1992.

2. Conduct interviews with Mission personnel and TGE officials as appropriate to ascertain the degree to which the initial assessments evaluation of the political and economic climate for privatization has changed.

3. Coordinate research with the Team undertaking the private sector survey (Scope of Work in Annex B) and assessing the competitive environment of particular sectors.

4. Organize and implement a 2-3 day seminar for senior TGE officials which will cover the following topics:

   - o Objectives of privatization: experiences around the world
   - o Overview of Privatization Approaches (IPO, MBO, ESOPs, Direct trade sale, etc.), their strengths and limitations.
   - o Determining the value of the enterprise: approaches to valuation
   - o Management of the privatization process: experiences from other countries and lessons learned

   The seminar should include theoretical material as well as case study illustrations relevant to the Ethiopian environment.

5. Assess supply response to privatization initiative. This includes an assessment of the purchasing power (individual capital as well as access to credit) and interest of the Ethiopian private sector to play a major role in the privatization process. It also includes an assessment of the potential role of the foreign investors as providers of capital, technical expertise, technology, markets, and the political and social limitations for increased foreign participation in the economy.

6. Consolidate data on and provide a general schematic assessment of Ethiopian SOEs in the sectors of interest: industry, transport, trade.

7. Create a typology of these SOEs (in terms of strategic/ non-strategic, viable/non-viable) by sector.

8. On the basis of the above evaluation, identify prime privatization candidates by sector and provide a rank order of the same in terms of their economic importance and their performance (revenues, profits, employment). The contractor will also provide and present the criteria used for selecting the rime candidates.

9. Present findings from the above assessments to senior TGE officials.

10. Present recommendations on the strategy to be pursued based on the assessment and TGE reactions to the findings. This will be a draft of a full terms of reference for proposed follow-on activities (including hands-on transaction assistance and training). It will include a detailed action plan identifying in concrete terms the next steps to be taken to implement the privatization program. Each action should be accompanied by the identification of the appropriate action-take (e.g. TGE ministry, SOEs, Mission, etc.).

Deliverables:

1 Seminar on privatization

1 Draft Report presenting clear strategies and options to permit TGE officials to address opportunities and constraints of a comprehensive privatization program. The draft report will include:

- o Background to Privatization
  --Investment Climate
  --Ethiopian private sector
- o Assessment of selected SOEs
- o Privatization Options and Preliminary Recommendations
- o Terms of Reference for Follow on Activities

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SCOPE OF WORK
PRIVATE SECTOR ASSESSMENT

Purpose:

The objectives for this assessment are:

1. To obtain a current description and baseline data to measure the components of the private sector, to determine their constraints and to assess their potential for growth;

2. To assess the competitiveness in sectors of interest (transport, food, textiles, retail);

3. To collaborate with local business support institutions and help strengthen the capacity of local support institutions to identify member needs and design appropriate interventions;

4. To widen the Mission's base of private sector contacts with which the Mission can work in implementing private sector support activities.

Scope of Work:

The contractor will coordinate all research and analysis with local support groups. The private sector assessment will consist of the following phases:

1. Phase I - Policy Environment for Business Growth

The objective of this phase is to review the published (secondary) sources, summarize the key policy changes since 1991 and evaluate their effect on private sector. The contractor will examine the effect of the regulatory environment on growth patterns, geographic/sectoral distribution of private sector activity, as well as on the evolution of linkages between local firms. The contractor will also be expected to evaluate the possible areas of growth and opportunities emerging for the private sector in the short and medium term in light of these changes as well as continuing constraints to entrepreneurial growth. In particular, it is expected that the contractor will:

1.1 Describe the changes in the legal environment that affect the prospects and operations of the private sector, and the differential impact of general legislation on foreign, medium and large scale enterprises and small business.

1.2 Changes in the regulatory environment governing the private sector, particularly a chronology of the removal of discriminatory regulations, a summary of remaining differentiating regulations, and a summary of regulations that differentially impact small business.

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1.3 Changes in the fiscal and monetary policies of government that affect the private business sector, with particular attention to changes in taxation, subsidy, credit, and privatization policies.

1.4 Changes in training policies (including tax rebates and credits) of government and how these affect the prospects for entry and growth of to the formal private sector.

1.5 Provide a preliminary analysis of:

- o Which of the above changes are most significant in altering the prospects of development in the private sector.

- o Which aspects of the current policy environment are most significant as obstacles to advancement in the private sector.

- o Possible future changes in the policy environment (currently under discussion or anticipated) that will have importance for the prospects of advancement in the private sector.

1.6 For 1.5, to the extent that one can evaluate the extent to which impacts are differential by sector of the economy (e.g. retailing, manufacturing, construction, etc), size of business, formal/informal, or geographic area, so specify.

1.7 The contractor will provide a comprehensive bibliography of all the sources consulted for this assignment, and source all information and data to be provided.

2. Phase II - Private Sector Survey

The contractor will design a survey questionnaire to be administered to a number of private firms in the country large enough to yield statistically significant results. The survey will target industry (particularly textile and food processing), transport, retail trade and construction, though there may be other sectors targeted, depending on the Phase I results. In the past the survey has included anywhere from 136 firms (in Lesotho) to 778 firms (in Kenya). The contents of the questionnaire and the types of firms chosen as well as their location will be determined on the basis of Phase I results and in consultation with the local business counterparts, and the Mission, as well as in coordination with the privatization team. The data from the survey will serve to quantify and develop indicators for the competitive environment for business, formal business employment growth, investment and trading patterns. Government policies which may be impeding development of the private sector, as well as determination of opportunities and constraints of capital

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availability, natural resources, labor and markets will be catalogued and ranked.

On the basis of the preliminary results from Phase I and the Survey (Phase II) the contractor will be able to identify the strengths and weaknesses, constraints and opportunities for private sector growth. The contractor will identify trends both in the private sector and in the current policy environment which impact private sector development.

The output of Phases I and II will be a section of the final report which describes and analyzes the local private sector and current prospects for growth. It will identify and quantify the impact of constraints to growth.

3. Phase III - Dialogue

The results of Phases I and II will be presented to the Chamber of Commerce and other relevant organizations identified during the assessment. The options of presenting these findings to TGE in collaboration with the Chamber will be explored.

4. Phase IV - Data Base Training

The contractor will ensure the data bases from Phase I and II are entered in a format which is compatible and usable using local computing resources. It will provide as required training for the Chamber and other interested groups in the use of the private sector survey statistical data base and develop a user friendly format through which local business support groups can access the information readily.

5. Phase V - Integration of Results into Program Activities

The contractor will take account of current programs and projects and how they are meeting identified constraints to private sector growth, without undertaking an evaluation of each program's effectiveness in meeting its objectives. The Team will then identify on the basis of the results from Phases I-IV, implications for privatization support, how the efforts might overlap with current programs, how they might relate to other donor programs and with the Government's own development priorities.

The Team will also suggest an evaluation methodology to measure the impact of the Mission's programs (e.g. Title III or ERRP) on the private sector, using the baseline data gathered through the Phase I and II studies.

Reports and Deliverables:

Training session for local Chamber and subcontractors on the content and access to the data base

The following reports:

- o A draft report summarizing Phase I, the finalized SOWs for the survey and documentation on the selection process for local subcontractors.

- o A draft report, summarizing results of Phases I through IV upon completion of the final phase. The report shal l be comprised of three components:

  --The Business environment
  --The Structure of private businesses in Ethiopia
  --Implications for Mission Activities
  --Monitoring and Evaluation

In addition, with Mission approval, the Team will provide summary documents of all three reports appropriate for general dissemination.

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VISITS

	INDIVIDUAL	ORGANIZATION
1.	Mr Bekele Tadesse	Ministry of Industry
2.	Mr Ahmed Hussein	Minister of Trade
3.	Mr Sime Kulala	General Manager, EDDC
4.	Mr Kumela Gragne	General Manager, Agricultural Marketing Corporation
5.	Mr Nils Enqvist	Director of Operations, World Food Program
6.	Mr Tsegaye	General Manager, National Textile Corporation
7.	Mr Wondwossen Kebede	Vice Minister of Finance
8.	Mr I Kidane-Mariam	Vice Minister, Office of Foreign Economic Relations
9.	Mr Tsegaye Teklu	Head, Office of Investment & Joint Ventures
10.	Mr D Habte-Yohannes	MD, Management Consultants International (MCI)
11.	Mr Abdella Abdulmalik	Import-Export Manufacturers Representative
12.	Mr Seyoum Teferra	Director General and Manager of Operations, Ethiopian Import-Export Corporation (ETIMEX)
13.	Mr Yohannes Bayonakis	Manager/Owner, Baro Construction
14.	Mr Shiferaw Bekele	Secretary General, Addis Ababa Chamber of Commerce
15.	Mr Asfaw Teferra	Hotel Investor & Manager/Owner, Chamber Printing
16.	Mr Tewfik Sherif Mr Ibrahim Nawd	Tewfik Sherif & Co General Manager Airport Motel Ltd. Tel 61 04 22
17.	Mr George Dikker-Hupkes	General Manager Shell Oil-Ethiopia

VISIT NOTE - 1

Mr Bekele Tadesse, Ministry of Industry. Tel 518025

January 22, 1992

1. The purpose of this meeting was to discuss privatization and private sector development following the meeting held with the Mr Assefa Kebede, Vice Minister of Industry on January 15, 1992. The USAID Mission Representative, Mr Pearson, accompanied Ms St Martin and myself.

2. The meeting opened with outlining the meetings that had been held during the past week and the positive reaction that had been obtained relating to private sector development and public enterprise divestiture following the meetings held with the Ministries of Trade and Transport. Further, we indicated that there had been a large increase in the number of new entrepreneurs as reported by the Office of Foreign Investment and Joint Ventures, and the Ethiopian Chamber of Commerce. This was confirmed by the Minister.

3. The Minister said that he was strongly in favor of the private sector, both domestic and foreign and that it had an indispensable role to play in the future development of the economy. The Minister said that past investment in the agricultural, industrial and mineral sectors had been distorted and that public enterprises had been effective. Currently, there were some 104 public enterprises under the Ministry of Industry in addition to the four public enterprises where the Ministry of Industry was a direct shareholder - Crown Cork, Nylon Textiles, paper and pulp, and Ethiopian Tire. We were provided with documentation of their past economic and financial performance - it should be noted that this was in Amharic language and that it requires translation. This was the first detailed information that we had been provided as regards the scope, range and financial performance of these enterprises.

4. As regards privatization, the Minister said that

(a) There was privatization legislation being prepared by his ministry and that primarily that only loss making public enterprises would be privatized. To support this the Ministry was going ahead with initial steps to implement privatization through the incorporation of business units controlled by holding companies and this these would be incorporated. Monopoly units, eg beverages that included both beer and soft drinks, would be so incorporated.

(b) Draft legislation on new labor laws.

(c) An internal evaluation of the parastatals was being carried out so as to value assets, evaluate liabilities, the need for management training so as to cope with the transfer to the private sector and the eventual removal of tariffs, protection and competition.

5. I described the privatization strategy that had been developed in Burundi with the development of SCEP, the identification of strategic and non-strategic public sector enterprises and their further sub-division into viable, restructuring and liquidation companies, and the contribution which AID proposed as regards audit, valuation, prospectus preparation and investor identification. There was agreement that this type of assistance would be useful.

6. As regards private sector developments the Minister confirmed the statistics concerning new license applications provided by the Office of Foreign Investment and Joint Ventures for Agriculture and Industry (4,000 and 3,000 respectively) and that with his Ministry temporary licenses were issued within a 24 hour period which had later to be supported by a feasibility study, confirmation of premises bank account, etc when a permanent license would be issued. The Minister saw his ministry's role as developing an enabling environment for the private sector to flourish and to remove restrictions to its development.

7. As regards assistance required the Minister said the following would be needed:

(a) To develop the autonomy of the individual enterprises through managerial independence, incorporation and accountability. This was likely to be completed within the next few months.

(b) To be clear as to what privatization was - what were the pitfalls, the shortcomings and advantages.

(c) The training and reorientation of staff with the enterprises and the public enterprises so as to cope with the new private sector environment.

(d) Audit, asset valuation, prospectus preparation and investor identification.

(e) The effect on other institutions, eg banking sector and sectoral linkages.

(f) Capital market and share market development the potential in this area. During the 1960's there had been a small but relatively active share market and that potential existed to reactivate this.

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VISIT NOTE - 2

Mr Ahmed Hussein, Minister of Trade. Tel 159527

January 17, 1992

1. The Ministry of Trade is charge of commercial and distribution activities and has operating under the Ministry the following public enterprises:

   Ethiopian Domestic Distribution Corporation (EDDC)
   Agricultural Marketing Corporation (AMC)
   Oil and Pulses Corporation (OPIC)
   Ethiopian Import Export Corporation (ETIMEX)
   Ethiopian Retail Trade Corporation - supermarkets and food stores.
   Ethiopian Household and Furniture Enterprise

2. The Ministry of Trade is responsible for issuing licenses for many categories of goods, most of which are in short supply.

3. The Minister said that he would like to privatize the Retail Corporation and the Household and Furniture Enterprise. The former has 3,500 employees and the latter 800; in the Minister's opinion they were overstaffed and should not be in the public sector as their activities are primarily retail. We discussed possible means for their privatization, eg sale of stores (either individually or grouped) to managers and staff, valuation of inventory and premises.

4. As noted in other visit notes EDDC has a monopoly of distribution of public enterprise goods to the country. Its activities have been adversely affected because of low production rates (as sale prices) by manufacturing public enterprises and the sale at low (subsidized) prices to retailers.

5. Further, ETIMEX is the import wing of the Ministry responsible allocating licenses to EDDC for the import of goods for subsequent distribution. Since, the allocation of import licenses is down in recent years EDDC has not been able to obtain imported goods for distribution.

6. See additional visit notes on EDDC and AMC.

VISIT NOTE - 3

Mr Sime Kulala, General Manager, EDDC   Tel: 125143

January 16, 1992

1. EDDC is the public sector enterprise responsible for the wholesale distribution of foodstuffs (dry goods, sugar coffee, salt), general goods, textiles and building materials (not cement) and tire and tarpaulins to some 135 depots/warehouses around the country which is then responsible for selling to the retail trade. EDDC is solely a distribution company and not a trading company. It has 2,975 staff. I was provided with short summary of EDDC's activities.

2. EDDC obtains its supplies at low prices from the public sector enterprises which sell most of their products to EDDC and which in turn sells at low prices primarily to the kabeles, the government controlled retail outlets in urban areas and farmers' cooperatives in the rural areas. Prices are fixed by the government and a margin added to cover transport and handling costs. Actual purchases from public enterprises in 1991 were 50% of the planned level at Birr 442 million and are now some 35% of their levels of 1987 and 1986. Thus, public enterprise production has fallen considerably.

3. EDDC is also responsible for the distribution of imported goods for those goods which cannot be provided domestically. For this import licenses are issued and the FX is provided by the Central Bank.

4. Prior to 1974 EDDC was a private sector firm (A Besse) when it was nationalized. Apparently, no compensation was paid to the former owners. The structure of the private sector firm was maintained and EDDC continues to distribute the same products/commodities as before.

5. Trucks are rented from the private sector after approval from the Ministry of Transport and EDDC pays the truckers at the tariff rate. There have problems in the past over the tariff rate as it was argued that it was too low. Apparently, EDDC rents up to 100 trucks form time to time. Interestingly, there is no link up with AMC which uses its trucks on a seasonal basis (at harvest time) and which should from time to time have surplus equipment.

VISIT NOTE - 4

Mr Kumela Gragne, General Manager, Agricultural Marketing Corporation

January 16, 1992

1. AMC until 1990 had a monopoly of grain marketing in Ethiopia, the import and distribution of grain together with purchase and distribution of fertilizer and pesticides. These monopolies have now been abolished and AMC has to compete with private grain merchants. Further, the import of grain has been given to ETIMEX the public sector import/export agency. Also AMC has activities vegetable oil and pulse exports.

2. As a result of the removal of its monopolies AMC has under-utilized assets such as grain and storage facilities. From what Mr Gragne said, he implied that AMC is under pressure as it is leasing out some of its trucks to the Coffee Marketing Board, and premises to other organizations. Further, AMC has relatively high operating costs as its payroll has not been reduced to reflect the reduced scale of activities and its borrowings are high resulting in high interest payments. Mr Gragne mentioned a survival plan to address these points.

3. Mr Gragne said that private sector grain traders did have access to finance and capital but, interestingly, Mr Gragne said AMC was being requested by farmers to return to certain areas to overcome/provide competition to private sector traders. Important areas were the rebuilding of confidence of farmers and the provision of facilities to farmers.

4. As regards the State Farms they produce 100,000 tons of wheat and 80,000 tons of maize and sorghum and that most of it was produced in the three months from January to April. He said that one of the key problems was the utilization of the country's flour milling capacity of 360,000 tons. Of this 100,000 was provided by the State Farms and the private sector with another 160,000 being provided by food imports, NGO's etc. A key issue as Mr Gragne saw it was the ownership of land and linked to this fertility, investment and size of farms.

5. Mr Gragne saw AMC's strengths with regional distribution and the ability to offer joint venture possibilities with firms. Further, frequently his trucks were empty going out but full returning and that better utilization of the truck fleet could be obtained.

VISIT NOTE - 5

Mr Nils Enqvist, Director of Operations, World Food Program (WFP/WTOE)

January 15, 1992

1. The purpose of this visit was to link in WFP's food delivery program, donors' food contributions with development of a private sector transport sector, ie to use the leverage of the food to develop the private sector's impetus in the sector. This is likely to come about when the WFP's vehicles come up for replacement and that they should be sold to the private sector.

2. WFP has over 300 trucks of which some 120 are more than six years old. Further, there are some six truck models presently used which necessitates WFP holding large inventories of spare parts which Mr ENqvist estimated at $6-$8 million. If the trucks could be reduced to one model he estimates that this requirement would fall to $3 million.

3. WFP as owner of the trucks could sell or lease the trucks although apparently this would require Ethiopian government permission. Further, there is no leasing company which could provide the financing. It would be preferable not to finance the trucks by loans from the banking system because of the inherent problems of loan recovery and the banking system's inexperience in credit appraisal and loan recovery procedures.

4. If WFP were able to rationalize its truck fleet this would accelerate its truck retirement program.

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VISIT NOTE - 6

Mr Tsegaye, General Manager, National Textile Corporation.

January 23, 1992

1. Mr Tsengaye began by giving a general review of the operations of the NTC. NTC has 16 textile plants ranging from integrated mills to one operation plants and cut, make and trim (CMT) factories. Prior to our visit the USAID mission provided with a summary of NTC operations (attached) and its need for cotton imports.

2. NTC is operating at a loss, although Mr Tsegaye described some of its operating facilities as profitable. He was not specific as to which ones. Mr Tsegaye knew that privatization was scheduled for NTC and its individual units. In Mr Tsegaye's view privatization would have to be handled carefully in view of the importance to the economy and the numbers employed (36,000).

3. Mr Tsegaye put down many of the problems to the previous government especially regarding procurement from the State Farms and the fixed selling prices to parastatal trading companies. Also, NTC was altering its production mix from a war time economy to a peace time one. Nevertheless, NTC has reasonable facilities (Mr Tsegaye's comment) with equipment in recent years coming from Korea. These were generally financed on a government to government basis. He also mentioned that some of the factories had old equipment but which was reliable.

4. NTC estimated that 20,000 tons of cotton were needed in addition to that produced by the State Farms which would have to be imported. Likewise, there were FX needs for spare parts, chemicals dyestuffs which amounted to Birr 50 million pa and could be regarded as working capital finance. As a result NTC was operating at 50% of capacity.

5. Interestingly, Mr Tsegaye said that raising the price of cotton would not result in additional cotton production for the State Farms. We suggested that contract farming be developed by smallholders. This was something that had not been thought of by Mr Tsegaye; further, he did not know how long it took for new cotton plants to mature (6-9 months) and thus that there was only a short lag in such contact farming producing input.

6. Exports amount to 3% of sales and all FX has to be surrendered to the Central Bank. There is FX retention scheme whereby NTC could retain FX for purchasing imported inputs and spare parts. Further, NTC is unable to take advantage of its quotas under the MFA or tariff free access under the Lomé agreement for the export of products tariff and quota free. See visit note relating to Office of Investment and Joint Ventures relating to possible Hong Kong direct investment.

7. Mr Tsegaye was unable to give details of the market make up say as to the spit between imported second hand clothing, informal market production, and private sector production. Linking in with this was Mr Tsegaye's comments that with privatization there would be considerable need for management training in the areas of production and inventory control, marketing, accounting, financial reporting, MIS and treasury management. Thus, there would be strong demand for technical assistance. To this end, we should perhaps look at the TA that USAID Burundi financed for Cotebu, the main Burundian textile parastatal.

8. Likewise TA was needed for audit, prospectus preparation and investor identification either on a JV basis or otherwise. Mr Tsegaye said that when privatization began it should begin with the garment mills first as they were smaller and less complex (mainly CMT) and the better integrated mills (presumably for JV's)

9. Mr Tsegaye was unable to give details of the textiles mills prior to 1973 -some, if not all were most probably in the private sector and several of

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them may have been listed on the Addis Ababa stock exchange (such as it was). This may well result in compensation claims being filed by previous owners/shareholders.

VISIT NOTE - 7

Mr Wondwossen Kebede, Vice Minister of Finance. Tel 552171
January 22, 1992

1. In this meeting we were accompanied by Mr van Egmond. The meeting opened with a discussion of the food aid program and the distribution of cheap/ subsidized food (wheat, flour, cooking oil) to low income families and its targeting to these beneficiaries. It was recognized that is private traders were used the benefit of the subsidies would largely be captured by them. This was unavoidable. Targeting would be better achieved through distributing coupons (food stamps) entitling low income people to reduced rates.

2. However, the issue of the dual distribution system through government food shops and the private sector went back directly to the prices paid in agriculture, and the agro/food processing industry which was largely under the Ministry of Industry (see notes under Ministry of Industry and their intention to privatize these companies).

3. As regards specific sectors Mr Kebede said that the 350,000 demobilized soldiers were an issue, especially as regards their finding employment. Like wise, during the war years parastatals in the industrial sector has produced for the military. This was especially so for the textile and footwear which had produced military uniforms and army boots.

4. Licenses when issued were sold from one person to another, often with the civil servants and operators working together. Thus, as a result of this the value of a licence was captured by the private sector with the Government obtaining little or no revenue from the issue of a licence.

5. According to Mr Kebede the main problems for the private sector are infrastructure problems associated with plant, machinery and distribution. Mr Kebede was vague as to what the principal activities of the private sector were, eg construction, textiles, footwear, metal/cars/trucks or that there were problems as regards access to finance; managerial, marketing, production and inventory control; support activities and premises.

6. Mr Kebede asked us as to what the donors saw as the most necessary, the situation in Ethiopia and what can be implemented. In respect of public sector divestiture Mr Kebede suggested:

   (a) Overdraft loans being converted into long-term loans

   (b) Evaluation of those enterprises which are profitable and which are loss making, evaluation of value added, management and capital needs.

   (c) What is to be the role of local/foreign capital and foreign investors, which sectors and incentives.

CONCLUSION

The impression given by Mr Kebede was one of little knowledge, poor appreciation of the government's program and its impact on public finance. In fact he demonstrated naivety especially as regards the role of private merchants in trade and distribution and arbitraging between the state trading system and the private sector traders. Likewise, his comments about the problems of the private sector seemed off the mark. In summary, he is most probably aware of them but did not want to discuss them.

Mr Kebede was one of the founder members of the Government and arranged its finances during the armed struggle period. It is, perhaps, for this reason that he does not understand finance very well. See also Financial Times article attached.

<u>VISIT NOTE - 8</u>

Mr Israel Kidane-Mariam, Vice Minister,
Office of Foreign Economic Relations (OSFER). Tel 152875

January 17, 1992

1. Under the previous government OSFER was part of the Central Planning Committee but now has been established as a coordinating agency for foreign assistance - grants, assistance and loans by multilateral, bilateral and NGO's.

2. OSFER also acts as a monitoring committee with IBRD.

3. OSFER also has under its wing the Office of Investment and Joint Ventures (OIJV). The Vice Minister was not familiar with its activities, except in general terms, and suggested that we meet with the OIJV to get more details.

VISIT NOTE - 9

Mr Tsegaye Teklu, Head,
Office of Investment & Joint Ventures (OIJV). Tel 157962

January 22, 1992

1. The OIJV was set up in mid-1990 and has evolved into now what its management call a "one stop" shop for inward joint ventures. It currently has a staff of 12 professionals. The OIJV deals with two principal types of investment:

   (a) Those investments (both local and foreign) where sponsors are looking for additional incentives over and above those offered under existing legislation.

   (b) All foreign investment which currently is obliged to invest with a public sector enterprise - local private sector co-investment is not currently allowed.

2. The OIJV is required to issue a decision within four months (90 working days) and requires an application form, feasibility study and documents of incorporation - statutes, etc. To date the OIJV has had 24 serious J/V proposals submitted of which four have proceeded and two have been approved. The two approved ones are hybrid seed development and underwater maintenance of sea vessels at the main port. The other two relate to the automobile sector (tires) and Hong Kong investors looking at the leather, mineral water and textiles sectors - these Hong Kong investments will be substantial, ranging from $25-$45 million each. Importantly, there is no minimum or maximum limit of foreign ownership or, alternatively, the minimum government participation in the enterprise.

   Besides the above the OIJV also has project profiles of investment opportunities in selected areas. These now total 51 and range through many sectors of the manufacturing and industrial sector.

3. Mr Teklu recognized the importance of the Investment and Commercial Codes, double tax agreements and the importance of the political stability and recent promulgation of the Government's New Economic Policy. He mentioned that Ethiopia had joined MIGA and had ratified the agreement for the Settlement of International Commercial Disputes.

4. The OIJV is largely independent of the Central Planning Committee - in the past it had largely operated under the auspices of the Central Planning Committee.

5. Recent liberalization of the licensing procedure has resulted in a surge of license issues (3,000 in agriculture and 4,000 in industry - however, in the agriculture sector only 6 had been approved as a result land ownership/title problems. Temporary licenses are now issued by the Ministry of Industry within 48 hours and a final license is required to be issued with 45 days.

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6. Investment can be categorized as follows:

(a) National projects which required to be endorsed/approved by the Government in the sectors of energy, mining, transport.

(b) Other projects, generally smaller, which were regional or specific to one area.

In order to expedite the issue of final licenses the OIJV had set up a coordination unit with the Municipality of Addis Ababa concerning the allocation of land. Further, the OIJV had developed a small scale industrial park with serviced sites near Addis Ababa.

7. All investment projects which request special incentives and all foreign J/V's have to be submitted to the OIJV and approved by the Investment Committee chaired by the Deputy Prime Minister. Mr Teklu indicated that the incentives have been developed to counter balance the parallel markets - these are described in the attached brochures and comprise primarily duty free import of plant, equipment and raw materials, tax holiday (5 years).

8. Specific areas where assistance would be required by the OIJV is in the following areas:

(a) Evaluation of investment codes and incentives offered by countries which have recently developed industrial and commercial zones, eg Dubai, Karachi, Sri Lanka and Egypt.

(b) Assistance needs regarding foreign investment identification relating to privatization and the offering of incentives and safeguards to investors.

(c) Development of double tax agreements with Ethiopia's main trading partners.

(d) Assistance regarding investment in agriculture, both domestic and foreign) so as to overcome the problems related to land tenure.

(e) Assistance regarding to up to date information of incentives offered by other countries - eg through financial newspapers, journals, etc.

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VISIT NOTE - 10

Mr Debebe Habte-Yohannes, Managing Director of Management Consultants International (MCI), and Chairman of the Corporation of Ethiopian Entrepreneurs. Tel 18 15 84

January 23, 1992

1. Mr Debebe is one of Ethiopia's most experienced entrepreneurs. He founded and was the general manager for on of the country's most successful private commercial banks--the Addis Ababa Bank. During the "red" period of Mengistu's regime he spent 8 years in jail. But since his release he formed MCI and has been busy as a management consultant. The World Bank and the TGE regularly seek his advise on financial and monetary issues.

2. Recently, Mr Debebe and a nucleus of highly placed Ethiopian private and public sector figures formed the CEE, with the intention of providing investors project feasibility services and seed capital. The CEE already has 50 subscribers and according to Mr Debebe it is already fully capitalized.

3. Mr Debebe believes that despite continuing difficulties and potentially explosive ethnic differences, the business climate is fast improving. He thinks now s the time to invest and knows, given the relative ease with which the raised capital, that there is plenty of money (both locally and from Ethiopians living abroad) for private investment. But he understands that until the TGE makes certain fundamental policy changes to restore quickly investor confidence. He also said that new business leaders who know the culture but who also have some historical perspective have yet to emerge. Seventeen years of revolutionary upheaval may have left badly depleted this type of leadership.

4. The key issues TGE needs to address are:

   - Revision of the tax policy. The rates continue to be too high; they should be competitive with rates elsewhere in the world. The present rates simply encourage corruption.

   - Reduction of bureaucracy. This includes particularly simplification of tax payment, customs and importation requirements, price controls, and labor laws (firms must be given the right to hire and fire).

   - Fostering competition. This include abolition of preferential treatment for SOEs in terms of credit, access to foreign exchange, raw materials. It also includes policies to encourage investment and new business start ups, perhaps by revising the investment code and extending the same privileges accorded to joint ventures to local businesses.

5. Mr Debebe believes the single most useful action donors such as USAID can take is to maintain the pressure on the TGE to hold its present liberalizing course. They should also foster a new mentality among government officials--that of servants of the people rather than dictating from above. He also pointed out that the US in particular needs to proceed very carefully. Its position vis a vis this government has not been well defined and its program priorities not well articulated. Many believe the US has decided to simply give this regime a carte blanche, and he believes this is wrong. There is a need for imposing the discipline conditionality brings.

   The US could also provide access to expertise in those technical fields where it as vast experience and an excellent reputation for innovation: such as capital market development.

6. He believes the Addis Ababa Chamber of Commerce is an excellent organization and was quite pleased with the lobbying efforts they have

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been carrying out recently on behalf of the private sector, particularly their response to the NEP.

7. Mr Debebe is a strong opponent of devaluation. He argues that devaluation would hurt far more people than it would help. The people most affected now are the 1,000 or so foreign expatriates living in the country. Ordinary Ethiopians have generally very little to do with the parallel market, in terms of the prices they pay for their goods. It would be highly inflationary. Devaluation would destroy investor confidence. What you need is to deregulate prices and then you will obtain a supply response. You also need to restructure the current foreign exchange allocation scheme.

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VISIT NOTE - 11

Mr Abdella Abdulmalik,
Import-Export Manufacturers Representative, Tel. 11 93 40

January 23, 1992

1. Mr Abdella is a prosperous businessman who expresses a willingness to invest potentially significant sums in new business start-ups or perhaps acquiring some SOEs which may be put up for sale. He also said that like him there are a significant number of entrepreneurs with resources willing and able to invest in the country. But neither he nor any investor is not willing to do this until the foreign exchange allocation policy has been changed. In his opinion, this is the single most critical constraint affecting private businesses.

2. He is highly critical of the franco valuta system. In his opinion it creates more problems than it solves and fosters corruption. Moreover, it also encourages exporters to under-invoice, thus enabling them to accumulate illegally additional hard currency for future imports. Finally, given the large discrepancy crated between the official and the parallel trade, there is a large amount of speculative and non productive activity.

3. Mr Abdella is also a strong opponent of devaluation. For him, it is a matter of altering the current allocation policy, and providing entrepreneurs with the ability to establish legal foreign exchange accounts. Thus exporters would be able to retain at least a proportion of the foreign exchange they generate and use it to acquire imports.

4. Another critical change needed is the tax code. The present rates simply encourage everyone to keep two books.

5. Mr Abdella noted that there is a long tradition of responsible management in the country. Major private employers in Ethiopia prior to Mengistu's time had generous training, health, social security benefits. But they cannot afford to do so any more.

6. Another area where there is a void is insurance. There is only one insurance company, and no one has any confidence that it can pay its obligations if they come due.

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VISIT NOTE - 12

Mr Seyoum Teferra, Director General and Manager of Operations, Ethiopian Import-Export Corporation (ETIMEX), Tel. 15 24 19

1. ETIMEX employs 300 people, 40% are professional and the remainder support/general services staff. Mr Seyoum believes he can run the organization, given its fairly high level of computerization, with abut 50 people.

2. Mr Seyoum is extremely interested in privatization. He believes privatization of the retail sector should begin with traders in consumer goods and bulk items. But he believes that due to 17 years of oppression, the private trade infrastructure has been destroyed. Therefore privatization should proceed slowly and in a phased manner. To him this means that there is need to do serious studies of the market for basic consumer and bulk item goods as well as of the structure of the private sector trading in these goods. Then one can target specific goods for foreign exchange allocations and tariff reductions, thereby allowing private traders access.

3. He also believes ETIMEX has a central role to play in the successful "decentralization" of the import-export business, since it is the largest and most experienced trader and will likely dominate even a competitive market. That role will be one of regulating trade and helping to stabilize prices until the private traders acquire more experience setting sound prices. ETIMEX could also provide services for smaller traders by engaging in bulk purchases on their behalf for a fee.

5. Mr Seyoum believes the fees charged by ETIMEX and EDDC at this time are too high. He has proposed a reduction of ETIMEX fees from 5% to 2,5%.

4. He believes the key role for a donor such as USAID is to assist in privatization of the retail sector and to provide commodity imports, using the proceeds of the sales to help finance projects.

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VISIT NOTE - 13

Mr Yohannes Bayonakis, Manager/Owner Baro Construction Tel. 16 49 78
January 24, 1992

1. Mr Yohannes is one of the largest and most experienced private contractors left in the country. He employs on average 250 people. He has managed to continue operating during the Mengistu regime, when all private contractors were essentially excluded from government works projects, by serving as a subcontractor in foreign funded construction projects.

2. The Ethiopian construction sector is currently dominated by 4 large state owned companies, which compete against each other for government contracts. There is much graft and under the table payments. They are also highly inefficient. Private contractors are at times allowed to bid against them simply so that the government can find out what the "real" price could be. Then they award the contract to a SOE and make it take the job for the amount bid by the private contractors. The bidding process is not transparent and no one can find out the exact criteria for awarding contracts, or get some indication of the reasons for the losing bid.

3. The private sector is suffering from acute shortages of raw materials. What materials are available in the formal market economy, either locally or from abroad, are given to the SOE contractors. Private contractors must scramble around in the black market and pay 6-8 times as much. This also cuts into their ability to remain competitive.

4. Another factor affecting their competitiveness id the fact that private contractors are required to pay a performance bond (10-15% of the total contract amount) as well as face burdensome collateral requirements; for an advance of Birr 380,000 to mobilize his team he needs a collateral of Birr 1.1 million. There are also problems wit timely payments, including in foreign contracts. This affects their cash flow enormously and inflates their overhead.

5. He believes ETIMEX and EDDC are absolutely useless organizations which need to be eliminated. They have very little idea or interest in what actual market needs are. They follow orders from government regarding imports and distribution priorities. What is imported is not related to actual needs.

6. The quality of the skilled labor is excellent and unskilled labor is easy to train.

7. The biggest changes required to get the construction sector moving and revitalized are: access to spare parts (a function of local production incentives and access to foreign exchange).

8. He and others in the sector are forming an association of contractors. It is their hope to focus primarily on lobbying and pressuring TGE to focus on key policy issues including access to foreign exchange or spare parts, reduction in tax rates, reformulation of performance bond requirements.

9. There are 600-700 contractors in the country, the vast majority concentrated in building construction and housing. There are about 8 larger contractors with over Birr 15 million in turnover.

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VISIT NOTE - 14

Mr Shiferaw Bekele, Secretary General,
Addis Ababa Chamber of Commerce, Tel. 51 38 14

January 24, 1992

1. The Chamber is the largest private business support organization in the country, with just under 26,000 members. The General Assembly elects Board of Directors, which consist of 10 members representing the different sectors elected for 2 years. The Secretary General is appointed by the Board. The SG job is awarded through pen competition and the vacancy announced in the press. It is a full time position. He has a staff of 10, including press secretary and marketing director.

2. The Chamber is active in the area of lobbying and training. The Chamber provides comments on upcoming legislation and regulations. The TGE requested its comments regarding the NEP. They believe the TGE takes into account about 70% of their recommendations. In the case of the NEP there were a number of issues with which they were not happy, and are presently preparing comments on proposed b-laws for the NEP. Areas which they feel have not been adequately addressed are the need to get government totally and immediately out of trade and the need to acknowledge the principle of private property and returning property to former owners. They will be making comments on the Investment and Labor Codes.

3. In the area of training, the Chamber provides monthly training for low, medium and high level employees, including senior executives. The training covers basic accounting, marketing, management, operations. Trainers are individuals recruited from universities or the Management Institute, or perhaps from private businesses with experience in the area. They pay all the teachers salaries (as high as US$35/hour) and organizational costs. Participants are not charged. They are able to raise funds from members initial registration and annual renewal fees. They also have an intensive follow-up, to ensure participants and their employers were satisfied with the quality and the focus of the material presented. They use this input to design subsequent courses.

4. The Chamber also provides members with translation services and marketing information. They acknowledge their library resources are rather poor and would be interested in donor support in this area. They also lack basic reproduction equipment, king it extremely difficult to reproduce training material. For a relatively small amount of money a donors can make a major contribution to the Chamber in the form of a Xerox machine.

5. They also do all accounting by hand, as they lack computers and sound management information and accounting programs.

6. The fastest growing areas in his opinion are the tourism/hotel sector.

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VISIT NOTE - 15

Mr Asfaw Teferra,
Hotel Investor & Manager/Owner Chamber Printing House Ltd. Tel 20 42 45

January 25, 1992

1. Mr Asfaw has invested over US$5 million in a luxury hotel a few kilometers from the Bole Airport. He believes he will be able to compete with Hilton, as his rates will be competitive. he also believes there will be increased tourist and business traffic, and has been told to expect and increase in the number of daily flights from Nairobi, Frankfurt and Rome within the next year. For these reasons he stated building this hotel less than a year ago. Construction was proceeding very fast and then his allocation of foreign exchange disappeared. He is unable to finish the hotel because he cannot get basic items such as ceramic tiles, refrigerators, kitchen equipment and glass. They cannot get local bricks either but the contractor has started manufacturing them in the premises of the construction site.

2. Obtaining local currency loans has not been a problem. He has a Birr 2 million 7 year loan from the CBE to cover local costs. He is paying 9.5%.

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VISIT NOTE - 16

Mr Tewfik Sherif, Tewfik Sherif & Co,, Tel 65 17 00
Mr Ibrahim Nawd, General Manager Airport Motel Ltd. Tel 61 04 22

January 26, 1992

These observations were made during an informal dinner.

1. Mr Tewfik has over 45 years in business. He lost to expropriation US$3.5 million under the emperor's time, another US$6 million (in expropriated farm property, mainly) during the era of the Dirgue and has been in jail numerous times under various regimes. Yet he keeps on coming back and investing. He has confidence not in the government's ability to do what it says it will do, but in his own ability as an entrepreneur. He is now investing in real estate, and developing a new office complex near Bole. His construction site, like others visited, is behind schedule because of foreign exchange shortages.

2. Mr Ibrahim is a hotel operator who has actually been able to start and finish his project, though an expansion phase scheduled for late last year is on hold until the foreign exchange shortage issue is resolved. His hotel has 20 bungalows, 17 of which are operational (the other 3 serving temporarily as staff housing). Most of his clients are foreigners, and reports that well over 70 percent of his earnings are in hard currency. He took a tremendous risk, since he began construction of his hotel 4 years ago. He was lucky, and his project eventually coincided with a gradual willingness of the Mengistu government to consider liberalizing the economy. During these time foreign exchange shortages were not quite as acute (things did not get excessively bad until 1989), and he was able to obtain all the materials to finish construction. The entire project was self financed.

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VISIT NOTE - 17

Mr. George Dikker-Hupkes, General Manager Shell Oil-Ethiopia

January 28, 1992

1. Mr. Dikker-Hupkes manages the largest foreign investment (and he believes the largest single tax payer) in the country. He finds that the skill level in the country is very high and points out to the fact that he is the only expatriate in a company of 260 people.

2. He has been living in the country for many years, and has been collecting a sets of issues he feels must be addressed if one is interested in private sector development in Ethiopia:

   - Peace. He believes this has finally been achieved, though there are still some skirmishes.

   - Access to foreign exchange. His company as many others in Ethiopia, have been cannibalizing spare parts since 1989. There are acute shortages of basic raw materials.

   - Remittances. Shell is 100% privately owned. It has over US$17 million of money from profits and service fees since 1983--money on which taxes had been paid already--which are not allowed out of the country. His shareholders are fed up with the situation and refusing to consider any additional investment in the country until this issue has been resolved. Alternatively, if you cannot remit, then at least recognize the money in-country re-invested as new investment.

   - Investment protection. New investors, and an older investor such as Shell are not rated alike. He believes the government's view is that once you have invested in the country, they can treat you as they wish: "you are their prisoner." But the TGE needs to understand that they hold no investors prisoners, and that an investor who has been in the country for over a decade is far more committed and should be more pampered than a new operator.

   - Investment promotion. Get away from fancy videos on Ethiopia, which no one believes, and do some real investment brokering.

   - Consideration of a retention scheme for foreign exchange earnings. All foreign earnings must be remitted to the NBE and they get Birr 2.07 in return.

   - Lending policies. It makes no sense to have the private sector borrow at 9-9.5% but paying accounts with over Birr 100,000 only 2%. This is what they are currently receiving on the Birr 40 million they have deposited at the CBE. He firmly believes private sector banking should be encouraged, otherwise there will b no incentive to provide better rates, no matter how the policy changes.

   - Taxes. Taxes of all type types are too high. Kill al incentive to work and make money.

   - Censorship. There is still too much censorship. Eve their internal news magazine must get approved by official government censors.

   - Privatize all SOEs, particularly AMC and EDDC which have wrecked agriculture. Here he wants to caution donors. He has seen too much recent activity under the economic recovery programs, whereby SOEs are again receiving preferred allocations of foreign spare parts, raw materials and vehicles. Instead of bringing raw materials for SOE X, he would auction this among all, and open it to the private sector for bidding. Otherwise, donor programs will continue to

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strengthen the SOEs and the rationale for privatization will disappear.

- Free licensing. There is no reason to charge.

- Free movement of labor. There are no free markets for labor in the country. All graduates must apply to work with government. Only after their 17-20 years service can they move on to the private sector. At times they try to get particularly bright candidates before they finish their last year.

- Even-handed treatment of management-labor grievances in the courts. The courts consistently side with the unions. Unions are too powerful. They are even allowed to keep a room with arms and to arrest management if they so see fit. Apparently the union leaders arrested the Hilton management last year.

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