Privatisation for sustainable growth in Ethiopia

A review

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Privatisation for Sustainable Growth in Ethiopia: a review

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1. Introduction

Policy dilemma with respect to divestiture of state assets is prevalent because mainstream economic theory provides little guidance on privatisation (Roland, 2008). However, there is a wealth of empirical evidence accumulated over the past several decades that countries such as Ethiopia can tap into as they attempt to improve the performance of state-owned enterprises. To guide the ongoing economic reforms in Ethiopia, this report aims to synthesize the existing evidence on privatization along several key dimensions, provide further reflections on the overall trends and present some econometric evidence on the effect of foreign direct investment/foreign ownership on productivity of firms in Africa. For the purpose of this report, we define privatisation as “…deliberate sale by a government of state-owned enterprises (SOEs) or assets to private economic agents...” (Meggison and Netter, 2001: 321).

Privatisation is often proposed to correct government failures and inefficiency of state-run assets. However, on the other side of the argument, developmental state, selective government intervention, oversight and regulation of the economy are proposed to protect economies from sudden economic collapse as witnessed over the decades when markets failed to deliver on social and economic objectives. Hence, countries constantly deal with delicate balancing acts of state-private sector management of their economy. Some end up with a mixed economy set up with active involvement of the state in the affairs of running an economy (e.g. economic stabilisation). There are well-conceived and empirically supported arguments that justify the expansion of the private sector to manage a certain portion of an economy. In addition to supra-national phenomenon such as globalisation, there are underlying macro and micro/firm level imperatives to justify the process of privatisation.

There is a good reason for the role of the state and the private sector as economic history provides traces of their respective (entrepreneurial) contributions. Governments (e.g. in advanced economies such as the US) are instrumental in driving most of the current mega
technology trends such as supporting Apple in its early days and with transfer of ownership to private hands. This means the role of the state has not been restricted to the provision of education, health, social security, regulation and macroeconomic stabilisation. The state can drive industrialisation and long-term structural transformation by nurturing and maintaining strategic partnership with businesses or even taking an active role in driving the development of a dynamic private sector and proliferation of entrepreneurial activities (Mazzucato, 2018; Stiglitz, 2003). Mauritius is a good example which is considered to be an industrialising small state in the African continent with effective private-public sector coordination of development and economic activity (Kedir, 2019). Without facing fiscal crisis which often triggers divestiture of state enterprises, Mauritius embraced privatisation of vital companies and developed a diversified economy alongside the promotion of export driven growth (via its export processing zones-EPZs). It also maintained a democratic political system and a strong social safety net with free education including university level provision, free health care and public transport for school children (Stiglitz, 2011). The role of the private sector is pivotal in diversifying the economy in key sectors such as tourism, finance, textiles and to some extent advanced technology. Currently, it is working towards becoming a financial technology (FinTech) hub of Africa. There is a lot to learn from its privatisation exercise and economic management.

In this report, we recognise the limits of the private sector. Hence, we argue that there is a legitimate and important role for the state. This very much varies from country to country given heterogeneous initial political and economic conditions. Both market fundamentalism or neoliberalism and exclusive state planning and control have their own respective shortcomings. Much intellectual effort should be focused on striking the appropriate balance in Ethiopia which is undergoing a major privatisation process of its own on the back of the current economic reforms.

The global privatisation drive was spearheaded and gained worldwide momentum by the Thatcher and Regan administrations in the 1980s. Subsequently multilateral international institutions such as the IMF and the World Bank led many African countries towards transferring ownership and management of large state-owned enterprises (SOEs) into private hands through their conditionality conditions for economic assistance. Downsizing of the state’s role in development, free market reforms and policy reorientation were fast tracked by the controversial Structural Adjustment Programme (SAP) of the Bretton Woods Institutions. Privatisation of SOEs took centre stage even though the process has been progressing at
varying pace in different countries. Countries opened their economies and actively engaged in trade liberalisation, financial liberalisation and reduced the role of the state.

It should be recognised that privatisation is not entirely the creation of SAP in Africa and countries such as Cote d’Ivoire embarked on the process as early as the 1960’s. It is true that renewed efforts were made during the late 1980’s and 1990s to implement privatization and undertake wide-ranging economic reforms. However, progress was slow mainly because of muted political commitment coupled with strong resistance from interest groups such as senior management officials, SOEs and public sector workers (backed by their unions) that feared losing their jobs. Due to nationalist concerns, some countries had strong aversion to increased foreign ownership in different sectors of the economy. On economic grounds, foreign ownership is good for annual sales growth but not for employment growth (Baricakoa and Kedir, 2019). The job creation capacity of any foreign company involvement or private ownership in the running and management of any SOEs (e.g. telecoms) will be critical for sustainable and inclusive economic growth in Ethiopia.

In the EU, privatisation proceeds rose to peak levels with countries addressing fiscal deficit after the financial crisis of 2008. Correspondingly, privatisation activity slowed down in Africa after 2008 mainly due to economic slowdown in the source countries of foreign private capital. In contrast, there have been some privatisation activities in some African countries such as Benin, Nigeria and Chad in the last decade. In China and India, the number of privatisations in recent years were not large. But the value or privatisation revenue proceeds were high in 2015. Despite its slow pace and sporadic nature in the past, there is currently an increasing trend in privatisation in developing countries and encouraging investment policies which are leading to a rapid rise in inward foreign direct investment (FDI) from emerging economies such as China, India and Turkey as well as from traditional development partners of OECD. Many African countries such as Kenya, Senegal, Ghana and Ethiopia are attracting investment from diverse set of countries. In 2015, Angola became the top recipient of FDI in Africa with its oil and gas sectors continuing to attract investors from abroad. Table 1 below provides a list of countries which embarked on privatisation over the last 50 years. Note that some countries are featured in more than one row. This is due to the fact that privatisation is a long process and most countries are engaged in the process in more than one occasion in their economic history. As we can clearly see, Ethiopia is one of the late starters of the privatisation process and is now embarking on one of the largest privatisation process in its economic history.
Table 1: Privatisation in Africa

<table>
<thead>
<tr>
<th>Period</th>
<th>Privatising countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960’s - early 1980</td>
<td>Cote d’Ivoire, Benin, Guinea, Niger, Senegal (mainly Francophone Africa)</td>
</tr>
<tr>
<td>Late 1980’s</td>
<td>Ghana, Nigeria, Cote d’Ivoire, Mali, Kenya, Malawi, Mozambique, Madagascar and Uganda</td>
</tr>
<tr>
<td>1990’s - present</td>
<td>Cameroon, Ethiopia, Sierra Leone, Tanzania, Burkina Faso and Zambia</td>
</tr>
</tbody>
</table>

Source: Compiled based on Estrin and Pelletier (2018).

Equally, there are regional developments that open economies further. For instance, major continental initiatives such as the African continental free trade area (AfCFTA) and local policy reforms such as privatisation in Ethiopia are expected to strengthen trade and investment links of African nations amongst themselves and with the rest of the world. Through privatisation, countries are keen to mobilise development finance for transforming their economies and embark on industrialisation. The purpose of privatisation in advanced countries tends to be more focused on efficiency and reduction of production costs while it is mainly a revenue raising instrument in developing countries via the sale of assets (Estrin and Pelletier, 2018). Removing the fiscal burden created by loss making SOEs help many developing countries to improve their balance sheets and reduce their fiscal deficit along with a short-term injection of much needed foreign exchange. In addition, regardless of the level of development of the economies in questions, divestiture is implemented with the purpose of better service delivery to consumers at competitive prices, job creation, transfer of skills and knowhow particularly in managing the operations of complex entities such as telecoms, energy and logistics.

2. Rationale for Privatisation

As our review in this report shows privatisation initiatives have a cyclical nature, increasing in certain periods and declining at other times in the economic history of many countries. The process is undertaken with speed and momentum when it is coupled with important political reforms that loosen the state’s grip on the economy, and transfer of ownership of financially weak SOEs characterised by rent seeking behaviour. Hence, there are both economic and political economy rationale for privatisation. One of the key messages of our review is that privatisation should be mainly driven by weak and unsustainable economic/financial imperatives. Therefore, it can be a risky exercise to privatise economically viable entities (e.g.
the Ethiopian Airlines). When a portion of an entity either on the management and operations arm of a state-owned company is not viable demonstrably, a cautious case should be made to justify privatisation. With the change of the political and economic policy direction of the current Ethiopian government starting from April 2018, privatisation is central to the policy reforms designed to sustain the encouraging economic growth the country has achieved since 2000. There are numerous reasons why countries embark on aggressive privatisation some of which may also apply to Ethiopia. There include;

- Efficiency (savings in subsidies and running cost of operations) and turning loss making enterprises into viable business entities with the purpose of providing affordable and important services to customers (e.g. telecoms);
- Improvement in doing business environment to boost competitiveness of the private sector;
- Tax base expansion to create a much-needed fiscal space and pressure to reduce the growth of fiscal deficit which might be contributing to the build-up of unsustainable public sector debt (e.g. due to the subsidy channelled to lose making SOEs);
- Access to foreign exchange, finance, technology and management know-how via foreign direct investment (FDI), mergers and acquisitions (M&A), joint ventures (JVs), ..etc;
- To encourage development of the private sector (a strong policy signal) that paves the way for job creation; and
- To achieve long term economic growth via diversification;

It is instructive to identify the most common forms of privatisation in Africa and possibly to shed light on questions such as “which methods applies better in which sector?”. Based on experiences of African countries AEO, (2003) identified several forms of privatisation which are arranged in descending order of importance as measured by the number of transactions completed. These include competitive sale of shares; liquidation; competitive sale of assets; direct sale of assets; pre-emption rights; concessions/leases; public flotation; direct sale of shares; management contracts; restitution; joint ventures, management/employee buyouts; trustees and equity swaps for existing or new debt. Even if direct sale of SOEs is the most common practice in privatisation, it can open doors for exploitation by aggressive negotiators, mispricing, bidder collusion, distortion of investment incentives and rent seeking on the part
of public officials. Hence, a careful choice or mix of privatisation forms is warranted and the absence of capital markets, the choice is very limited and should be conducted carefully and transparently to gain trust of the public and other stakeholders. For instance, in the late 1990s some advocated for a quick sale of state industrial assets in China. The problem with this remedy is that, by itself, privatization may not effectively solve the problems of non-excludability or non-diminishability. In the absence of a well-functioning property-rights market, privatization may result in the transfer of public assets to private agents who do not use them in a substantially more efficient way than they had been used under state ownership (Jefferson, 1998). Hence, there is no guarantee that private ownership (whether through partial or full privatisation) is intrinsically more efficient than public ownership.

3. **Microeconomic and Macroeconomic effects of privatisation**

Privatisation can be a conduit for attracting FDI which subsequently might lead to better job creation and technology transfer for host economies. In this section, we review the extant literature on the microeconomic and macroeconomic effects of privatisation both in the short and long run. There are several studies that explored the effects of privatisation. The evidence is more conclusive concerning the microeconomic effects (e.g. firm level efficiency and productivity effects) of privatization than the macroeconomic effects (e.g. the fiscal/budget and foreign exchange inflow effects) (Sheshinski and Lopez-Calva 2003). The socio-economic (often micro) as well as macro effect of privatisation depends on the nature of the industries that are targeted by the privatisation process. Studies so far identified several methodological problems in exploring the economic effects of privatisation (Megginson and Suttor, 2006). The table below summarises some of them by type.

<table>
<thead>
<tr>
<th>Type of problem</th>
<th>Specific manifestation of the problem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Methodological</td>
<td>Lack of data;</td>
</tr>
<tr>
<td></td>
<td>Poor data consistency;</td>
</tr>
<tr>
<td></td>
<td>Sample selection bias (sequence-wise if only the best performing firms are privatised first or if the process targets underperforming firms element of randomness is lost)</td>
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Privatization remains one of the most ubiquitous economic reform strategies that has swept over both industrialized and developing countries alike in a span of a few decades. However, the economic and social implications of privatization continue to be contested and inadequately understood. The challenge begins with the malleable nature of the privatization narrative, i.e. the multiplicity of rationales and corresponding goals associated with privatization. John Quiggin (2012) remarks, “as with the war in Iraq, different players in the policy process supported privatization for different reasons and expected different outcomes”. Notwithstanding the idiosyncrasies around individual cases of divestiture, most of the major waves of privatization including the earlier ones in the 1980s were aimed at correcting for what was perceived to be an overreach by the state in previous decades.¹

Assessing the overall impact of privatization is considerably difficult mainly because there is no clear counterfactual in most cases. Privatization is often rolled out against the backdrop of fluid and interconnected economic and political dynamics. Particularly in transition countries, the privatization process is subject to sizeable aggregate uncertainty, leading to enormous variation in outcomes across cases (Roland 2002). There is more consensus on the effects of privatization on specific and straightforward metric such as productive efficiency than on complex social indicators such as individual and household welfare. For instance, firm level evidence from Mexico showed the rapid performance of privatised SOEs which closed the large performance gap with industry level private firms prior to the privatisation. However, one should note that this is a snapshot and a short-term window. The long term economic

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¹ There are important differences in the main objectives of privatization in developed and developing countries. “OECD countries were seeking to reduce production costs in a context of stagnating demand, while the African countries were aiming to increase supply and raise immediate revenue for the government through the sale of assets” (Berthelemy et al. 2004, pp. 9).
realities also matter. The Mexican workers in the privatised SOEs had a significant increase in wage but this came at the expense of lost employment for many in the privatised firms which obviously has long term welfare consequences (Estrin and Pelletier, 2018). At a most basic level, the raison d’être of a firm changes when it is transferred from public to private hands. Even if some of the narrow measures of firm performance apply to both forms of ownership regardless of divestiture, other more complex social indicators may cease to be part of the objective functions of the firm after privatization. This is part of the reason privatization is sometimes more of a political project than an economic one. It is equally true that checks and balances should be at the heart of any regulatory framework which monitors and evaluates conduct of privatised companies not to lose sight of the underlying developmental objectives.

Much of the discontent with privatization in the former communist countries is related to the mode and pace of the process notwithstanding the criminal investigations following suspicious deals and uncovering of incidences of systemic corruption within the fabric of the state apparatus and foreign investors. In many of the early cases, ‘mass privatization’ was presented as a political imperative even when it was clear that such an approach would involve a leap of faith. The experiences of those countries underscored the importance of ethical conduct, integrity, initial conditions (e.g. governance and institutional quality) and sequencing among other things. Particularly, the Russian experience shows that initial conditions, especially the quality of institutions, matter more than the actual privatization itself (Black et al., 2000). Similar examples can be cited for the telecom privatisation experiences of former socialist countries such as Montenegro and Macedonia. Moreover, the sequencing of reform measures that are complementary to privatization is necessary but not a sufficient condition for the success of the whole exercise. “Privatization without effective competition policy puts existing monopolies in private hands, which may in turn have enough power to capture the state apparatus to prevent the introduction of competition policy as well as any measure that is opposed to their interests, as the Russian experience has shown” (Roland 2002, pp. 42).

The outcomes of earlier waves of privatization also warrant caution in determining the pace of privatization. There is strong evidence that, from the point of view improving firm

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2 Jeffrey Sachs (1992) advises Russia to avoid following the one-by-one and “voluntary” approach that “has frustrated the reforms in Eastern Europe and to adopt transparent and fair privatization methods that address the ownership system on a comprehensive and rapid basis” (pp. 44). Such views might have encouraged Russia to adopt a mass privatization approach which eventually produced poorer results than countries that had adopted a gradualist approach.
performance, full privatization tend to have greater impact than partial privatization (Li and Xu 2004, Sheshinski and Lopez-Calva 2003). However, others argue that governments should consider ‘staggered privatization’ in which the gradual divestiture of public companies allow time for regulatory institutions to be established and strengthened (Black et al 2000). This is at times contradicted by the merits of joint ventures in recent times (Greenaway et al 2009). By retaining ownership in partially privatised firms, a government bears residual risk which may signal commitment to non-redistributive policies in the future (Perotti 1995). In addition, high state ownership may decrease the cost of new debt in privatized firms as the government’s presence could be viewed by debtholders as an assurance of repayment (Borisova and Megginson 2011). Deals and privatisations transactions and the legal contractual text should clarify all this implicit risk sharing by explicitly outlining the boundaries of the responsibilities of the parties to the contract. Either way, there appears to be little disagreement in the literature that government should relinquish control eventually even if transfer of ownership may be gradual. But its presence should be felt and enforcement (e.g. protection of consumers as well as investors, property rights, profit repatriation rules/limits, price control, enforcing competitive market presence …etc) should be the driving force behind any legal and regulatory obligations to be fulfilled by the privatised firms when operations fall short of expectations.

Sheshinski and Lopez-Calva, (2003) show that privatization increases profitability and efficiency of firms both in competitive and monopolistic sectors (e.g. natural monopolies such as telecoms). Full privatization has a greater impact than partial privatization and monopolistic sectors show an increase in profitability that is above the component explained by increases in productivity, which reflects their market power. This poses an important challenge for the designers of regulatory policies, especially in natural monopolies. The change in employment at the firm level is ambiguous, though firms that are publicly traded show an increase in employment level after privatization. Based on the limited extant evidence, the distributive effects are shown to be sensitive to the market structure. From the macroeconomic perspective, no conclusive evidence can be drawn, but the short-term trends are favourable in terms of public sector deficit, attraction of foreign direct investment, easing foreign exchange constraints and stock market capitalization. Corporate governance issues after privatization, as well as legal changes for investor protection are among the main challenges for privatization to succeed.
The most common reason given by politicians for privatization in developing countries is restoring the macroeconomic balance that is often destabilized by subsidising unprofitable state-owned enterprises (SOEs). By reducing inflation, via its impact on budget deficit, privatization could protect efforts to expand exports through currency devaluation (Bienen and Waterbury 1989). Improved export performance, in turn, contributes towards debt sustainability by facilitating the servicing of foreign debt more easily. Ethiopia’s pledge to embark on the latest round of privatization is driven, more than anything else, by the need to address the deteriorating macroeconomic imbalances. The increasing debt servicing requirement coupled with the stagnating export performance has forced policymakers to rethink the SOE-led industrialization strategy.

One area where there is significant divergence between the political narrative in favour of privatization and the underlying economic analysis is the fiscal benefits of privatization. Regardless of the tendency to present privatization as a move to get the fiscal side of the economy in order, the long run effect of divestiture on fiscal stance is highly contingent on several dynamic factors. Basically, privatization is the act of foregoing future streams of income from a state-owned enterprise in exchange for one-off receipts for the assets involved. One of the earliest accounts of the macroeconomic implications of privatization cautions that unless significant efficiency gains are realized and captured by the budget, privatization may in fact worsen budgetary prospects over the medium term (Mansoor 1987). This is despite any short-term improvements as a result of the proceeds from privatization. One of the reasons for this unfavourable outcome is that state assets are often under-priced. Another reason is that the government usually continues to shoulder the associated costs of divestiture such as labour retrenchment pay-outs well into the future. Therefore, Mackenzie emphasises the point that privatisation should not be undertaken to fix a hole in the budget (Mackenzie, 1998). He also underscores he need to keep long-term economic growth in mind in the process of privatisation.

Part of the challenge with relying on privatization to help improve macroeconomic conditions is that privatization itself is endogenous. Privatization usually occurs in unfavourable economic environments when are faced with structural and temporal macroeconomic problems. “The same fiscal and macroeconomic instability that increase the utility of short-term revenues for the state lowers the economic value of the state enterprise for private investors” (Pinheiro and Schneider 1995, pp. 769). Contrary to its purported purpose, privatization could contribute to a tightening of the government’s intertemporal budget
constraint by forcing a country to accept a lower price for the sale of public enterprises if there is an ongoing balance of payments problem. “When a country cannot borrow abroad, it is in effect income-constrained. The shadow price of the foreign exchange it gets from the sale of an enterprise to non-residents may then substantially exceed its face value” (Mackenzie 1998, pp. 367).

The elimination of subsides is billed as one of the most common fiscal benefits of privatization. But the social or political imperative that was behind such transfers might not disappear immediately with divestiture. Heller and Schiller (1989) note that privatization would yield no savings in terms of the subsidy if the government continues to pursue the original policy objectives through other means of equal cost. The effect of privatization on the macroeconomic environment could materialize through its impact on investment and – therefore – aggregate demand. Improved efficiency in privatized firms may help to attract further investment. However, the empirical evidence is not so straightforward as there may be other countervailing factors inherent to the divestiture process negatively affecting investment. For instance, weak regulatory institutions may create significant uncertainty which may in turn reduce investment. “Recent evidence from the World Bank confirms a sharp drop in private power sector investments in lower income economies since the late 1990s, reflecting institutional difficulties” (Parker and Kirkpatrick 2005, pp. 525). Moreover, regardless of the institutional environment, the transfer of poorly performing state-owned enterprises to private hands could reduce investment in those enterprises from earlier levels (Mackenzie 1998).

Although the thrust of the argument in the preceding paragraphs implies that the macroeconomic benefits of privatization are more precarious than the proponents of the policy make them out to be, staggered privatization could contribute to improving fiscal outcomes in the medium-term. Primarily, the privatization of a few SOEs could demonstrate the government’s commitment to fiscal goals, incentivizing managers of remaining SOEs to be serious about cost cutting and budget discipline (Pinheiro and Schneider 1995). In addition, the government could maximize long-run revenue because the value of its shares in partially privatized enterprises may increase over time as the credibility of the privatization program is established (Ramamurti 2000).

Ethiopia’s decision to privatize underperforming and highly indebted SOEs may signal the government’s commitment to deal with the debt problem. The perennial balance of payments problem also adds to the importance of securing new infusion of foreign currency from
potential foreign buyers of government assets. However, the sale of financially healthy SOEs operating in high growth sectors might be hard to justify only based on improving fiscal stance. This point is more salient particularly because the current economic distress might artificially lower the government’s discount factor, leading to the decision to privatize growing SOEs. Moreover, it should be noted that foreign investors’ need to repatriate some of their profit later could offset a short-term balance of payments gain due to divestiture.

4. Challenges of Privatisation

4.1 Asset valuation and capital markets

The foregoing discussion of the literature on the macroeconomic implications of privatization underscores the importance of valuation of state assets in the privatization process. There is no shortage of cases from past waves of privatization where state assets were discovered to have been significantly undervalued after the fact. A recent review of the evidence from across the developing world states that such undervaluation could happen “in order to make the assets more attractive to the market, or because the SOEs were lossmaking and the short-term requirement to balance the budget dominated long-term state asset portfolio criteria” (Estrin and Pelletier 2018, pp. 87).

Privatization usually takes place in an environment riddled by information asymmetries and policy uncertainties. Private investors are often more risk averse than the state. Since risk aversion reduces the value of a company for investors, this leads to lower prices for public assets than the government’s own valuation (Pinheiro and Schneider 1995). The government may be well aware of the fact that private investors are risk averse. However, it may find it difficult to evaluate the reservation price of the private sector, which may ultimately lead to underpricing of assets (Mansoor 1987). Partial privatization of SOEs may have its own advantage in terms of allowing for risk-sharing between the state and private investors. But, on the other hand, it reduces the control of private investors over management decisions. The evidence shows that, as a consequence, “continued government involvement and share retention reduces the number of bidders and therefore the price per share sold” (Nellis 2003, pp. 9).

The valuation of firms also depends on industry parameters that are usually beyond the control of individual firms (Lopez-de-Silanes 1996). In an open economy setting, industry-level conditions are often determined by global factors that are largely exogenous to the
decisions of small players. The importance of industry-level trends can be seen in the overvaluation of telecommunication assets that were privatized in the late 1990s during the period when the dotcom bubble was at its peak (Li and Xu 2004). In contrast, the valuation of sugar factories such as the ones Ethiopia is planning to privatize may suffer due to the global sugar supply glut and an increasingly competitive global marketplace for the product.

Both the initial valuation of state assets and the eventual movement in the price of partially privatized firms can be influenced by the mode of privatization and the existence of a robust domestic capital market. At the very least, the inexistence of capital markets could significantly limit the options of the government for divestiture. But this does not mean that Share Issue Privatization (SIP) necessarily leads to superior outcomes in terms of valuation and the efficiency of the process. In fact, there is evidence that, as far as firm performance is concerned, privatization to concentrated owners yields better results than privatization to the general population via share offerings (Estrin and Pelletier 2018).

Regardless of the impact of prior capital market development on the outcomes of privatization, Share Issue Privatization could be used as a way to stimulate the growth of local capital markets (Megginson and Netter 2001). This could contribute to catalysing private sector development and improving social welfare provided that initial income inequality is not too high. In addition to the direct impact of SPIs in vitalizing local capital markets, Perotti and Oijen (2001) claim that privatization plays an important indirect role for stock market development by signalling political commitment to market-oriented policy reform. A successful completion of a major privatization programme showcases the system’s capability to resolve political uncertainties, which increases confidence for capital market development. The use of share issue privatization with the aim of market development, however, requires the difficult task of building regulatory institutions to oversee both the privatization and capital market development at the same time. That is the reason governments in emerging economies are unlikely to target dispersed private investors as buyers of SOEs regardless of the potential benefits for capital market development (Ramamurti 2000).

Ethiopia is going to rely on foreign buyers to divest the government from some of the large SOEs. However, the subjective risk assessment of foreign buyers could be markedly different from that of the government’s, particularly because the politics and economy of the country are going through a major phase of transition. By privatizing Ethio Telecom first, the government may be following a global trend of using telecom privatization to demonstrate its
seriousness about pro-market reforms. If this goes well, it could contribute to strengthening the government’s bargaining power for subsequent divestitures. However, the downside risk is that it would be hard to recover from the reputational damage the bungling of such a major divestiture could cause.

The absence of a functioning stock market in Ethiopia may deprive the country of a good opportunity to empower the domestic middle class through the transfer of some of the most valuable national assets. This could be a particularly attractive policy considering that wealth inequality is still relatively low in Ethiopia. It should be noted, however, that the oversight of the establishment of a stock market and regulation of its operation require significant legal and bureaucratic capabilities. Moreover, there are technical and economic (balance of payments) imperatives that may require the government to show preference for established foreign buyers for initial offerings. However, privatization could provide significant impetus for the establishment of a national stock market which could eventually serve as a platform for both initial offerings and secondary trading of privatized companies.

4.2. Welfare and inequality implications

It should be noted at the outset that privatization has earned its controversial reputation in several parts of the world mainly due to its perceived or real impact on social welfare and wealth inequality. It should also be clear that pinpointing the causal implications of privatization on complex social outcomes such as poverty and inequality is not always an easy task. The fact that privatization is often preceded by overall economic stress and accompanied by other austerity measures may also make it difficult to isolate the impact of privatization on welfare outcomes. “In these cases, privatization, a policy with more tangible results than liberalization, may bear the brunt of the people’s discontent” (Van de Walle 1998, pp. 611).

Some of the most important channels through which privatization could impact social welfare are employment, price levels and access to infrastructure services. The overall record of privatization on employment is negative on balance. Birdsall and Nellis (2003) reviewed the empirical evidence that had accumulated over the preceding decade to conclude that “more

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3 Li and Xu 2004 note that telecommunications share-issue privatization almost always represents the largest share offerings in many countries, and telecommunications stocks often are the “bellweather” stocks on national exchanges.
people have lost jobs than gained them through privatization”. Privatization commonly involves underperforming and overstaffed SOEs. This means some degree of retrenchment is inevitable as part of the restructuring that usually accompanies divestiture. The key moderating factor that can potentially minimize or reverse net job loss due to privatization is increased revenue. Frydman et al. (1999) find that the strong revenue and productivity impact of privatization to outside owners is accompanied by the absence of any pronounced employment effects. Post-divestiture employment outcomes also depend on industry characteristics, i.e. whether the firm is situated in high growth sectors such as telecommunications in the 1990s.

Clearly, post-sale profitability does not guarantee net employment creation. In fact, retrenchment could be a core part of the strategy to improve profitability after privatization. Panel data evidence from Mexico shows that transfers from laid-off workers contribute up to 46 percent of the increase in post-privatization operating income in the median firm (La Porta and Lopez-de-Silanes 1999). Compounding the welfare implications of privatization, the brunt of such losses might be borne by vulnerable groups such as women and low skilled workers. There is already some evidence that privatization in Hungary was more costly to women because divestiture often involved the closing of the firm’s social services such as canteens, clinics and day-care centres which were crucial to female participation in the workforce (Nellis 1999).

The other channel through which privatization could impact social welfare is the price of essential services. This mainly concerns possible price hikes in network and infrastructure industries such as telecommunication, water and electricity. In many cases, post-divestiture price increases happen because the prices were previously below cost-recovery level. The distributional impact of such increases depends on whether such services constitute a larger share of the poor’s consumption basket than that of the rich’s (Estrin and Pelletier 2018). The analysis by La Porta and Lopez-de-Silanes (1999), which decomposes the post-privatization increase in operating income in Mexico, attributes 7 percent of the increase in income to price hikes. Privatization’s record on access and quality of services appears better than the record on price. In telecommunication, network penetration has deepened, and price increase restrained when privatization was complemented with increased competitive pressure (Li and Xu 2004).

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4 It is interesting to note that the tone of John Nellis’s arguments on the welfare implications of privatization shifted markedly over the course of the 1990s at the same time as the public discontent over privatization increased.
As far as the distributive implications of privatization are concerned, there is a growing consensus that almost all privatization programs have done much more to enhance efficiency than equity (Birdsall and Nellis 2003). The authors claim that “at least initially, and on average, privatization has worsened wealth distribution and, to lesser extent, income distribution” (pp. 1624). The extent of the effect of privatization on inequality also depends on the valuation of state assets. Discounts on the market clearing price of SOE assets is tantamount to transfer of wealth from the wider public to the new private owners (Yarrow et al. 1986).

The welfare implications of privatization could in the end prove to be so complex that it might be difficult to measure the net outcome. However, it is useful to keep in mind that privatization is simply an undertaking to switch an asset from one form of ownership to another, both with their own imperfections. “Market failures can lead to divergence between profit and welfare objectives in private firms. Government failure leads to divergence between political/bureaucratic and welfare objectives in state-owned enterprises. Monitoring failure leads to divergence between the objectives of enterprise managers and their principals, whether the principals are private owners or political superiors. The effects of ownership changes on welfare will depend upon the relative magnitudes of these imperfections” (Vickers and Yarrow 1991, pp. 130).

In the absence of a robust private sector, the public sector in Ethiopia has weathered the structural adjustment storms of the 1990s to continue to play the role of providing social SafetyNet by creating employment. As the country continues to struggle with high youth unemployment, the employment effects of privatization require careful consideration. Some SOEs such as Ethio Telecom have already undergone some level of restructuring under alternative arrangements such as management contacts. This may reduce the negative employment effects of eventual privatization. Moreover, other projects that are slated for privatization but are not yet fully operational will have minimal employment consequences.

The prospect of price hikes for the services provided by network industries such as Ethio Telecom and Ethiopia Electric Power would depend on whether prices under state ownership were below cost recovery. Considering that Ethio Telecom is already one of the most profitable firms in the country. If there is a strong regulatory apparatus in place, telecom price increases might not be a threat to social welfare in the short run. In the case of SOEs such as Ethiopia Electric, there is a real possibility that privatization might threaten pro-poor expansion and
affordability. However, the efficiency gain from privatization could be harnessed to restrain price increases provided that there is robust regulation.

4.3. Political economy considerations

However much the international financial institutions tried to sell privatization as a technical fix to economic problems, the sale of state assets is an inherently political issue. The process and outcomes of privatization are heavily influenced by political economy parameters such as interest group dynamics and control of corruption. The outcomes of privatization, in turn, may contribute to reshaping the political landscape in a profound way. In many cases, there is a two-way relationship between privatization and political fundamentals. “One can argue that a high concentration of wealth and power like in Russia is the result of the mass privatization policy chosen favouring the insiders. However, the choice of the mass privatization policy itself can also be seen as the result of prior rent-seeking activities” (Roland 2002, pp. 36). Some investigated whether corruption is correlated with austerity policies, particularly privatization, and argue that there is a potential for heightened rent-seeking during privatisation (Hart, 2012).

Given the multidimensionality of goals pursued by SOEs, their existence and the roles they play could be an important part of the social contract undergirding the political equilibrium. For instance, in China, SOEs have served as social SafetyNet by creating employment in many parts of the country. As far as the existence of SOEs has social and political dimension, their divestiture can become a politically polarizing agenda. Privatization could be so unpopular in some cases that local politicians may attempt to protect their constituency from it. For instance, there is evidence from India showing that no firm located in the home state of the minister in charge of privatization is ever privatized (Estrin and Pelletier 2018).

The scope and depth of privatization is determined through the interplay of various interest groups such as organized labor, managerial groups and investors. In past decades, it was commonly the case that SOEs in developing countries were concentrated in import-substituting sectors whereas the small private sector was left in charge of export-oriented activities. This often led to political resistance against privatization because the coalition for import-substituting industrialization (i.e. the military, the state managers, organized labor, civil servants and large parts of the professional middle class) are more powerful than the small and
often-disorganized exporting class that may stand to benefit from reforms such as privatization (Bienen and Waterbury 1989).

Large scale privatization can affect the distribution of wealth and power in society considerably. Depending on initial conditions with respect to the strength of democratic and fiscal institutions, the transfer of wealth through divestiture can worsen rent-seeking behaviour. Privatization to foreign investors might undermine democratization in transition countries by moving wealth which could have been used to counterbalance the power of the political elites away from the domestic constituency. Privatization to indigenous investors, on the other hand, can give rise to a newly empowered business class pressing for political favours (Parker and Kirkpatrick 2005). The experience of post-communist transition countries shows that the new business elites could collude with the political elites to protect their newly-gained rents from being errored by further reform. This could lead to a socially inefficient partial reform equilibrium (Hellman 1998).

Aside from perverse incentives and unintended consequences created by political economy factors, the other common misgiving aired in relation to the governance of privatization concerns the implementation capacity of the state. Privatization often involves complex processes and multifaceted negotiations with a number of stakeholders. More importantly, it requires establishing a robust regulatory framework to safeguard the common good. However, privatization is a government activity, and as such it cannot be expected to be exempt from the impact of government failure (Vickers and Yarrow 1991). If there is any argument that is shared by parties on both sides of the privatization debate, it is that strong state and market institutions are a prerequisite for successful privatization. In this regard, the observation made by Parker and Kirkpatrick (2005) is a poignant reminder that privatization cannot really be a panacea for pervasive government failure: “One intriguing paradox in privatisation policy is the apparent belief that governments, which are so self-seeking and incompetent that they are unable to run industries successfully, can nevertheless privatise them efficiently and effectively” (pp. 532).

In Ethiopia, the revolutionary democracy ideology of the ruling party prescribed that the state should remain in control of the ‘commanding heights’ of the economy until such time as socio-economic transformation is achieved. Therefore, primarily, the existence of large SOEs dominating certain sectors of the economy has ideological origins. Nevertheless, it was inevitable that this ideological reasoning would eventually morph into interest-group
motivation as the SOE sector creates rents for insiders with vested interest. This is clearly manifested in the rise and, ultimately, fall of the military industrial conglomerate METEC (Gebregziabher 2019). The recent privatization effort has emerged as the ruling party abandons the revolutionary democracy ideology, albeit unofficially, and the power balance shifts away from the old guard including METEC’s leaders.

The fact that most of the SOEs to be privatized still have monopoly over their respective markets does not only create an efficiency threat but also a potential political economy trap. The lack of organized interest advocating for the introduction of competition, coupled with the perverse incentive the government may have to cash in on the monopoly rent, may lead Ethiopia in the way of a partial reform equilibrium. Even though the foreign investors who are likely to buy some of the large SOEs may not have a direct representation in the domestic political game, it is quite plausible that a local comprador class could emerge doing the bidding of foreign investors.

Finally, the apparent weaknesses in the state’s implementation capability could lead to serious problems in such a high-stake privatization drive. First, the state might not be as cohesive as it was some years ago due to fractures in the political settlement supporting it. Second, it is doubtful that state has sufficient personnel and bureaucratic capacity to oversee the implementation of the envisaged privatization. Over the last decade and a half, the civil service has been battered by over-politicization of the bureaucracy and declining real wages that it is not clear if it has the required motivation to carry out such a demanding programme. Moreover, some institutional memory and tacit knowledge might have been lost as the fulcrum of the privatization effort shifted away from the public enterprises agency to the ministry of finance.

5. Privatisation in Ethiopia: historical and current context

5.1 The Ethiopian privatisation experiment (1991- mid 2018)

Recognising the importance of the private sector in economic development, the government of Ethiopia has been constantly reviewing its position in allowing the private sector in the running of different sectors and key state-owned enterprises (SOEs) over the last 30 years. Therefore, after the fall of the military government that ruled the country from 1974 to mid-1991, significant changes took place in the management of the economy. In reviewing the privatisation experience of Ethiopia, there are two important elements of privatisation that we
should keep in mind. First, the current privatisation drive should be thought of as a subset of the progressive opening up of the economy to entrepreneurship and private sector development. This forms the broader direction of the economy. The second is the actual transfer of ownership of specific SOEs to private hands via any of the forms of privatisation we briefly outlined above. The literature that focuses on the latter element of privation is the core of our discussion even if most of the existing literature in Ethiopia is mainly on issues that relate to the former i.e. broader private sector development. Since late 1991 Ethiopia has gone through different waves privatisation. In the early days of the 1990s, privatisation took the form of direct sale of different establishments such as factories, farms and hotels. Other privatisation initiatives focused on larger establishments such as breweries and strategic sectors such as the mines (Negash et al 2018).

The recent economic history of many African countries including Ethiopia shows progressive acceptance of the importance of market-based rules and increased participation of the private sector in contrast to the central planning-based resource allocation of the decades before 1990. In the early 1990’s as part of the conditions of the Structural Adjustment Programme of the World Bank, Ethiopia embarked on measures and economic reforms to increase the role of the private sector. Divestiture of public enterprises led to a wave of retrenchment of workers (Degefe, 1994) The reform programme in the country in the early 1990 emphasised the importance of prudent macroeconomic management (via fiscal and monetary policy discipline) to accompany changes such as privatisation of SOEs, trade and financial liberalisation policies (World Bank, 2004). The new economy policy of the Transitional Government of Ethiopia in November 1991 attempted to create more room for the increased participation of the private sector in the economy. The attempt included tax incentives and foreign currency retention provisions. Once the political set up was transformed to multi-party democracy and relative stability, the uncertainty surrounding the transitional government arrangement abated and the state embarked on a developmental state approach to economic transformation which led it to maintain ownership and running of key enterprises in water, power, telecoms and transport. However, a room for private ownership of banks and financial institutions only for domestic investor was created. During the period in the 1990’s and 2000s and even to the present day, the ownership and management of key SOEs barely changed and establishment of firms via endowment funds increased. Hence, except for limited private sector involvement in agriculture and manufacturing, there was limited signs for domestic and foreign investors to be involved in key sectors of the economy.
As in the current case (e.g. the Privatisation Advisory Council), a privatisation committee that oversees the privatisation process was established in the early days of Ethiopia’s privatisation. In 1992, lifting of subsidies to SOEs was announced along with deregulation of transport tariffs, and revision of investment laws under the Economic Reform and Rehabilitation Programme (ERRP). The privatisation decision of manufacturing enterprises and state farms was based on the profitability criteria. Hence, the process took place only in cases where state was not running establishments profitably. In cases where operations are profitable the state has maintained the ownership and management of all SOEs (Taddesse 1994). In terms of geographical distribution and overall profit, there is a concentration pattern following the prevailing agglomeration of economic activities. Virtually most of the privatisation activities have been in Addis Ababa where most of the strategic economic sectors are concentrated. Sector-wise private sector involvement in trade and services is more prominent but with very small capital involved indicating the limited role of the private sector in the overall economy. In the presence of incentives for investors, one may wonder why the development of private sector is very slow in Ethiopia. Some of the major impediments concern the rules and regulations that are more in favour of large capital owners as outlined in proclamation No. 15/92 (Wole, 1994).

Foreign direct investment in a resource poor economy such as Ethiopia is not resource-seeking but often market seeking. Creating space for foreign investment is one thing. In practical terms, there is more to privatisation than revising investment laws/codes and provision of incentives for would be foreign investors. That is why for most of the period from 1991 to 2004, the number of foreign investments in the export sector is not as large as expected. With the expansion of enterprises working in the industrial parks and major developers, this current privatisation is expected to boost the arrival of export oriented FDI and the much-needed foreign exchange. From a policy perspective, desirable FDI is the one that is market seeking both on the domestic and foreign front with job creation and poverty reduction as the ultimate goals. Clearly, the state plays a crucial role in providing complimentary policies that enhance meaningful economic transformation with the involvement of domestic as well as foreign private capital. As part of the comprehensive overhaul of the economy, the government embarked on major infrastructure projects since the mid-1990s, (e.g. ports, dams, rail networks, and roads) which provide the critical public goods that facilitate the private sector operations.

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This commendable public investment driven infrastructure provision by government improved the environment for private investment in Ethiopia. Much of the future fiscal/fund allocations should focus on maintaining existing infrastructure as well as future provisions (Adam and Bevan, 2014). Hence, continuing the effort that the state is putting towards global integration and improving operations in trade logistics/facilitation and unlocking short-term capital constraints are critical as foreign capital does not flow if there are logistics bottlenecks (Kedir and Burl 2020; World Bank, 2013).

After the new administration took over in April 2018, more sectors are open to foreign investors including giants such as telecom, port administration and transport. For the period from 2000 to 2018, many sectors were restricted to a limited proportion of domestic investment as the government maintained significant presence in the economy through the webs of SOEs in banking, insurance, telecoms, transport and electricity. In power/electricity generation (through hydropower facilities), a joint venture arrangement with the state was allowed over the last two decades but the involvement of the private sector in this strategic area is not clear (World Bank 2003).

5.2. Privatisation, industrial policy and structural transformation of the Ethiopian economy

In recent years, industrialization has emerged as a key strategy in the long-term development plans of many African countries. In many ways, Ethiopia has trailblazed the recent shift towards more activist industrial policy across the continent. Therefore, it befits to reflect on the potential impacts of privatization on industrial development with view of Ethiopia’s ambitious quest for structural transformation. A discussion of the role of privatization for industrial development should begin with the roles SOEs are intended to play for industrial development in the first place. In many cases, SOEs are established or expanded as part on an activist policy for industrial development. This means SOEs are part of a strategy to correct market failures that would otherwise hinder development in certain sectors such as manufacturing. Some SOEs might be designated ‘national champions’ with the mission of protecting the national economic interest in their respective sectors. China stands out as the most successful country in recent history in using SOEs strategically to increase its dominance over the global economy (Lin and Milhaupt 2013).

The firm-level evidence on operational and financial outcomes of privatization is largely positive particularly in contexts where privatized firms are exposed to competitive
pressure. The privatization of SOEs operating in the tradable sectors, such as manufacturing, usually leads to sizeable gains in productive efficiency. As one of the key indicators of industrial development, manufacturing export can be used to gauge the impact of privatization on global competitiveness. The performance of privatized firms in China suggests that privatization has a positive effect on export propensity (Todo, 2016). However, this effect is almost entirely driven by the performance of small and medium-sized SOEs.

In addition to industrial SOEs, governments could hold on to strategic firms such as infrastructure and utility companies for the purpose of creating selective economic rents for priority sectors. This could include offering priority sectors special rates and expedited access. For instance, Ethiopia has a policy of affording export manufacturers preferential access to electricity supply. In this regard, privatization of key infrastructures and utilities may lead to higher cost of operation for some firms in a way that undermines the development of export capabilities in nascent sectors. However, in some cases “SOEs which are neither reformed nor privatized provide shoddy and unreliable critical services in electricity, communications and transportation, and thus hamper private sector development.” (Kennedy and Jones 2003).

The positive link between privatization and firm performance might not hold for every sector. This may be particularly the case in nascent sectors that require investment in innovation and are characterized by positive externalities. Under these circumstances, private ownership might lead to underinvestment (Ramamurti, 2000). In contrast, SOEs can take a longer-run perspective because they have deeper pockets to back them or easier access to bank loans and land in many cases (Bardhan, 2017). Nevertheless, operating in nascent sectors cannot rid SOEs of the most basic agency and incentive problems usually associated with government ownership. “Whereas state ownership could enable a firm to obtain more resources for innovation (i.e., more R&D input), it may also decrease the firm’s ability to convert its R&D input into innovation output (i.e., to have lower efficiency)” (Zhou et al, 2016, pp. 376). Therefore, minority state ownership could be a good compromise to optimize innovative capabilities.

In recent years, in Ethiopia, the continued ownership of parastatals and the establishment of new ones was principally justified on the grounds of leveraging the state’s role in facilitating industrial development. As it has now become clear, this rationale has been abused to perpetuate an undisciplined government overreach and imprudent spending of public resources. However, this should not lead to the repudiation of the state’s role in
industrialization and the strategic role SOEs could play in compensating for market failures. Ethiopia’s recent misadventures with public investment show that the range and size of SOEs should be rationalized. Moreover, China’s experience shows that competition and corporatization could be used to discipline SOEs management.

The upcoming round of privatization could stimulate private sector development which is essential for structural transformation. There is a good chance that greenfield investment could follow successful investment through privatization. The reversal of course Ethiopia has experienced during the last decade, which saw a large increase in the number of mega SOEs, might have led to crowding out the private sector. As long as there is a coherent policy framework distinguishing between government overreach and strategic participation in the economy, privatization could be a powerful tool to recalibrate the structure of the economy.

5.3. Recent pre-privatisation actions by the Ethiopian government

After deciding to embark on privatising major SOEs and broader economic reforms, the Ethiopian government demonstrated commitment to be receptive to professional advice on matters of the economy. The privatisation attracted glowing endorsements by development partners (e.g. immediate concessional finance released by the World Bank) and foreign investors who were waiting on the wings to play a part in the private sector development and benefits from its spoils by tapping into one of the largest markets in the African continent. As part of the diverse set of the pre-privatisation activities and in addition to preparing SOEs for privatisation, the parliament approved a proclamation of the privatisation of public enterprises in 2019 which got the process underway at pace.

In addition, it took actions to draw a number of experts from a cross section of professionals (e.g. lawyers), business leaders/owners and independent economic advisors. To date, there are two sets of council of advisors. These are the Privatisation Advisory Council which was established in the middle of 2018 and the Council of Independent Economic Advisors. However, the launch of a council of independent advisors is underway with the call for applicants realised at the beginning of 2020 and it is expected to be yet to be concluded soon. So far, it is not clear who constitute this new council. These measures are useful for providing council on the implementation of the privatisation process as well as the other planned economic reforms which are designed to promote inclusive and sustainable development. The new independent council is expected to have about 15 members and will be
mandated to provide regular policy advice based on empirical evidence. This clearly shows the intention and commitment of policy makers to promote policies of economic importance for the countries in a transparent and predictable manner which will be very beneficial both to business and consumers.

From a sequencing perspective, it appears that the government is focusing its priority in the sale of the Ethiopian telecommunication which is so far a natural monopoly. Fast progress is being made in the pre-privatisation preparation of the telecom sector. The licensing arrangements are going to be complex as this is the first of its kind in the history of the country. Different advisors for undertaking the transactions as well as overseeing licensing contracts are being put in place. One of the major global firms in charge of advising and supporting the government in the process is KPMG. As in any complex process involving major privatisation deals, any responsibility given to KPMG should be carefully monitored and reviewed. Often, a sensible and cautious checks and balances can be put in place if independent consultant(s) are appointed that are tasked to review and assess the firm’s relevant experience, ethics and integrity and its compliance to regulatory and other conditions of the Ethiopian government. In addition, the advice of reputable accountancy and consulting agency such as KPMG should be compared to the advice of independent consultants. For instance, advice received on fiscal and operational challenges of partially privatised SOEs from KPMG should be compared with advice elsewhere as they constitute a body of evidence that feed into policy decision of critical importance for the economic development of the country and viability of the privatised entities. Other pieces of advice can be on items of critical important, valuation of the targeted firms in the absence of a capital market, include licensing, management and accounting/auditing practices of privatised enterprises. In addition, as the appointment of council member and advisors is a public knowledge, it is important to make reports of consulting companies and independent advisors accessible for genuine debate on the privatisation and reform process ideally in a dedicated website.

It appears that a decision has already been made to add two more providers. These will be private companies that will be given a share of 49% of the stake of telecom services in Ethiopia bringing the total number of providers to 3. Companies that have the relevant industrial expertise and experience are competing to gain access to the lucrative Ethiopian telecom sector and these include Safaricom (a major operator in neighbouring Kenya), Vodafone, MTN, Orange, Etisalat and Zain. Most of the existing discussion is around licensing
and it is unclear how potential investors are invited to bid for the infrastructure part of the deal (e.g. the telecom network). This requires time and care and it should not be rushed. Regardless, the results of the bidding process and the winners with the prize of license permits to operate is expected to be announce in the spring of 2020.

6. Lessons on privatisation processes

In this section, we summarize some of the key lessons drawn from the preceding discussion. Even if we attempted to focus the review more on the experiences of countries that are comparable to Ethiopia such as the ones in Africa, we do not rule out experiences of advanced countries and emerging economies such as China and former socialist countries (transition economies) in our review in this section. For instance, there are useful lessons in the privatisation of telecoms and other sectors in the UK – a country that pioneered the process of largescale privatisation. This is justified because the scale of the current privatisation in Ethiopia is much larger than what the country attempted in the last 30 years and there is limited peer learning from other African sectors because African countries privatised a very small percentage of their SOEs compared to other regions such as Latin America and transition economies (Estrin and Pelletier, 2018).

One of the most important considerations in reviewing the literature to draw lessons for the current privatisation exercise is the focus on the effects of past and ongoing privatisation initiatives and foreign ownership on welfare, jobs, long-term growth as well as firm performance. To draw lessons, we highlight the importance of context and the need for careful consideration of direct and indirect effects of privatisation.

Scale and mode: The empirical evidence from developing countries suggests that better benefits are derived primarily from complete privatization of the firm than a partial change from state to private ownership because the latter is associated with little effect on long-run productivity growth (Estrin and Pelletier, 2018). Notably, privatization to concentrated owners, such as to foreign firms or to small groups of strategic owners, yields greater improvements in performance than privatization to the general population via share offerings, or to managers and workers (Estrin et al. 2009). Megginson and Netter (2001) find robust results that choice of method of privatization is influenced by capital market, political and firm-specific factors, and report that share issue privatisations (SIPs) are more likely to be used when capital markets
are less developed, presumably as a way to develop capital markets, and when there is less income inequality.

Regulation and competition: However, in the telecom sector, privatization alone is associated with few benefits, and is negatively correlated with connection capacity. In addition, privatization only improves performance when coupled with effective and independent regulation and increases in competition. In Africa, privatization outcomes proved to be poor in both resource-scarce landlocked countries and resource-rich African countries due to weak contractual design and inadequate enforcement of policies in the infrastructure sector, as well as insufficient aggregate demand. In the absence of strong state capacity, competition appeared to be a more effective instrument to foster performance than privatization.

Asset valuation: More generally, state assets have frequently been undervalued. This may have been in order to make the assets more attractive to the market, or because the SOEs were lossmaking and the short-term requirement to balance the budget dominated long-term state asset portfolio criteria.

Distributional implications: Distributional consequences of privatisation are heterogenous across countries. Piketty (2014) argues that the transfer of wealth through privatization was an important element in growth of private wealth in Britain than in other Western European countries between 1970 and 2010. However, prices may increase if they were previously below cost-recovery level. The distributional impact depends on how the consumption of the firms’ goods and services varies by income levels. Price increases are common following privatization in network or infrastructure industries, along with increases in the quality of services.

Fiscal implications: The study by Davis et al. (2000) on 18 developing and transition countries showed that the net fiscal effects of privatization were receipts in the order of 1% of GDP. In some countries, the main fiscal benefits of privatization have been to eliminate subsidies.

Type of ownership: Given the growing incidence of privatisation and government policy directed at attracting foreign capital, there is a lot of research exploring whether foreign ownership leads to better performance. Focusing on the return on assets, the return on sales, labour productivity, and total factor productivity, Greenaway et al (2009) found that joint ventures perform better than wholly foreign owned and purely domestic firms in China. This
suggests that both the domestic and the foreign parties of a joint venture bring in important and complementary attributes essential to achieving high performance. This provides an important insight the type of privatisation a country like Ethiopia should attract.

Privatisation improved firm performance. For instance, Polish manufacturing SOEs performed well after reform. The authors concluded that these improvements were due to the imposition of strict budget constraints reinforced by tighter bank lending behaviour, consistency in government’s “no bailout signal”, import competition, and reputational concerns of SOE managers.

Sequencing: there is some early evidence from the World Bank (Kikeri et al 1992) suggesting that governments should restructure SOEs prior to divestment since governments are better able than private owners to cushion the financial blow to displaced workers by using unemployment payments or pensions. However, another study shows that other restructuring efforts (other than bringing in a new CEO) slow down the process and can be too costly to be worthwhile.

Productivity and profitability: A recent work by Li et al. (2016) adopted a triple difference approach which enable them to separate the pure privatization effect from the listing effect, using a database of 204 Chinese Share Issue Privatisation (SIPs) from 1999 to 2009 matched with otherwise comparable state-owned enterprises and privately-owned firms. Their findings show that a significant positive increase in profitability post-SIP in divested Chinese state-owned companies, even after the negative IPO listing effect is considered. Megginson and Netter (2001) underscore that the impact of privatization will differ across countries depending on the strength of the existing private sector. However, privatization can also stimulate the development of institutions that improve market operations. Performance improvements could be due to greater exploitation of market power, which has harmful effects on allocative efficiency despite improvements in productive efficiency. Overall, various studies almost unanimously report increases in performance associated with privatization. This consistency is perhaps the most telling result we report – privatization appears to improve performance measured in many ways, in many different countries. Another key finding is that privatization does not automatically mean employment reductions in divested firms -although this will likely occur unless sales can increase fast enough after divestiture to offset very large productivity gains.
Part II: Africa wide evidence on the consequences of Privatisation with reference to Ethiopia

Does privatisation lead to higher levels of FDI, technology transfer and employment creation?

One of the enduring effects of privatisation is the opening up of economies for further integration with global markets through trading and investment relations. The share of foreign ownership in local economic sectors is associated with privatisation and attracting inward FDI brings a lot of advantages to host economies in the form of skilled management know how, technology transfer and jobs (Kedir and Barikaco, 2019).

To put privatisation and FDI in a broader context and its subsequent impact on employment and job creation, this section of the report focuses on Africa and provides evidence on the current FDI inflows landscape and trends using the latest available data from United Nations Conference on Trade and Development (UNCTAD) followed by a brief discussion of the likely drivers of FDI inflows and data on top destination countries. Then the discussion focuses on key policy issues and the link between continent-wide regional economic integration initiatives and the movement of FDI. The most important objective is to examine the link between FDI and technology transfer including the discussion of enablers and constraints to technology transfer in Africa. Using firm-level econometric evidence from Africa on 40 countries based on company data, we attempt to show how foreign ownership matter for employment growth.

1. FDI inflows landscape and trends in Africa

We begin by highlighting key facts about the investment landscape in Africa and trends in FDI inflows using data covering the last three decades (1990 to 2018). FDI and its contribution to growth has been extensively documented. The available body of work remains somehow fragile since no consensus is reached so far. A strand of literature confirms the positive contribution of FDI to growth on a wide sample of countries. FDI can have positive spillovers on growth through job creation, technological transfer/diffusion, backward and forward linkages with domestic enterprises and capital accumulation (Crespo and Fantoura, 2007; Borensztein et al. 1998; Soltani and Ochi, 2012). But all these benefits are not automatically granted. There are different variables at play in a strategy, not only to attract FDI, but also to retain and optimize their contribution to the economic development of the destination economy (Echcandi and Scronce, 2016). A different strand of the literature has
highlighted a bi-directional linkage between FDI and economic growth. FDI is a vehicle of economic growth; which in turn becomes a critical attraction of FDI (Nguyen and Nguyen, 2007). Contrary to the two views above, others find a non-significant or negative effect of FDI to economic growth (Akinlo, 2004; Ayanwale, 2007; Hermes & Lensink, 2003). Even if FDI is unequivocally accepted as a potential source of financing for development, one of the underlying explanations is that an economy controlled by foreigners might derail the direction of development (Amin, 1974), particularly in Africa where the FDI are mainly channelled into the natural resources sectors (Pigato, 2000).

In this section, we look at investment inflows and investment policies in Africa, linking them to the dynamics of regional integration patterns across the continent. It goes beyond the traditional debate of FDI inflows and its contribution to economic development and poverty reduction. What matters is not only the size of inflows but also the way they are managed and channelled to optimise their positive effects such as technology transfer that sustainably support sectoral or nationwide economic development objectives. If they are not properly managed, they will not provide the expected results, especially in Africa where recent experience shows that FDI are targeted to natural resources sector where rent-seeking behaviour and other distorted incentives prevail.

Even if the main beneficiaries have unstable inflows of FDI, the general trend is a fall in 2017 in contradiction to the increase in growth and trade, followed by an expansion of 11 per cent to $46 billion in 2018. This figure stands below the annual average of the last 10 years, which was about $50 billion. The main reasons underpinning the rise in 2018 are the continuation of resource seeking investments, the efforts to diversify investments in a few economies, as well as a quantum leap of FDI flows to South Africa (from $2 billion to $5.3 billion) which has more than doubled. The change of political power in the country triggered/signalled confidence in the investors which was subsequently followed by quick investment inflows. However, at the global level, FDI decreased again in 2018 at $1.3 trillion down from a revised $1.5 trillion in 2017 (see Figure 1 below). This was the third consecutive year which registered a fall in FDI on the back of a combination of factors. The gradual and protracted global growth recovery and policy changes in major global economies dictate the trends in FDI and trade. For instance, following tax reforms in the United Stated in 2017, multinational enterprises engaged in a major repatriation of their foreign earnings. Given the size of this effect, the large cross-border merger and acquisitions (18 per cent), mounting at $694 billion and $816 billion respectively in 2017 and 2018 could not be offset. Similarly, the 41 per cent increase of promising greenfield investment (from $698 billion to $981 billion)
could not change the general trend. For the sample period of 1990-2018, Europe is the main beneficiary of FDI; hence the fluctuation has been pronounced. Africa, the last beneficiary in the world, recorded a moderate fluctuation across time.

Table 1. Average FDI inflows in Africa and the world

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<tr>
<td>2018</td>
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Source: UNCTAD, 2019
2. Drivers of FDI and top FDI destinations in Africa

As the experiences of Chinese investment in Ethiopia in recent years showed, there are a number constraints that hamper investment. China is becoming one of the largest investment and trade partners of many African countries. Some of the bottlenecks we discuss below relate to the importance of having a well-educated manpower with affordable labour costs for outside investors. First, the importance of trade logistics should be emphasised. In Ethiopia, the China’s investment is negatively affected by the web of trade regulation and customs clearance inefficiencies. The underdevelopment of trade logistics in many other countries is a major deterrent of many potential other investors. The is barely a reliable local supply network due to the low level of private sector development. Hence, investors have to rely on imported supplies and materials for which the efficiency of the logistics matters most. However, the long-standing weakness of institutions in many African countries lead to the design of regulations that fail to facilitate imports but rather delay customs clearance of imported materials.

Second, risks associated with exchange rates are real impediment in countries where there are restrictions on the level of foreign currency transactions such as Ethiopia. In addition, the relatively common haphazard monetary policy decisions in Africa introduce sudden foreign exchange shocks in the form of devaluation. Often the foreign exchange rate is unstable and lacks a clear path which makes it difficult for investors to enter. Such shocks damage the assets valuations of existing firms, and lead to hikes in local labour costs and imports since markets do not provide the critical inputs required for production locally. Third, clear tax laws are fundamental but, in many countries, there are far too many tax law changes and investors are faced with unclear and confusing interpretations of the law. Fourth, investors end up having larger training costs instead of saving on labour costs. They have to work with existing stock of human capital and skills in Africa which is much lower than the average skills at home. Therefore, they have to fund training either locally or internationally to meet the skill requirements of their investment activities in the host country. Fifth, there is no access to loans from local banks (e.g. export finance) with excessive delays in applications by SMEs which have to deal with complex set of regulations (Geiger and Goh, 2012).

The sudden increased inflows in South Africa is mainly attributed to the confidence of investors stemming from change of power in 2018. Nigeria and Ethiopia have been impacted by political turbulence and uncertainty. On an optimistic note, Morocco sustained a slight
increase in investment for two consecutive years, thanks to active campaign as well as Mergers and Acquisitions (M&A). Morocco’s recent return to the African Union brought hope of improved business climate in the country and a signal of political commitment and institutional improvement. Since, the African continent is big and with heterogenous institutions and economic conditions and diverse degree of ease of doing business environment, we show a breakdown of FDI inflows by sub region.

**Figure 2. Africa FDI inflows, by sub-regions, 1990-2018**

At sub regional level, disaggregated data shows strong performance of the North Africa, followed by West Africa and Southern Africa sub region. The Eastern and Central Africa sub region are the least performing. FDI inflows to North Africa increased by 7 per cent to $14 billion, thanks to an overall increase in investments in most countries of the sub region. Egypt remained the largest FDI recipient not only in the sub region but also in Africa in 2018, despite a decrease of 8 per cent to $6.8 billion. UK plays an important role in trading and investment links with Egypt. From a policy perspective, Egypt is embarking on a number of reforms with an ambitious repositioning initiative to be a global destination for investment. FDI flows to

**Source:** UNCTAD, 2019
Morocco increased by 36 per cent to $3.6 billion thanks to a stable economic performance and diversified economy. In Sudan and Tunisia, FDI increased by 7 per cent to $1.1 billion and 18 per cent to $1 billion in 2018 respectively a bit lower than the 22 per cent registered by Algeria to $1.5 billion. However, the sound performance has been hampered by sharp decline during the economic and financial crises as well as the Arab revolution. The recent political volatility in Sudan dents investor confidence ushering a less optimistic investment outlook for the country. On an opposite side, FDI in central Africa remained stagnant. FDI flows to East Africa have remained unchanged in 2018 at $9 billion. Inflows in the biggest recipient of the sub region, Ethiopia, decreased by 18 per cent to $3.3 billion. Encouraging privatisation policies are being pursued by the new government since April 2018 but recent regional political tensions might lead to a reduction of inflows. Kenya has been the exception of the sub region with a noticeable FDI increase of 27 per cent at $1.6 billion.

Unsurprisingly, looking at the main destination of FDI across the world, no African country makes it to the top beneficiaries. Within the continent, Egypt, Nigeria and South Africa remain the top three main destinations of investments inflows from 1990 up to 2018. Nigeria was leading in the 1990s and then Egypt took over and stands at the top position, followed by Nigeria and South Africa. Mozambique and Ghana joined the list of leading countries in the 2010s. It is worth noting that in the 2010s newcomers such as Ethiopia with its vibrant investments in infrastructure, DRC and Congo with dominant investments in primary commodities sector and Sudan have joined the top ten list. In Congo for instance, more than 90 per cent of FDI are in petroleum sector. Additional data on main destinations is given in Annex I.

Table 2: Level of FDI inflows (in billions of USD) and change (in %), top 5 host economies, 2017 and 2018 and (%)

<table>
<thead>
<tr>
<th>Rank</th>
<th>country</th>
<th>2017 Inflows</th>
<th>Δ</th>
<th>country</th>
<th>2018 Inflows</th>
<th>Δ</th>
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<td>Egypt</td>
<td>6.8</td>
<td>-8.2</td>
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<td>South Africa</td>
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<td>+165.8</td>
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<tr>
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<td>-21.3</td>
<td>Congo</td>
<td>4.3</td>
<td>-2.1</td>
</tr>
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<td>4</td>
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<td>Morocco</td>
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</tr>
<tr>
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<td>Morocco</td>
<td>2.7</td>
<td>22.9</td>
<td>Ethiopia</td>
<td>3.3</td>
<td>-17.6</td>
</tr>
</tbody>
</table>

Source: UNCTAD, 2019

In terms of FDI outflows, no single African country is amongst the top 20 home economies of investors in 2017 and 2018. Africa is traditionally recipient of FDI inflows than a potential
investor abroad, with some rare exceptions. In 2018, FDI outflows from Africa decreased by 26 per cent to almost $10 billion, following a sharp drop in outflows from South Africa by 40 per cent ($4.6 billion) and a complete drying up of outflows in Angola, compared with $1.4 billion in 2017.

3. Policy Issues

In recent decades, evidence shows that governments across the globe have taken significant measures to attract FDI. In this section, we cover both national and international initiatives designed for promoting FDI. The investment promotion agencies have shown substantial results in boosting FDI, particularly in developing countries (Harding and Javorcik, 2011a, b and 2013; Gómez-Mera et al 2015). Countries such as Ethiopia are aggressively pursuing privatisation policies with selling of varying level of stakes and assets in different state owned or operated enterprises including telecoms and transport. Analysis of policy developments show that countries are taking measures to improve investments and investment environment. In 2017, 65 countries adopted at least 126 investment policy measures covering a range of sectors, including but not limited to infrastructure, manufacturing, energy, transport, among others. In a bid to attract outside investment a great majority of the policy measures (84 per cent) were favourable to investors. In 2018, 55 economies introduced more than 112 measures affecting foreign investment levels. More than 22 Mergers and acquisition deals were withdrawn or blocked for different reasons stemming from regulatory or political motivations. Similarly, cases of screening mechanisms have increased over time since 2011. In Africa, given the FDI’s induced benefits and their implication to growth, attracting investments remains a priority.

Accordingly, numerous countries devised investment reform and other relevant policies such as liberalisation, promotion mainly via provision of tax breaks, facilitation, and removal of investment barriers. Investment promotion agencies have been revamped, empowered and created in countries where they did not exist before. In the recent years, entry restrictions of foreign direct investments have been lowered or simply removed in many countries, fiscal incentives and the conditions for start-ups and new firms have been enhanced .. Given its longstanding policy advice for private sector development and expansion, the World Bank has provided loan and other support to African countries in their effort to attracting more FDI.

However, policy makers should not welcome investors with reckless open door policy due to the pressure they face to raise finance for development purposes. This is because tax
incentives to investors in the form of corporate income tax holidays (e.g. for businesses in Export Processing Zones and industrial parks), and reductions in import duties and value-added-tax (VAT) have detrimental effect on public finance. The trade-offs should be carefully examined in the interests of sustainable and long-term economic development instead of falling victim to open-door policies that lead to a race to the bottom as all countries engage in harmful tax competition to attract the attention of potential investors. Not only government revenue but environmental standards might be compromised as rules and regulations are relaxed to accommodate investors.

Potential international investors would like to carefully gather information on regulations for starting a business, direct and indirect costs, the availability and price of productive factors such as land, labour and capital, the tax systems, the investor rights or the potential feasible investment sectors and opportunities (OECD, 2015c). In Africa as well as elsewhere in the world, governments have established national investment agencies to overcome this information gap and make their country attractive to foreign investment.

In Rwanda, the one stop shop of Rwanda Development Board allows an investor to start a business within a day. Similar practice exists in Congo, Ethiopia, and Madagascar with different speed and ease of setting up a business. The Government of Rwanda has improved the investment law and defined the priority sectors with a package of incentives to make the country more attractive for investors. In Ethiopia, the national legislation which prohibits a foreigner to own land, a house or related asset has been softened. Industrial parks are decreasing drastically the cost of initial investment and improving the business environment for potential investors. They provide facilitation scheme in terms of steps required to start a business, initial investment, regulatory framework, infrastructure, as well as facilities. They create quick jobs and produce for exports only. Most of them are operating in the textile industry. From Ethiopian Investment Commission (EIC), a potential investor has the full free assistance in all the required administrative steps for starting a business. In Madagascar, the investment promotion agency, the Economic Development Board of Madagascar (EDBM) is the entry point for an investor and supports in all the steps required to start and operate a business. Its one stop shop provided free tailored advice on regulations and incentives to a business. The advice also include information on exploration of promising opportunities, planning, opening and operating a business. In Congo, numerous initiatives have been launched to attract FDI with an objective to boost the economy and make Congo an emergent country by 2025. In this context, FDI regulation, starting a business, land access and infrastructure, and taxation systems have
been substantially simplified even if challenges and areas of improvement remain. Kenya developed a draft national investment policy with the objective of investment promotion, facilitation and retention. The Kenya’s Vision 2030 targets a 10 per cent annual growth rate and a transition to a middle-income industrialized country. To achieve these objectives, a strategy is in place to attract, retain and promote foreign direct investment to reach private investment of 24 per cent of GDP by 2030. Accordingly, the investment policy needs to implement and coordinate investment oversight, investment promotion, retention and facilitation, amongst others critical measures.

4. Regional Integration and FDI inflows

The Africa-wide regional integration effort is gathering pace unlike recent developments in key global markets such as the European Union. Ethiopia participates in various regional economic integration initiatives including being a signatory of the recently launched African Continental Free Trade Area (AfCFTA). The signing of the continental initiative signifies that African is moving away from its fragmented regional integration blocks to a continent-wide bloc. On March 21, 2018 representatives of over 44 countries launched the AfCFTA agreement in an extraordinary summit held in Kigali. Five more countries signed the agreement towards the end of the year 2018. The agreement is expected to be extended to the full continent with its 55 countries, covering a combined GDP of US$2.5 trillion, and a population of 1.3 billion, with the majority (60 percent) being young, below 25 years. Besides this trade agreement, Africa has been recognized as a land of opportunities which just need to be unleashed (McKinsey, 2018).

Moving forward, the critical question one may pose is whether the regional integration effort is conducive to investment flows and the proliferation of investment opportunities. With the removal of import duties in Africa, the AfCFTA is expected to increase intra-African trade by 52.3 per cent. If non-tariff barriers are reduced or removed, trade may double (Karingi and Mevel, 2012). This will open the door for market seeking FDI. Investors usually target relatively big Africa economies (for market size) and countries with growing the middle class (for purchasing power and seizing local demand). The first phase of the AfCFTA became effective on May 30, 2019, when the 22nd ratification instrument was deposited with the Chairman of the African Union Commission. It concentrated on important and contentious areas such as tariff concessions and the rules of origin for trade in goods and services. The negotiations of the 2nd phase are planned to be completed by 2020 concentrating on competition
policy, investment, and intellectual property rights (IPRs). Therefore, the achievement of this phase should provide the blueprint for more investment promotion across the continent and a relatively clearer direction on volume and composition of FDI inflows to the continent.

However, in the meantime, the prospects for 2019 are mixed despite the promising AfCFTA, with a projected modest global increase of FDI. The reasons underpinning this prospect are the slowing down of African growth, and uncertainty surrounding macroeconomic policy and the overall business environment. In terms of policy, the opening up of emerging markets that boosted FDI in the 2000s is losing its momentum (e.g. the economic challenges of Brazil), hampered by restrictions based on national security considerations or strategic technologies. Furthermore, the rate of return to investments continues to decline over time. In Africa, return on investment dropped from 11.9 per cent in 2010 to 6.5 per cent in 2018. Finally, the fast growth in digital technologies is changing the international production pattern and economies that are not near the technological frontier might be having limited option to attract FDI and improve their chances of promoting production and trade to be part of the global value chain (GVC). At regional level, there are ongoing initiatives spearheaded by the Regional Economic Communities (RECs) which pursue their respective integration agendas. Despite the bright promises of AfCFTA and young generation potential (‘the demographic dividend’), the macroeconomic management, the overwhelming conflicts, weak institutions and governance remain perennial challenges despite the mushrooming of economic reforms and incentives to attract investments. Furthermore, the share of R&D-related FDI in Africa remains low and that limits the technology transfer that can accompany FDI.

5. FDI and technology transfer

Standard growth theory states that frontier advanced countries have a steady state growth at the rate of technological progress while other countries play catch up and attempt to fill the technology gap via diverse set of initiatives aimed at technological convergence. In addition, Romer (1990) reiterates the importance of investment in research and development. There is a large body of technology transfer but the scope here is to cover only FDI related technological spillover. We do approach the discussion with an open and critical perspective and recognise the following views (i.) technology can be transferred at a lower cost than the original cost incurred to develop it in the first place; (ii.) technology developed elsewhere is potentially useful and (iii.) equally technology developed elsewhere can also be harmful (Arora, 2007).
Many African countries have embarked on privations since the 1990s with the aim to attract foreign direct investment (FDI) with attractive tax breaks. FDI can be a conduit for technology transfer which is either damaging or beneficial to the environment (Kedir, 2014). This depends on the complex interaction between the behaviour of firms at home as well host countries in addition to prevailing institutional factors. Institutional weaknesses and absence of conducive infrastructure may hamper FDI-driven technological absorption and adoption. For instance, foreign investors who would like to enter a market for export purposes are required to maintain production standards of their home country government. A typical scenario is a transfer of technology from an advanced economy (home/source country) to developing countries (host economy). But destination countries’ institutional contexts (e.g. in regulating and respecting environmental standards) might deter them from entering certain markets with a view to maintaining quality production systems. Therefore, even if FDI can be a conduit for technology transfer and spread of innovations, the actual process is thwarted due to inherent and longstanding dysfunctional institutions. Hence, opportunities for technology transfer as well as sharing management practices can be lost.

On the other hand, FDI can be a forceful positive agent for inducing firms to adopt environmentally friendly management practices. This is particularly important in developing countries where the market is dominated by firms with specific environmental impacts such as tannery and textile dyeing factories. For some investors the destination/host country might be a viable option to enhance exporting. Therefore, market seeking FDI with a keen interest to expand exporting is most likely to be influenced by the environmental awareness of source/home country citizens which drives the careful choice of destinations. For instance, a German firm investing in Africa is likely to improve environmental standards in host country production systems with a view to sell to environmentally conscious German consumers or consumers in other countries with similar expectations on environmental standards. Here, it is clear that the external stakeholder pressure (i.e. from the buyer/supply chain perspective) is important in determining the destination of both FDI and the possible technology transfer that might take place (de Oliveria and Jabbour, 2017). However, not all FDI is compatible with ethical and desirable technology transfer. Some foreign firms might flee ‘over-regulated’ or optimally regulated regions/markets and invest in institutionally weak environments characterised by ‘under-regulation’ or lax regulation and relational (non rule-based) work practices (Du 2015; Blackman and Kildegaard, 2010).

*Technology transfer enablers and barriers*
Technology capabilities are key for economic growth and competitiveness, but the process is fundamentally dependent on the absorptive capacity of recipient countries such as the initial level of skills. In addition, there are some exogenous factors such as location and intellectual property (IP) rights which can determine the success or failure of FDI-induced technological transfer. In our discussion, we take the case of Mauritius to examine how they make the most of FDI for technology transfer to benefit its industrialisation process with innovative institutional interaction between the public and the private sector. There are a number of important lessons that other African countries can learn from the Mauritian case study.

i. Skills

Clearly, there is a positive correlation between skills and absorptive capacity of available technologies. Excitement about the potential technology is not enough. In the context of sustainable development goals (SDGs) and the future of production in cleaner and climate-conscious systems, the level of skills required is not only of the skills required to adopt conventional production technologies but also of green production technologies. Therefore, the continent faces a monumental challenge when it comes to building human capital to be able to benefit from technology transfer via private investment from abroad. The set of skills required for future economic development is daunting even for advanced economies where there is already a shortage of ‘green’ engineers.

Bowen (2012) maintains that there are at least three ways through which the demand for skills and human capital are affected. First, there is a structural change across industries (e.g. moving energy generation and mining from coal to nuclear or hydro). In this structural change, consideration of employment is important. Given the demographic dividend and growing unemployment challenge, African countries should strategically opt for labour-intensive renewable energy sector relative to a fossil fuel energy which requires higher skills (Pollin et al 2009). Second, technology transitions under green growth principles might lead to creation of inclusive green jobs in different sectors (both formal and informal) of the economy and contribute to the reduction of unemployment. These jobs can be in waste management, recycling, carbon footprint assessment, biofuel crop farming, environmentally-friendly commercial plantations (Nhamo, 2017). Third, the nature of existing jobs changes as they
reflect energy efficiency and lower levels of application of potentially harmful technologies which were by far less costly than cleaner technologies. However, cost of cleaner and eco-friendly technologies is coming down. Regardless, African countries should invest in human capital which is fit for purpose in the changing production landscape so that the required skills are there to benefit from FDI-driven technology spillovers. Existing human capital stock in Africa is one of the lowest relative to all global regions. The future of technology transfer improves if there is a radical and strategic investment in R&D and overhaul of school and university curriculum with sustained financing of the overall education system focusing on quality.

ii. Intellectual Property Rights

We highlighted the importance of institutions for technology above. Weak institutions, corruption and lack of investment in R&D are at the heart of the current state of poor technological progression at national and regional levels across all economic sectors in Africa. Unfortunately, the state of intellectual property rights laws contributes to Africa’s technological backwardness. Economic history tells us that many of the presently advanced countries (e.g. USA and UK) took advantage of lack of IPR laws at the beginning of their economic development (Chang, 2002). Hence, the current state of technological progress in Africa is partly self-inflicted and partly exogenous. The effectiveness of the domestic privatisation policies and reforms depends on addressing the inherent in-country institutional weaknesses. In the absence of institutional reforms, a privatisation policy alone with ambitions to attract foreign investors does not help to secure diverse benefits of inward FDI including possibilities of appropriate technology transfer. The most common forms of intellectual property are trade secrets, copyrights, and patents. There are royalty payments and licensing fees related to patents which are important for technology transfer. Advanced countries can allow some technologies to be adopted by developing countries without breaking IPR laws. From a policy perspective, a careful consideration of costs and implementation of IPR laws is warranted. African countries should benefit from a number of support initiatives in their bid to step up their effort to improve their technological landscape. As a specialised agency of the UN, the World Intellectual Property Organization (WIPO) is mandated to enable member countries to use the intellectual property (IP) system to drive technology adoption and innovation with the aim to help them achieve the ambitious SDGs.
6. The Impact of foreign ownership on host country employment growth

The key question to pose is: Does foreign ownership really create the jobs Africa desperately needs? Alternatively, one might justifiably ask “Why does attracting FDI matter?” If it leads to employment generation, it will go a long way by way of alignments with the long term development visions of many African countries including Ethiopia. To answer this question, we first provide econometric evidence using firm level data from World Bank Enterprise Survey (WBES) on 40 African countries. Even if we do not have a direct measurement of FDI, we use foreign ownership as a proxy variable to examine its effect on key outcomes such as employment. Most of the uneasiness as well as the high expectations with regards to foreign ownership of companies in Africa is intrinsically associated with its impact on relieving the prevalent unemployment problem and providing the much needed development finance. Therefore, we attempt to show whether foreign ownership has a positive impact on employment growth in the sample of firms. In cross-country data, we have variables capturing technological innovations used by firms. Hence, we also see their role in employment growth.

The enterprise data we use for this analysis is drawn from 40 African countries (see Annex II for the list of the countries covered). The World Bank Enterprise Survey (WBES) data is collected using a harmonized questionnaire and common methodology across all surveyed countries. This assures the cross-national and temporal comparability of the data. The data is collected from 40 African countries in 2006, 2007, 2009, 2010, 2011 and 2013. In each country, data is collected from a stratified random sample of formal private sector businesses with five or more employees, stratified by business sector, ownership (foreign and domestic), firm size and geographic region. The sample covers 1200-1800 business owners and top managers in larger countries, 360 in medium-sized countries and 150 in smaller countries. Overall, the survey captures data on ownership, employment growth and other variables from 7520 enterprises/firms.

Our dependent variable is annual employment growth (%) which is a derived variable in the WBES measuring the annualized growth of permanent full-time workers expressed as a percentage. Annual employment growth is the change in full-time employment reported in the current fiscal year from a previous period. For most countries the difference between the two fiscal year periods is two years. However, for some countries the interval is three years. Hence, an annualized measure is used. We have controlled for a range of independent variables in our specification. These include foreign ownership, technological innovations, corruption,
registration status of firms, firm age, firm size, legal ownership structure (i.e. whether a firm is state- or privately-owned, foreign- or domestic-owned and an open- or closed-shareholding, partnership or sole proprietorship) (Barbera and Moore, 2013), economic sector, access to finance, human capital factors (e.g. educational level, the skills and experience of the owners, managers and the workforce, the level of professionalism, and whether there is numerical flexibility in the workforce) and wider business environment.

To evaluate the impact of starting-foreign ownership on firm performance, we apply a pooled OLS regression technique (without controlling for endogeneity) and two-stage least squares -2SLS (with controlling for endogeneity). Alternatively, the impact of all the variables of interest on performance and its distribution can be studied using quantile regression technique which has a similar interpretation like the pooled OLS regression coefficients. Therefore, we use a standard setup given by the following equation;

\[ y_i = \beta_0 + \beta_1 x_1 + \ldots + \beta_n x_n + \beta_j F + \epsilon_i \]  

where \( y_i \) is the measure of firm performance (i.e. annual growth rate of employment), \( F \) is an indicator of the percentage of foreign ownership share in the company/firm, the \( x's \) capture the other key determinants of firm performance (e.g. firm size, foreign ownership, human capital, credit availability, sector, legal status, year dummies...etc) and \( \epsilon_i \) is the error term which follows a normal distribution with zero mean and constant variance.

Since one of our regressors is potentially endogenous as suggested by existing literature, we also estimate an instrumental variable (IV) regression. As OLS estimates do not account for endogeneity of corruption (i.e. one of the important variables for firm performance), further refinements of the above specification such as via an instrumental variable (IV) equation needs to be considered (Bardhan, 1977). Since firms are engaged in informal payments voluntarily, corruption can be viewed as endogenous and this makes the pooled OLS regression results biased due to the potential contamination of the estimated coefficients that fail to account for endogeneity of corruption. In the implementation of the IV method, two orthogonality conditions need to be satisfied, namely the instrument of choice should be correlated with the endogeneous variable (i.e. corruption) and uncorrelated with the error term of equation (1) above. In the data we have two candidate variables that can serve as instruments. One is a variable which captures the state of trust which is captured by asking firms whether they perceive that the court system is fair, impartial and uncorrupted. We argue
that the trust firms have on the quality of institutions in a given economy affects their behaviour and propensity to engage in corrupt practices and this is not necessarily and directly associated with firm performance such as such as annual employment growth. Another variable is the gender of the owner of firms. There is evidence supporting the risk-averse tendency of female owners relative to males. Therefore, they are less likely to engage in risky behaviours such as bribing, giving gifts and other payments to get things done. The particular variable we focus on is the average percentage of female ownership of firms. Owners are not necessarily managers of firms who can directly influence firm performance indicators even if we acknowledge their critical role in making fundamental decision pertaining to firms they own. We argue that these two instruments satisfy the orthogonality conditions for identification.

Model 1 in column two of Table 2 below gives us estimates without endogeneity correction while model 2 provides the 2SLS estimates after correcting for potential confounding factor or endogenous variable in our original specification. According to both models the association between foreign ownership and annual employment growth is negative but it is not statistically significance. From this firm level evidence, the suggestion is that foreign ownership does not lead to an improvement in the employment prospects of individuals in Africa. This might be due the fact that most FDI in Africa is not of the market seeking type (e.g. manufacturing where employment generation is a realistic possibility) but rather in the resource sector where employment is restricted to highly skilled individuals in the oil or mineral sector who are at times employees that come into the continent with the foreign capital.

Among other variables, the role of corruption is worth noting and unsurprising. Under both modelling options, results show that annual employment growth rates are lower in enterprises viewing corrupt payments as necessary to get things done compared with those who do not, and this difference is significant. Clearly, corruption harms the performance of firms (i.e. their employment growth potential). When firms pay corrupt officials, it is an additional burden on them above and beyond labour and non-labour costs. This burden is induced by the weak institutional situation under which firms are operating and leads to a sort of deadweight loss that is detrimental to firm growth as it leads to employment contraction rather than expansion. Thus, corruption can lead to loss of welfare and potential social surplus and the informal payments that firms make can act like extra tax. This may cause not only a decline in employment growth but also an increase in prices to consumers due to the extra cost faced by firms. The negative impact of corruption on employment is also a critical indicator of its distortionary impact on resource allocation away from productive use.
Finally, we have included four indicators of innovation and technology. Except for e-mail in model 1, overall results suggest that technology has a positive impact on annual employment growth. However, the only positive and significant technology and innovation indicator is the use of website by firms. Hence, digitally connected firms are more likely to be the ones employing more.

Table 2 OLS and 2SLS models of Annual Employment Growth determinants

<table>
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<th>Variables</th>
<th>Model 1-OLS</th>
<th>Model 2_2SLS</th>
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<td></td>
<td>Annual Employment growth (%)</td>
<td>Annual Employment growth (%)</td>
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<tr>
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<td>Coefficient (t-stat)</td>
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N.B.: Significant at p < 0.1*; ** p < 0.05; and *** p < 0.01. Standard errors in parentheses. Source: WBES 2006-2014 data set.

**Part III: Privatisation Frameworks and Policy: Some Suggestions**

Our policy suggestions for Ethiopia's privatisation process are based on the review conducted and the privatisation experiences of different countries so far. Even if some elements of this section are covered in other parts of the report, here we attempt to briefly address different aspect of the privatisation framework for Ethiopia such as (i.) Which enterprises to privatise (large vs small)? (ii.) Where can one find tariff flexibility for better service provision? (iii.) What level/percentage of the stake of foreign or private investment? (iv.) What frameworks are suggested for undertaking the privatisation process in Ethiopia?
Privatisation is a complex process which often takes longer than planned due to the time required in executing the complex undertaking of particularly preparing large SOEs for divestiture. If SOEs are financially sound, there should not be a pressure or the need to privatise assets of operating arms. For instance, it appears that there is no sound financial or non-financial reason to privatise Ethiopian Airlines except for outsourcing some services such as management and leadership training on matters of critical importance for the day to day running of the company.

Rapid deregulation has rarely been a good strategy particularly in banking and finance sector as the experience of Chile and Mexico showed in the 1990’s. Hence, Ethiopia’s cautious stance in opening up the financial sector to foreign private capital is appropriate. Private domestic capital is already allowed in the banking and insurance industry in Ethiopia and it has introduced a healthy competition and improved customer service. It is important to ensure that while the current reforms and privatisation initiatives are focused on privatising large SOES (e.g. power, logistics and telecoms), the necessary support should be provided to a large number of SMEs and self-employed individuals if the country has to move to a middle-income status. Without being able to exploit the job creation and competitiveness potentials of this portion of the private sector, there is no easy route to transform the Ethiopian economy structurally.

In addition to a careful selection of the scale and sector of privatisation, a conducive framework is associated with the presence of well-functioning capital markets, an effective regulatory environment that opens markets for local competition as well as adherence to sound corporate governance standards and control of corruption.

To improve the state of public finances, the Ethiopian government can bring in some changes with careful consideration of the welfare consequences of those changes. For instance, there is room to increase share of private sector in the power sector as the joint venture laws adopted since the early 2000s encourage it. Given the power tariffs paid by households are one of the lowest in Africa, there is some flexibility to increase tariffs. Under current conditions, collecting low tariffs and maintaining the power infrastructure and providing the required service to a fast-growing population contributes to fiscal pressures and building up of domestic and external debt. Unsustainable accumulation of public sector debt has detrimental consequences that might trigger economy wide crisis. For instance, indebted governments cannot bail out struggling banks, which are characterised by unsustainable building up of non-performing loans (NPLs) which might jeopardise the stability of the financial sector (Kedir et al 2018).
For privatisation to work, a robust regulatory framework and the a capable and independent organization that supports regulatory activities of privatised firms are critical. The experience of the UK suggest that an ambitious privatization drive should be matched with an equally forceful effort to build regulatory institutions. For instance, the Office of Gas and Electricity Markets (Ofgem) is a non-ministerial government department and independent regulator of the energy sector in the UK. Similarly, services such as telecom, TV and postal services are regulated by another independent authority, Ofcom. Having such regulatory organizations in place is essential to hold service providers accountable (e.g. who protects consumers, firms, manufacturing plants, electric cable run train operators). If there is power interruption due to failure by the privatised power operator, vital public organisations such as hospitals and school suffer. In such a case, the intervention of a regulatory body is useful to hold the provider to account and minimise or eliminate future malfunctions and/or malpractices.

Hence, the institutional dimension of privatisation is critical to make a success of the privatisation process (Negash et al 2018). There is empirical evidence to support our recommendation for regulation coupled with privatisation of major utilities. Focusing on the telecom sector, one of the studies that included 30 African and Latin American countries for the period 1984 to 1997 showed the improvement in access and affordability of telecom services after privatisation. However, due to lack of effective and independent regulatory systems, privatisation produced few benefits and in fact led to reduced connection capacity. Therefore, efficiency driven reforms often result in privatisation with potential cost to society or limited long term benefits for community groups who are excluded from digital age if connectivity is compromised. In practice, even under successful privatisation of SOEs a memorandum of understanding between the state and the concession holders should be carefully designed. Such an agreement should explicitly state who is responsible for maintenance of infrastructure (e.g. this can be a telecom focused infrastructure), investment for expansion, tariff setting and vetting procedure, the role of regulators…etc.

Segments of SOEs that are intrinsically linked to public safety should not be left to the private sector (e.g. air control systems at airports). If public utilities such as water and sewage are privatised, it is important to determine which regulatory authority ensures public safety via quality control of drinkable water, safe disposal of sewage…etc. These are grave public safety issues, which should be debated openly and often guarded zealously to protect welfare (e.g. tariff monitoring for economic regulation) and safety of the society. Minimising the role of the state in running SOEs is appropriate for various reasons we discussed earlier. But often this
went hand in hand with elimination of regulation. This should not be encouraged in the current privatisation drive in Ethiopia. It is not only one regulatory body that is needed to oversee the process. What we are suggesting here is a multi-layered regulatory framework to regulate and police activities of different sectors such as power, water, and telecoms.

There is wisdom in controlling the speed of privatisation. This might be related to broader issues of sequencing. There is a room to do partial privatisation. For instance, most exports can still be from enterprises owned by the state. By adopting partial privatisation, governments can prevent potentially exploitative foreign partners keen on shipping away profits abroad; find ways of taxing capital inflows; and leave rooms for flexibility. Partial privatisation is an important framework adopted by many countries. Careful privatisers compare trends in economic growth prior to the privatisation and after; compare employment growth, unemployment, poverty, and other key indicators for pre and post privatisation periods and make adjustments not to hurt longer-term economic development objectives.

Ultimately, it is imperative that the framework under which privatisation should take place is linked to long-term economic development as a priority without compromising service provision. If the framework of privatisation is justified on balanced-budget principles and due to fiscal deficit pressures, there is limited room for expansionary fiscal policy in the event of economic hardships. We already have sufficient evidence regarding the devastation that austerity brings to ailing economies and countries with large number of poor households. It should be underscored that, at the end of the day, the privatisation framework for Ethiopia should not lose sight of job creation and poverty reduction.

References


Annex I: Main FDI Destinations (in billions of Dollars)

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**Appendix II: List of 40 African Countries included in the study**

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