POLICY Brief

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PRIVATE SECTOR DEVELOPMENT IN ETHIOPIA: TRENDS, CHALLENGES AND POLICY ISSUES

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EXECUTIVE SUMMERY

The Ethiopian Economics Association (EEA) is pleased to present this policy brief extracted from a fully-fledged research report which provides a valuable contribution to policy makers to understand Ethiopia's private sector development challenges and assesses its contributions to the economy. An autoregressive distributed lag (***ARDL***) model was employed using a time-series data collected from various official sources from 1991 to mid-2021.

1. Introduction

The private sector plays indispensable role in driving sustainable and inclusive growth, poverty reduction, and creates jobs opportunities in developing countries. In Ethiopia, the private sector has been given much emphasis in several national policy documents over the last two decades. The sector has played a leading role in the structural transformation process towards industrialization. The private sector provides employment in Ethiopia including formal and informal jobs, delivers critical goods and services and contributes to tax revenues and efficient flow of capital.

In order to effectively use the opportunities available for sustainable development and transformation of the Ethiopian economy and to further leverage the private sector, it is important to examine the structure and performance of private sector development, identify key bottlenecks and challenges, and further investigate its contribution to the economy over the last three decades.

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2. Rationale for Action

Despite policy support from the Government of Ethiopia (GoE) over the last two decades, the contribution of the private sector to the national economy as compared to the public sector is less satisfactory. The economic growth that the county registered in the last decade has been largely driven by public investments such as transport, energy, and social services. The share of public investment in GDP increased from 5 percent in the early 1990s up to an average of approximately 15 percent in 2018/2019. Such a huge public investment might complement private sector development due to the expansion of crucial infrastructures. At the same time, it might also create "crowding out" effects due to the shortage of loanable funds and foreign exchange. Therefore, to identify the key macroeconomic determinants of private investment in the country, more information is required by policy makers on these factors. Empirical evidences show that the private sector is predominantly characterized by small-scale, informal, and service sectors oriented mostly operating in domestic markets and not vigorously entering the productive sectors (manufacturing and agriculture) and the export market. This necessitated a need to identify weaknesses and constraints of the private sector and thereby improving the country's export trade competitiveness and building its resilience capacity to various shocks.

3. Results and Discussion

Since the early 2000s, the Ethiopian government has implemented successive policies and strategies that promote private sector development in the country. In response to these, incremental trends of the private sector investment projects (both domestic and foreign) have been registered from 2003 onwards. The majority of the investment has been carried out by domestic investors. However, the implementation rate of projects in all development plan periods has been very low and showed a decline in the agriculture sector investment after 2000. This assessment shows that over the last three decades, the leading sector in terms of total number of project in the sector investment, is the service sector. The industry follows the service sector growth rate while lower investment projects were observed in the agriculture sector.

Although the industry sector has begun to show positive signals over the last recent years, less participation of domestic private investors in the manufacturing sub-sector and with no or little agriculture sector investment has observed. This reveals a less nascent structural change towards the productive sector of the economy. The policy lessons from GTP I and II suggest to scale-up the supports given to the manufacturing sub sector for agriculture is crucial policy direction in the years to come. Balanced policy support for the productive sectors (manufacturing and agriculture) with special attention to the manufacturing sector, is crucial during the current Ten Year Development Plan (TYDP) periods. Moreover, domestic private sector investment has not yet been adequately channeled into the productive sector (agriculture and manufacturing) and export market, which has trickle-down effect towards industrialization and structural transformation of the economy. On the other hand, in terms of creation of employment opportunities, the leading sector is the service sector. However, declining trends in permanent employment opportunities were observed in the service sector over the last three decades. Hence, the private sector plays less satisfactory role in employment generation, export, and economic growth of the country.

The study identified key constraints and challenges hindering the domestic private sector from entering the productive sectors and export market. The key constraints and challenges include: (1) inadequate physical infrastructure (electricity, transport and logistics, and water supply services), (2) restricted access to input markets such as lack of access to financial services, limited access to land, lack of technically skilled labor force, and lack of raw materials, (3) shortage of foreign exchange, (4) weak institutional framework for instance ineffective regulatory environments, malpractice in the informal market, corruption, custom, trade, and tax-related issues, and 5) political unrest and prevalence of COVID-19 pandemic.

The study analyzed various policy measures designed by the government in response to promoting private sector investment in the country. An increment trend in private investment projects (domestic and foreign) has been observed over the last few years. However, the majority of investment is owned by domestic than foreign investors. Besides, the implementation rate of projects has been very low across all plans and has particularly declined in recent years. The top three leading sub-sectors in terms of capital inflow are real estate from service, mining and quarrying from industry, and agriculture, hunting and forestry from the agriculture sector. Similarly, in terms of employment creation, the service sector remains the major contributor, followed by industry and agriculture in their respective order. However, the trends of permanent employment share declined over time over the last three decades. This implies domestic private sector has not yet vigorously entered in the productive sectors (agriculture and manufacturing) of the economy. The main constraints and challenges hindering private sector investment include inadequate physical infrastructure, lack of input markets, weak institutional framework, political instability, and the prevalence of the COVID-19 pandemic. On the other hand, the ARDL model result shows real effective exchange rate, amount of credit, government expenditure, and real interest rate are the main determinants of the privet sector investment in Ethiopia. The overall result shows the private sector plays a less satisfactory role in the employment generation, export, and output growth of the country.

4. Policy Recommendations

Based on the empirical evidence, the study recommends that the government should scale up the policy supports given to the manufacturing sector during GTP I and II to the agriculture sector, and quickly address the constraints to improve private sector development by designing various short and long-term strategies to allow much greater role for the private sector in driving economic growth and job creation in Ethiopia. In view of these, the government is advised to:

- Create enabling business environment by providing a range of incentive schemes including access to loan and credit facility in the priority sector of the economy;
- Resolve the bottlenecks through better functioning of input market (labor, land, and capital) through undertaking reforms in the financial sector, enhancing coordination within and between different layers of the government, and improving skill human resource shortages through continual capacity-building training; providing quality physical infrastructures and supplying modern, affordable and sustainable energy, providing and facilitating required raw materials and pieces of machinery, strengthening inclusive Public-Private-Partnerships (PPP) by providing preferential support for accessing raw material inputs, technologies, and financial services, and creating enabling business environment in the industrial parks;
- Ensure consistent management strategies to minimize corruption, minimizing the violent uprisings by strengthening ways for ensuring peace and stability and building up the confidence of private sectors, and minimizing bureaucratic inefficiencies in the government and financial institutions;
- Provide all-round support to protect the private sector investment from the adverse effect of the COVID-19 pandemic through developing short and long-term adaptation and recovery interim plans;
- Make priority for expenditure on high-impact investment preferably on physical infrastructure to stimulate private sector investment in Ethiopia;
- Adjust Real interest rate in such a way that encourages saving and private sector investment in the years to come;
- Provide adequate financial service and undertake reform to leverage private sector investment in Ethiopia;
- Provide various economic incentives for the domestic investors engaged in productive sectors that will help produce supply to improve the trade balance of the country; and
- Align macroeconomic policies with the comparative advantage of the country.

For more information, you can refer the PWP 04/2022 at EEA Website: https://eea-et.org/course/policy-working-paper-04-2022-private-sector-development-in-ethiopia-trends-challenges-and-policy-issues/

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Conflict of Interest

There is no conflict of interest among researchers.

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