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Ethiopia
Working Paper Series

Ethiopia 2030: A Country Transformed?

Options for A Next Generation of Reforms

Contents

Ethiopia

Working Paper Series

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Options for A Next Generation of Reforms

December 2022

Note: This Working Paper series is designed to bring the analytic work of UNDP-Ethiopia and its partners to a broad audience as a contribution to the policy agenda and debate in Ethiopia. The papers do not represent the official policy or views of UNDP.

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Ethiopia's 2022 population totals 123 million and is growing at an annual rate of 2.6 percent,[1] making it the second highest in sub-Saharan Africa (SSA). According to the United Nations, that number will rise from an estimated 117 million in 2020 to almost 150 million in 2030, a projected increase of 27 percent over the next decade.[2] The country's economy is now the largest in East Africa - US$111.3 billion in 2021 - followed closely by Kenya, and is the fourth largest in sub-Saharan Africa (SSA). The United Nations still classifies Ethiopia as a least-developed country and the World Bank ranks it as a low-income country, although it aims to reach lower middle income status by 2025.

At present, **between two to three million young people enter the labour market each year**, facing already high underemployment in rural areas and high unemployment in cities and towns. At the same time, while the public investment-driven growth model followed since the mid-1990s has raised incomes, reduced poverty and boosted human development, it has proven unsustainable, leading to **serious debt problems and rising macroeconomic imbalances**. Moreover, structural reforms have proven to be insufficient, in both intent and application. They have not enabled the private sector to emerge as the engine of transformation from a subsistence agriculture-based economy to a more modern economy based on the higher productivity – and, thus, higher income – of manufacturing and services. In essence, **the State's preponderant role in the economy has crowded out and stunted the growth of a vigorous private sector**. The situation has become more complex and complicated as a result of a **series of shocks** that have hit Ethiopia's economy and society in the second decade of the 21st century: the COVID-19 pandemic; the conflict in northern Ethiopia and elevated levels of insecurity elsewhere in the country; the war in Ukraine; declining ODA during 2020-22; and climate shocks evident in severe droughts and floods.[3]

Ethiopia is, thus, at a crossroads. It faces a daunting confluence of a rapidly growing and young population, the widespread effects of serious shocks, an uncertain domestic and external environment, including a subregion in flux, and a generally higher level of risk - often large scale - that threaten sustained and inclusive development progress. Managing the country's development policy agenda has, therefore, become more complex and difficult. At the same time, a real danger exists that the preoccupation with immediate threats or crises – and the related need to provide urgent life-saving relief and policy responses – will turn attention away from medium- to longer-term issues. Those issues are vital to foster peace and stability, trigger accelerated and inclusive growth, cope with the climate emergency and build a more resilient economy and society that can better prepare for, withstand and overcome likely future shocks. In other words, Ethiopia and, perhaps, more particularly, its development partners, could find themselves looking backwards rather than forwards. Neither Ethiopia's Ten-Year Development Plan (TYDP), Agenda 2030, the SDGs nor the African Union's Agenda 2063 will make headway in this pivotal country if such an outlook becomes entrenched.

This matters because the challenges facing Ethiopia are not temporary or transient phenomena but reflect a profound structural transition. This transition involves at least four dimensions: first, moving from an authoritarian political system to one based on electoral processes and plural politics; second, transitioning the development model from a state-dominant one to a private sector-driven approach centred on market principles and a more open economy; third, achieving the climate

1 The Ethiopian Statistical Services' estimate is lower than the projection of the United Nations' Population Division (2022).

2 Ibid.

3 United Nations Development Programme (2022).

transition to speed-up adaptation, prepare for, respond to and recover from natural disasters and manage the energy mix of a growing economy with rising production and consumption; and fourth, addressing an imminent demographic transition due to declining fertility and mortality and an age structure shifting towards a younger population.

As complex as this country setting may be, the problems facing Ethiopia are not insoluble. The thrust of reforms since 2018 has been to recognize this. **In that spirit, this study looks ahead to 2030 and tries to answer a central policy question: which core development policy issues could Ethiopia prioritize, and how, to achieve a peaceful, prosperous, inclusive and sustainable future for its people?** If Ethiopia succeeds in this endeavour, the positive ripple effects will be considerable not just for the country itself but will be felt across the Horn of Africa. This paper does not presume that this analytic task is simple or easy, that all major issues can be addressed in a single push, or that a single set of choices or a unique pathway can yield the best results. Rather, the aim is to lay out options, suggest possible choices and consider how they might play out under different scenarios. The aim is to contribute to the decisions that Ethiopian policymakers will make for their country and influence how the country's development partners consider the issues and determine their participation in the country's future.

Overall, the goal is to lay out options for a second generation of reforms to 2030 (and possibly beyond) to stimulate debate and contribute to policy development. The paper, thus, provides background on Ethiopia's development policies and performance, discusses the shocks that have occurred recently, and offers a diagnosis of developments and issues in key economic sectors: agriculture, manufacturing and services. It also addresses key cross-cutting themes: (i) labour markets and human capital formation; (ii) gender equality and women's participation in the economy; (iii) risk and resilience; (iv) public service reform, institutions of democratic governance and fiscal federalism; and (v) trade and foreign direct investment (FDI). Finally, the paper lays out a path forward that focuses on levers for transformation, to create a more prosperous, inclusive and sustainable society:

1. Investing in People
2. Revolutionising Agriculture and Achieving Food Security
3. Spurring a 'Take-Off' in Manufacturing and Services
4. Reinforcing Institutions
5. Recalibrating State Participation in the Economy
6. Opening the Economy
7. Preparing for Shocks
8. Managing the Political Economy of Liberalisation and Reform
9. The Macroeconomy

The paper then ends with three scenarios about how things might turn out, designed as thought experiments rather than predictions (sections V and VI, pp. 28-39).

1. Context

Until the recent shocks of 2020-2022, Ethiopia had experienced rapid economic growth, reduced poverty and improved human development. Spurred by public investment, its growth rate averaged more than 9 percent between 2000 and 2017. Gross domestic product per capita (measured in purchasing power parity or PPP has risen nine-fold since 1991, but remains low compared to other parts of the world (for example, emerging and developing Asian countries (figure 1)). Initially, per capita GDP growth barely exceeded population growth but accelerated after 2003, driven by public sector investment (figure 2). Compared to its peers, the country has had a relatively high investment-to-GDP ratio of 31.7 percent for the period 2017-2022, compared to the SSA average of 22 percent for the same period. Its savings-to-GDP ratio during the same period was 27.3 percent, higher than the SSA average of 19.8 percent. However, private investment in Ethiopia lags compared to many of its peer countries.

Strong improvements in social well-being also reflect the country's economic progress. Between 2000 and 2021, Ethiopia's Human Development Index (HDI), value increased by 73.5 percent; infant mortality fell by half; life expectancy at birth increased by 14.4 years, reaching 65 years; expected years of schooling increased by 5.3 years; and gross national income per capita rose by 225 percent. Between 2000 and 2016, headcount poverty declined markedly from 44.2 percent to 23.5 percent, supported by expanded social safety nets and fiscal transfers. Taking a broader view, the incidence of multidimensional poverty in Ethiopia, however, stands at 68.8 percent[4], indicating the strong impact of non monetary factors in determining poverty in the country. It is likely that both HDI and poverty values for Ethiopia deteriorated in 2020-2022, when the country experienced several shocks.

Figure 1: GDP per capita (PPP US$)

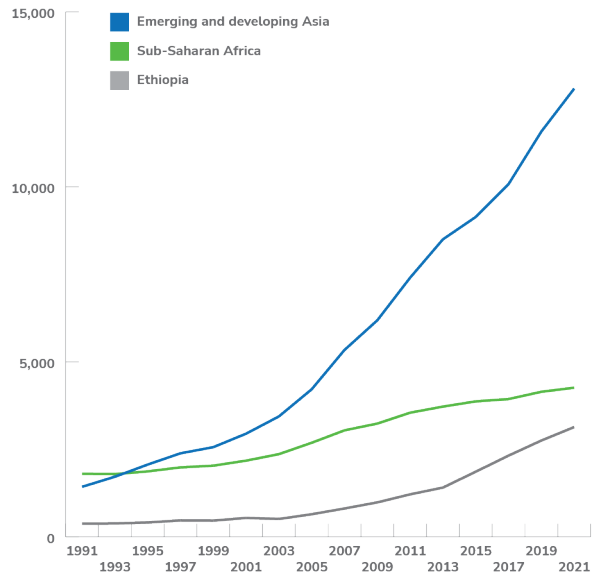


Figure 2: Investment and savings-to-GDP ratio

Source: IMF

4 UNDP and OPHI, Unpacking Deprivation Bundles to Reduce Multidimensional Poverty, 2022.

While the country has grown significantly, the levels of structural transformation and job creation have not kept pace and productivity growth has been slowing. Quality jobs are lacking for the more than 2-3 million young people who enter the labour market every year. Addis Ababa, the capital city, is under huge pressure to absorb internal migrants but the country has not been able to develop alternative secondary cities. Agriculture has underperformed relative to ambitious goals and Ethiopia still faces significant food insecurity. The services sector has been characterized by mixed productivity and a sprawling informal economy exists. Manufacturing has expanded with the construction of industrial parks, but has yet to achieve scale and significance. It represented about 6.8 percent of GDP in 2021,[5] with concerns growing about the current strategy that focuses on industrial parks to drive manufacturing growth, at least as it is being conceived and implemented at present. The manufacturing sector faces issues related to excessive regulation, foreign exchange shortages (to access essential inputs and repatriate profits), lack of incentives, and a private sector that is averse to risk-taking outside the trading, services and construction sectors. Exports are still very low and focus on primary products, especially coffee and gold, and the quest for export diversification has been elusive.

Productivity growth in Ethiopia has been low. Ethiopia's total factor productivity (TFP), which measures the efficiency of capital and labour use, has been on the decline. This is troubling, although the trajectory has been volatile. Consistent with the country's significant exposure to shocks in the past, there were negative TFP changes up to 2004. By contrast, positive TFP changes were the largest contributor to growth during the next 10 years.[6] Nevertheless, TFP growth and its share in GDP growth appear to have diminished slightly in 2010–2014.

Data for the period 2000-2018 show that labour productivity growth was either negative or very low in all sectors. This should be an anomaly in a developing economy that is successfully shifting its most abundant factor of production – labour – into more productive sectors. Nonetheless, productivity growth within the agriculture sector has increased since 2010: average productivity growth for the period 2010–2014 was 2.6 percent, rising to 5.1 percent during 2015-2018. On the other hand, productivity growth in industry has been negative over the past two decades, probably because of the predominance of construction over manufacturing in this sector. This explains the lack of large-scale job creation and the slow movement of labour from agriculture to industry.[7]

The dynamics tell an interesting story. Agricultural productivity changes when examining between-sector productivity.[8] It had been negative for the agriculture sector over the entire period (2000-2018), while it was positive, though low, for industry and services (figure 3). Between-sector productivity growth in the services sector was positive and rose to 2.5 percent between 2015-2018, explaining the shift of labour from the agriculture to the services sector. On the other hand, between-sector productivity growth in the industry sector was stagnant overall during 2000-2018, at around 0.6 percent, with a slight increase to 1 percent during the period 2015-2018.

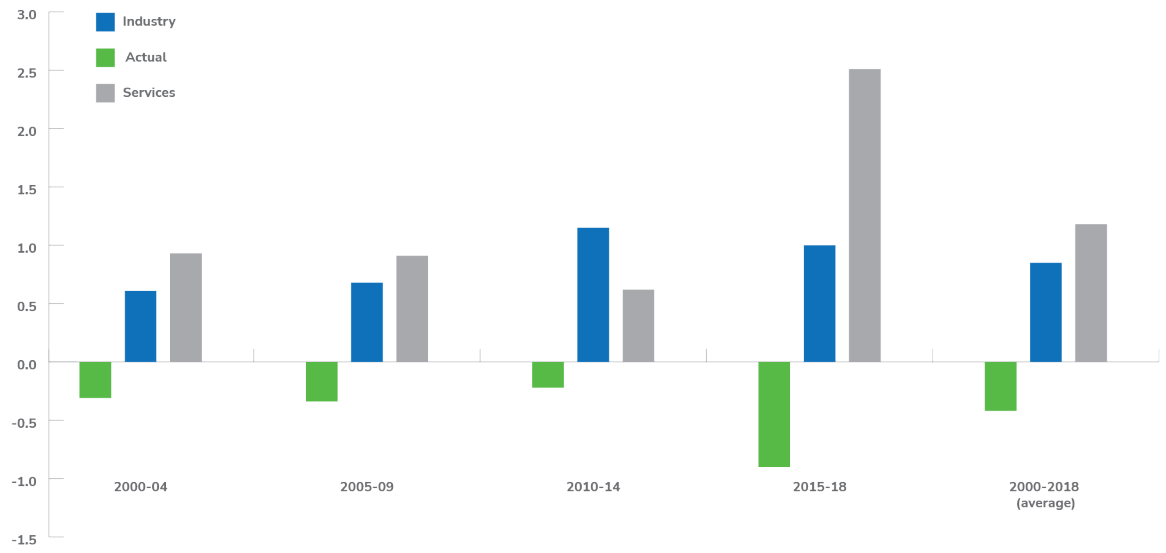
5 Federal Democratic Republic of Ethiopia (FDRE), Ministry of Planning and Development (2022).

6 Seid et al (2015).

7 Alemayehu (2021).

8 Between-sector productivity refers to labour reallocation from low- to high productivity sectors and measures structural change in the economy.

Figure 3: Between-sector productivity growth (%)



Source: Alemayehu, 2021

These data show that a significant proportion of the country's labour force is still engaged in agriculture. The relocation of the labour force to other sectors has, thus, been slower than hoped for. In 2021, 64.9 percent of the labour force was employed in agriculture,[9] which should play a smaller role in employment. Economic growth that is not accompanied by meaningful structural transformation, in which new industries emerge and are sustained, will trap Ethiopia in an economic equilibrium in which the fundamentals do not change.

Ethiopia also remains a hybrid economy, with a still significant footprint of State enterprises with varying levels of performance. The current 40 State-owned enterprises (SoEs) include Ethiopian Airlines, Ethio Telecom and Commercial Bank of Ethiopia (CBE), which are all profitable. Some others are not. Corporate ownership has shifted significantly due to privatization in the 1990s and 2000s and the government has refocused on several strategic sectors, including aviation, logistics, telecommunications, power, utilities, petroleum imports, and railways. SoEs are retreating from manufacturing. Nevertheless, they still enjoy considerable advantages compared to private firms, such as access to land, directed credit and foreign exchange.[10]

Ethiopia's private sector is nascent and fragmented. It consists of a combination of a few large conglomerates (more than 10), large firms, small- and medium-size enterprises, and microenterprises. Conglomerates span multiple sectors including agriculture, food and beverages, real estate, trading and manufacturing. Corporate governance remains a challenge and the various holding companies are difficult to understand. Firms are broken down by size as follows: 2.2 percent large; 7.5 percent medium; 18.9 percent small; and, 71.4 percent micro. In terms of value added, medium and large firms accounted for 75 percent of manufacturing value-added output.[11] For a

9 Ethiopian Statistical Service (2021).

10 Because there are no publicly traded companies in Ethiopia, no full consolidated picture exists of SoEs or of their finances. The Government of Ethiopia (GOE) has created a Liability Asset Management Corporation to manage the consolidation and servicing of a portion of the country's SoEs debt.

11 Oqubay (2019).

host of reasons that point to persistent distortions and disincentives in the economy, about two-thirds of Ethiopian enterprises operate in the trade sector, as it offers many benefits and lower risks compared to manufacturing. Industry associations do exist, but a strong private sector platform does not.

Ethiopia's macroeconomic performance has been generally good, although it has deteriorated recently. On the one hand, the country's macroeconomic performance has been stable in general, reflecting prudent fiscal and monetary policies, long stretches of single-digit inflation, a stable export base (particularly coffee), and support from overseas inflows, such as remittances. On the other hand, particularly in recent years, growth has slowed (figure 4), and inflation has accelerated (figure 5), ODA inflows have fallen, and the twin deficits (internal and external) have widened. A combination of accommodative monetary policy and supply chain shocks due to the Ukraine war have led to increased inflation in the past few years. Annualized headline inflation peaked at 37.2 percent in May 2022, but has since fallen slightly to 32.5 percent in September 2022. Both the fiscal and the current account deficit, which were historically balanced, have widened in recent years (figures 6 and 7), while the debt-to-GDP ratio has increased to 52 percent due to the public investment boom and high associated financing costs.

Figure 4: Real GDP and GDP per capita growth

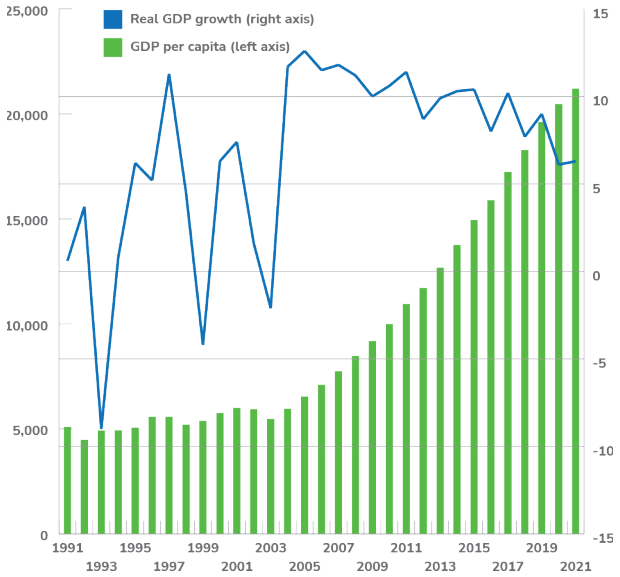


Figure 5: Consumer Price Index (annual percentage change)

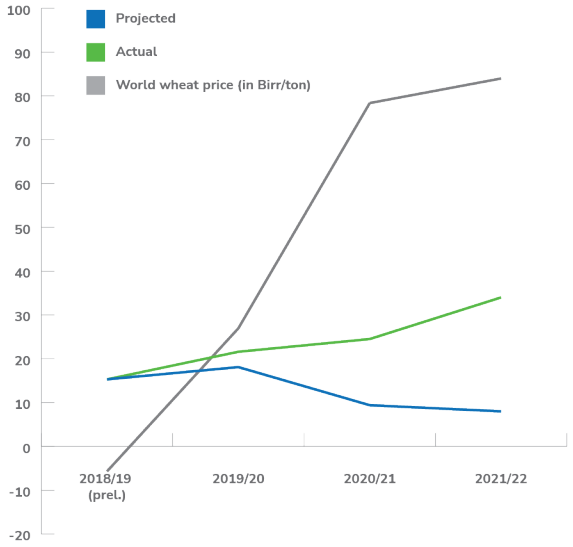


Figure 6: General government revenue and grants, expenditure and overall deficit

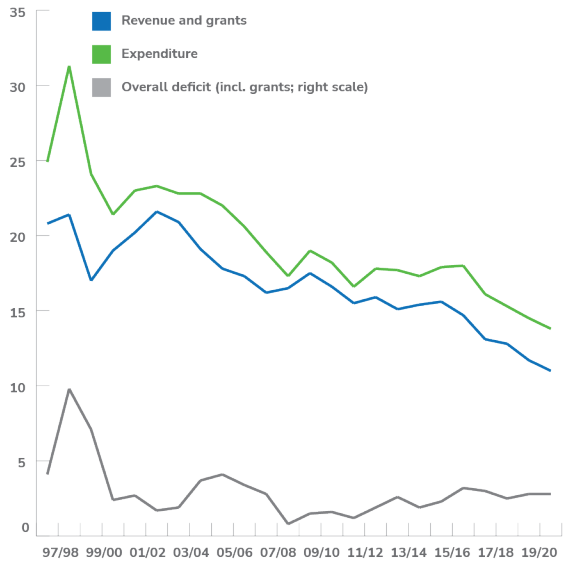
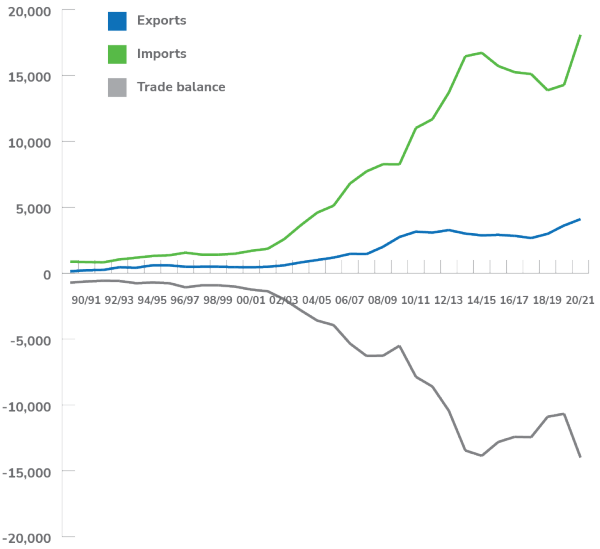


Figure 7: Export, import and trade balance



Sources: GoE, IMF, 2022

Box 1: The Homegrown Economic Reform Programme and Ten-Year Development Plan

In 2019, the government adopted the Homegrown Economic Reform Plan (HGER) to address macroeconomic imbalances and areas where structural reform had made less progress.[12] The HGER identified the following as key macroeconomic constraints to growth: (i) the persistent scarcity of foreign exchange, undiversified and low exports, an overvalued exchange rate and a large gap between the official and the parallel market exchange rate; (ii) the high risk of debt distress; (iii) limited private sector access to financing; (iv) high inflation; and (v) resource misallocation as a result of focusing on non-tradables instead of tradables (also resulting in increasing income disparities between the urban and rural population) and on inefficient or capacity-constrained SoEs.

The three-year program sought to sustain economic growth by creating an economic environment supportive of higher private investment and structural transformation. It encompassed three pillars:

> *Macro-financial reforms*: reduce the risks associated with external debt; lower external vulnerabilities, arrest inflation and enhance growth, investment and exports by (i) strengthening public finances; (ii) gradually moving towards a flexible exchange rate regime; (iii) strengthening the monetary policy framework; and (iv) enhancing financial sector development.

> *Structural reforms*: address bottlenecks inhibiting private sector growth by (i) easing the constraints to doing business; (ii) lowering tariff and non-tariff barriers to international trade; (iii) improving the efficiency of public institutions; and (iv) improving services such as logistics, telecom and electricity.

> *Sectoral reforms*: address market failures and sectoral regulatory and investment constraints in five key potential priority sectors, including agriculture, manufacturing, mining, ICT and tourism, that can leapfrog economic transformation.

The HGER was complemented by the Ten-Year Development Plan (TYDP): A Pathway to Prosperity (2021-30), which Parliament approved in March 2021.[13] The government opted for a 10-year plan to emphasize future development directions and longer-term objectives over the detailed policies and instruments laid down in previous plans. The TYDP is based on the HGER's policy frameworks, focus areas and structural reform strategies. It explicitly identifies the private sector as the engine of growth and lists institutional reform—including building capacity, strengthening accountability and improving peace and stability—as a priority.

12 FDRE (2019) and FDRE (2021).

13 FDRE, Planning and Development Commission (2018).

The TYDP's overall development goal is to improve welfare by improving Ethiopians' standard of living and quality of life. Its 10 strategic pillars are interlinked with the goals and targets of the United Nations 2030 Agenda for Sustainable Development and its commitments under the African Continental Free Trade Area and Agenda 2063.[14] Key medium-term priorities are (i) promoting multi-sectoral and diversified sources of growth and job opportunities; (ii) promoting sustainable and inclusive financial sector development; (iii) harnessing the demographic dividend; (iv) developing quality and efficient infrastructure; (v) promoting sustainable urban development; and (vi) fostering peace, justice, and inclusive institutions. Progress on these priorities will constitute milestones towards achieving the long-term goals.

HGER implementation was initially encouraging, but was adversely affected by shocks.[15] The government made good progress on structural reform, including deepening SoEs reform. Regarding macroeconomic policies, the exchange rate was allowed to depreciate more quickly, reducing the gap with the parallel market rate. A strong revenue effort, focused on improved tax administration, resulted in an even lower budget deficit than anticipated for the first half of 2019-2020. Financial repression has been tackled and a domestic treasury market developed in finance government operations. Starting early in 2020, however, Ethiopia was struck by several shocks,[16] which have led the economy to deteriorate sharply compared to the HGER's medium-term projections.

14 The ten pillars are: quality economic growth and shared prosperity; economic productivity and competitiveness; technological capability and digital economy; sustainable development financing; private sector-led economic growth; resilient green economy; institutional transformation; gender and social inclusion; access to justice and efficient civil services; and regional peace building and economic integration.

15 FDRE (2019), and IMF Country Report No. 20/150, May 2020.

16 This section partly draws on UNDP (2022).

The focus of this study is Ethiopia's development prospects until 2030 and beyond. The November 2022 signing of the Pretoria Peace Agreement creates the potential for economic growth and accelerated development to resume at a more rapid pace. This study examines policy options that can: raise human development and reduce mulit-dimensional poverty; create more, better and more inclusive jobs; leave no one behind, especially those historically disadvantaged such as women; accelerate structural transformation in the economy; and generate greater competitiveness. To do this, the study proposes a reform agenda to help Ethiopia find its way out of a low-level equilibrium. It asks:

> What are Ethiopia's development options and choices?

> What are best ways to strengthen resilience to shocks?

> How can the economy create more productive jobs paying higher wages?

> How will Ethiopia ensure that economic growth benefits youth, women and marginalized communities, leaving no one behind?

The analytical framework provides the basis for taking stock of inclusive growth and development in Ethiopia and sets out a five-step process to identify opportunities for transformational change. The study:

> Examines the development challenges facing Ethiopia, including the complex management of four transitions – political, economic, climatic and demographic.

> Identifies the broad range of constraints to economic growth in key sectors – agriculture, manufacturing, and services (finance, telecom, and tourism) - based on growth analytics, expert views and available empirical evidence, focusing on the binding constraints to growth in each of these three sectors.

> Examines general constraints to growth and focuses on five cross-cutting policy areas: labour markets and human capital formation; gender; risk and resilience; public service, institutions for democratic governance and fiscal federalism; and regional and global trade. The five areas were chosen based on a body of theoretical and empirical literature highlighting the relevance of these areas; potential development impact; political feasibility of reform; and overall strategic relevance.[17]

> Prioritizes reforms based on their expected impact on growth and structural transformation.

> Surveys the macroeconomic policies and context and provides an indicative macroeconomic framework for the medium-term until 2030. The goal is to show that challenges facing the authorities in ensuring structural transformation will require a stable macroeconomic environment.

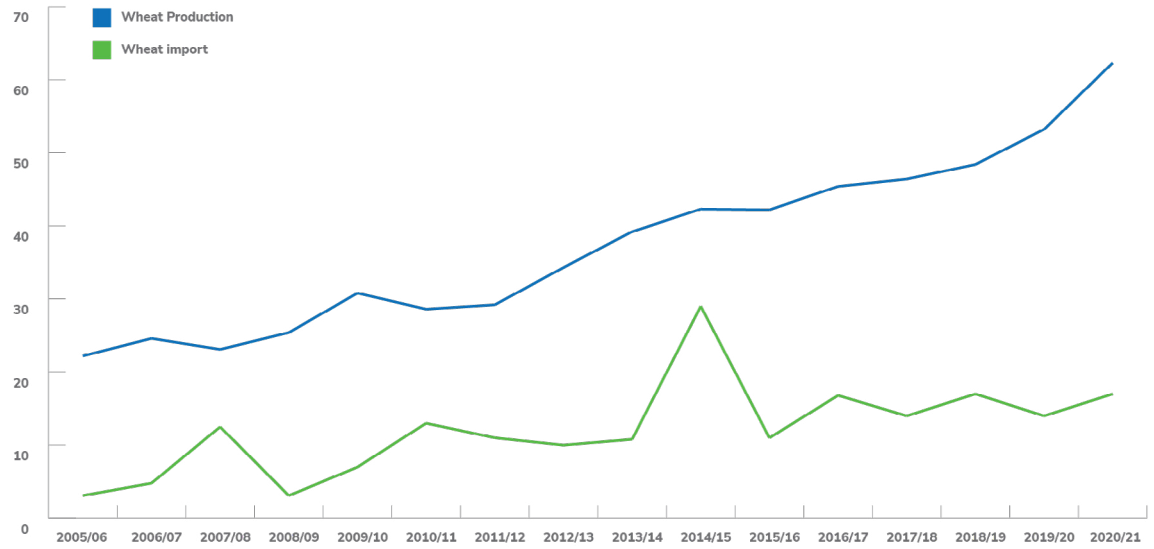
17 The paper recognizes the importance of energy and environment, which will be addressed in subsequent studies.

A. Agriculture and food security

Ethiopia has capitalized on its favourable resource endowment to generate growth in agriculture and agribusiness, but Ethiopian agriculture has underperformed compared to its potential. Nevertheless, national grain production increased from 223 million quintals in 2011 to 370.7 million quintals in 2021 (figure 8). The sector appears to have done better post-2005 than prior. The country also has a growing agribusiness sector, focussing on horticulture and floriculture. Starting in the late 1990s, Ethiopia has become the second-largest flower exporter in Africa, generating more than $542 million in exports in 2022 due to favourable government incentives, land leases and logistics support.

Ethiopia produces sufficient food to meet its population's daily energy requirements, but food security challenges remain. According to FAO's 2022 assessment, cereal per capita production (340 kg) is higher than per capita requirements of combined grains, roots and tubers (208 kg). However, this varies by region. Food security is also affected by a combination of factors: limited purchasing power due to high poverty levels; limited distribution and underdeveloped markets; high post-harvest losses; low diversity (cereal dense); and a production system dominated by smallholder farmers. More broadly, this food insecurity points to failures in the functioning of agricultural markets and the absence of farm and off-farm employment and income (or 'entitlements,' to use Amartya Sen's term).[18]

Figure 8: Wheat production and imports (million quintals)



Source: FDRE, Ministry of Agriculture

Ethiopia's agriculture has been plagued by the interplay among policy, environmental, climatic, economic and social factors. Despite considerable potential, agriculture has been held back for several reasons: small size of landholdings; an ecosystem that is still not fully functioning in terms of access to seeds and other inputs, financing, storage, transportation and marketing services; the incomplete reach and effectiveness of research and extension; low levels of technology; complex land tenure and land use policy; poor infrastructure penetration in rural areas (for example, feeder roads, electricity and telecoms); very limited private sector participation in the broader ecosystem; and the growing threat from climate change. While crash programmes to increase food production may be justified under these circumstances as a temporary or transitional measure, the structural

18 Sen (1993).

bottlenecks holding back agriculture in Ethiopia suggest that a longer-term effort will be required, one that is sustainable from an economic, financial, institutional, social, environmental and technological standpoint.

B. Manufacturing

Despite multiple interventions to boost the performance of manufacturing in Ethiopia, it has not contributed significantly to the economy and employment. An industrial park strategy was introduced after 2000 aiming to attract foreign direct investment (FDI), help create employment and generate foreign exchange. Thirteen public and five private parks are operating in Ethiopia today. In the last decade, this strategy has attracted FDI of $740 million from more than 60 foreign investors; boosted employment by 100,000 people, particularly of women; contributed to exports of $500 million; and resulted in relatively high park occupancy rates of more than 80 percent, especially in Bole Lemi, Kilinto and Hawassa. Textile and garments dominate, accounting for around 95 percent of exports from publicly-owned parks.[19]

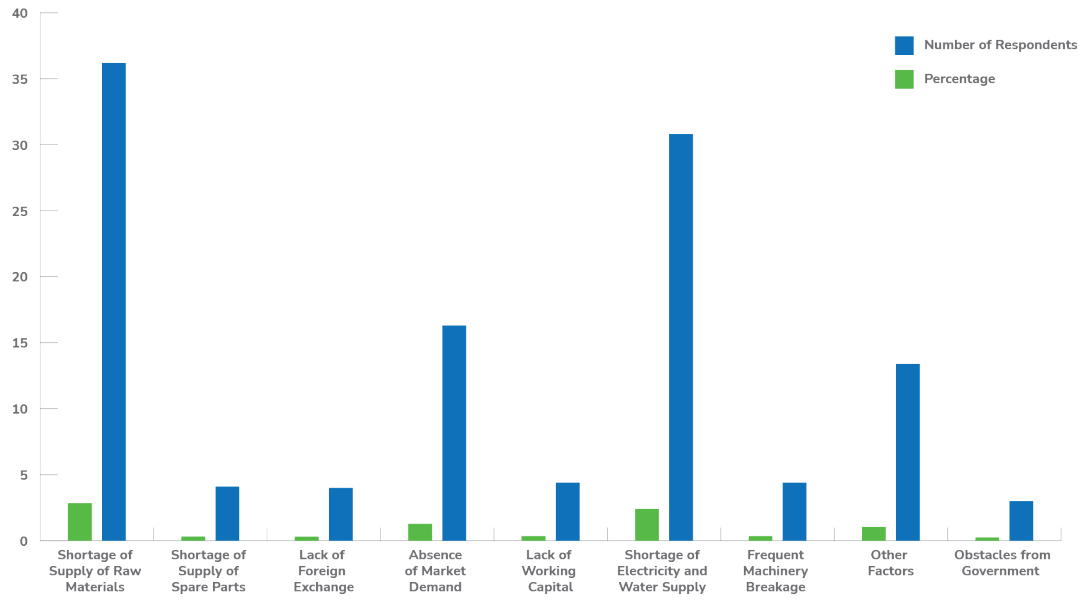
On the other hand, the strategy faces key challenges. The employment gains are small compared to the size of the labour market; technology and knowledge transfer are limited; and poor backward linkage to micro, small and medium-sized enterprises (MSMEs) through supply chains has inhibited the emergence of competitive domestic firms. Domestic firms may be subject to de facto discrimination in the industrial parks, partly due to the desire to attract FDI and generate foreign exchange. Labour productivity, absenteeism, and turnover remain problems. There are also issues connected to environmental footprint, further improvements in infrastructure (such as worker housing) and investor support. While an argument has been made that Ethiopia is on a similar trajectory to peer countries (e.g. Bangladesh, Kenya and Vietnam)[20], there are grounds to believe that this may be an optimistic assessment. Given that Ethiopia has incurred $1 billion of public debt (Eurobond borrowing at market rates) to finance the industrial parks, a question remains about the return on this investment to date.

Several factors account for the poor performance of manufacturing. The general competitiveness challenge facing Ethiopian manufacturing arises partially, if not wholly, from its stifled growth over a long period, predating the arrival to power of the Ethiopian People's Revolutionary Democratic Front. First, SoEs have received preferential treatment, including de jure or de facto monopolies in key sectors (for example, logistics), accompanied by a disabling, rather than enabling, regulatory environment for the private sector in some key respects. This includes foreign exchange rationing and inadequate funding, particularly for MSMEs. Second, the governance, management and leadership of local firms point to limitations in business planning, market knowledge, development of products and services, and skills levels. Third, raw materials, electricity and water have been plagued by critical shortages. A 2017 survey highlighted these as key challenges for manufacturers in Ethiopia (figure 9). A pro-private sector environment is still not fully established that can mobilize savings through the domestic banking system and channel them to entrepreneurs and firms that have both the risk appetite and requisite capacities to explore and grow their businesses, develop existing or enter new markets, connect with supply chains, and begin to have impact at scale on output, productivity, value addition and employment. Last, an often overlooked but crucial intangible factor is the stance, motivation and actions of the bureaucracy at federal and regional levels, which must shift from seeking to 'patrol and control' the private sector to enabling it to succeed. Ethiopia has not yet achieved this shift.

19 World Bank, On the Path to Industrialization: Review of Industrial Parks in Ethiopia, 2022.

20 Ibid.

Figure 9: Constraints for medium and large manufacturing firms in Ethiopia (%)



Source: Ethiopia Industry Survey, 2017

C. Services

Ethiopia's services sector is still nascent, but has been improving over the last two decades. It is now the country's second-largest employer and continues to grow. SoEs are responsible for many of the key sectors, but their performance record is mixed. According to the World Bank, Ethiopia's services sector is characterized by a high degree of restrictiveness.[21] The country's regulations impact the entry and operations of both foreign service suppliers and new domestic service suppliers, contributing to higher services costs. Change and reform are underway within finance, telecom and tourism. Private banks were allowed early in the 1990s, but the sector has been dominated by a State-owned bank and characterized by directed credit, mandatory project financing, administered interest rates, and a captive domestic market for government debt. This situation has enabled financial repression. However, the government has taken measures recently to liberalize the financial sector, with legislation submitted in September 2022. The telecom market has been opened to new competition with the entrance of a new service provider. Despite considerable potential, the tourism sector remains constrained by a combination of severe shortcomings: lack of viable plans; chronic under-investment; poor infrastructure and services (transport, hospitality, banking); a shortage of skilled personnel; low levels of private investment; reputational damage from lack of security and ongoing conflict in parts of the country; and the inability to build a strong brand.

21 World Bank. Services Trade Restrictions Database.

Box 2: Technology, Fintech and Business Processing Outsourcing (BPO)

Ethiopia is at the early stages of a fintech revolution, in which technology is becoming integrated into financial services companies to improve their efficiency. Globally, fintech and digital banking have emerged as a transformative and disruptive force, altering the financial ecosystem. This change is affecting some sectors of the Ethiopian economy, including financial services, information and communication technology (ICT), business outsourcing, and manufacturing. In March 2020, the National Bank of Ethiopia issued a new directive on issuers of payment instruments, allowing local non-bank players, including mobile network operators, to offer mobile money services. In June 2020, the Ethiopian Council of Ministers approved Digital Ethiopia 2025, a national digital transformation plan. Although the fintech ecosystem is currently small, it is projected to grow significantly. Currently, mobile subscribers total nearly 65 million (October 2022), or close to 60 percent of the total population, while Ethio Telecom reports that internet usage is only about 25 million. According to the 2017 Global Findex Database, only 0.3 percent of the adult population was using mobile money, compared to 20.9 percent in the sub-Saharan Africa region. Ethiopia had been significantly lagging its peers, despite its great potential based its population size. In 2021, Ethio Telecom launched Telebirr, a mobile money service provider, reaching a substantial subscription base within a short period of time.

Ethiopia is also emerging as a business process outsourcing centre (BPO). In a rapidly changing economy, where small enclaves – but not the entire economy – may be characterized as high tech, the BPO is becoming an integral part of the global economy. Given the combination of low wages, English language knowledge, youthfulness of the population, high proportion of university graduates and geographical location, Ethiopia could become one of the leading BPO and ICT hubs in sub-Saharan Africa. Under the Digital Ethiopia 2025 Strategy, the country has started focussing on several key technology sectors - particularly especially smart cities, cyber security, information economy, mobility, digital healthcare and telecom. These activities offer great potential for continued growth.

A. Policy area 1: Labour market and human capital formation

A stagnant labour market poses an obstacle to Ethiopia's future development. Despite strong economic growth, labour market outcomes are relatively poor. The employment elasticity of growth is low, but varies by sector. Overall, employment levels rise by less than 0.5 percentage points for every one percentage point growth in GDP[22]. Job creation is insufficient to absorb the growing working-age population, contributing to a decline in labour force participation (figure 10) and an increase in the unemployment rate. Most notably, rapid growth has clearly not translated into major changes in the sectoral distribution of employment (Table 1).

Table 1: Distribution of employment by subsectors and gender at the national level in % of total employment, Ethiopia, 2005, 2013 and 2021

	Total			Male			Female		
National level	**2005***	**2013**	**2021**	**2005***	**2013**	**2021**	**2005***	**2013**	**2021**
Agriculture, forestry, and fishing	80.2	72.7	64.9	84.3	79.5	71.6	75.5	64.7	55.7
Domestic personnel employed by households	0.8	7.3	11.1	0.1	1.9	4.1	1.6	13.6	20.7
Wholesale, retail trade, repair	5.2	5.4	5.9	3.9	3.8	4.4	6.8	7.4	8.0
Other service activities		1.1	3.8		1.2	3.9		0.9	3.8
Manufacturing	4.9	4.5	2.9	2.6	3.2	2.8	7.5	6	3.0
Education		1.6	2.3		1.9	2.5		1.3	2.0
Construction	1.4	1.9	1.8	2.1	2.8	2.8	0.7	0.9	0.4
Transportation and storage		0.8	1.3		1.4	2.3		0.2	0.1
Other sectors (<1percent of total employment in 2021)	4.5	4.6	6.0	2.9	4.4	5.7	6.1	5.1	6.3

*(when subsector available)

Source: Ethiopian Central Statistical Agency, Labour force and migration survey 2005, 2013, and 2021.

22 UNDP estimate.

Figure 10: Labour force participation in % of working-age population

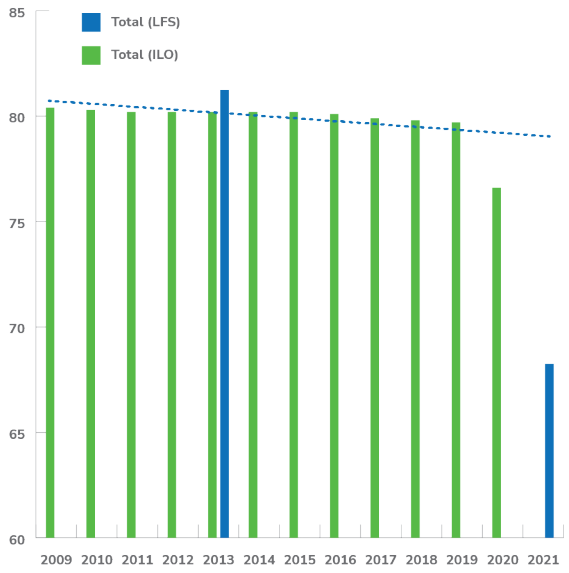


Figure 11: Unemployment rate in % of active population over 10 years of age

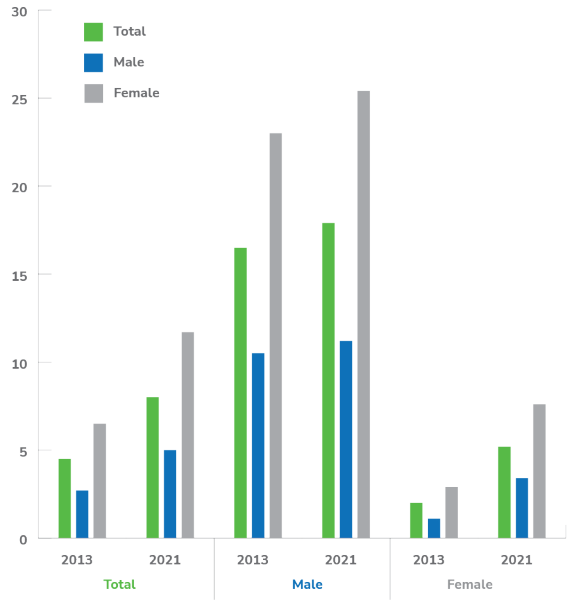


Figure 12: Unemployment rate by sex and location in % of the active population

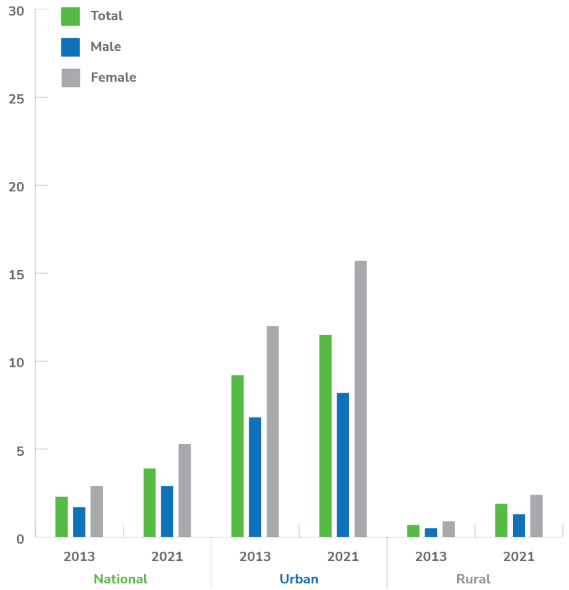


Figure 13: Underemployment rate by sex and location in % of the employed population

Source: ILOSTAT and Ethiopian Central Statistical Agency

Several signs of a poorly functioning labour market are evident: informality is widespread, with 85 percent of workers in insecure, low productivity, low wage employment; labour standards are applied spottily as regulation and oversight is minimal; skills gaps persist despite market demand; women have higher rates of unemployment and earn less than men; and discriminatory practices against women contribute to slightly lower labour market participation. The overall labour force participation rate in 2020 was 75 percent, while the female participation rate was 72 percent.[23] The reasons contributing to an inefficient labour market are myriad:

> low demand, especially in the formal sector, as manufacturing and services fail to grow sufficiently to absorb entrants into the labour market;

> supply side shortfalls in education and training to prepare the labour force for real world market conditions, even when demand does exist;

> poor information flows about opportunities;

> relatively limited mobility across the country as a result of cost (for example, housing availability and expense), formal or informal restrictions, and insecurity, among others;

> fragmented labour markets across rural and urban areas and between Addis Ababa and a host of smaller towns; and,

> social norms, among other factors, that hinder women's participation.

Human capital formation in Ethiopia remains a challenge. The educational level in Ethiopia remains low, especially in rural areas. In 2021, only 55 percent of the population had ever attended school and only 12 percent had graduated with at least a secondary education. Nevertheless, Ethiopia has done well in terms of primary education enrolment and in expanding access to higher education although the latest estimates show that 10 million children across Ethiopia between the ages of 6 and 18 years are not enrolled in school due to conflict, drought and other factors[24]. Moreover, primary education dropout rates are a major concern: while 85 percent of students make it past Grade 5, only 54 percent do so past Grade 8[25]. Compounding matters, enrolment rates in secondary education are relatively low (just below 25 percent of eligible adolescents). The situation is made more challenging by the apparent lack of learning taking place in schools. According to UNICEF, '63 percent of students in lower primary school are not achieving the basic learning outcomes needed to succeed higher up the education ladder.'[26] Men achieve higher levels of education than women. Ninety-four percent of the rural population has never attended school or has completed only primary schooling, compared to 66 percent in urban areas. Concerns also remain about the outcomes of technical and vocational education training (TVET) and the higher education system which have had limited effects on labour market integration and employability.

23 International Labour Organization Statistics (ILOSTAT)

24 UNESCO, 2022.

25 https://www.unicef.org/ethiopia/learning-and-development.

26 Ibid.

Ethiopia's health indicators have improved considerably but significant challenges remain. They range from a continuing heavy burden of communicable diseases to the increasing impact of non-communicable diseases[27] and persistent high levels of malnutrition[28] compounded by conflict and natural disasters; inadequate service coverage and quality; sustainability of the current health sector financing model; the need for substantial workforce improvements; gaps in disease surveillance and monitoring; and shortfalls in preparedness for future health emergencies.

B. Policy area 2: Gender

Women's potential in Ethiopia remains largely untapped. The 2021 Human Development Index for females is 0.478, compared to 0.519 for males. The (derived) gender development index value is thus 0.921, placing Ethiopia in the bottom fourth of countries. Women have markedly lower access to essential productive inputs and services: only 51 percent of women farmers are estimated to have access to agricultural extension services;[29] 8 percent have access to credit;[30] and just 40 percent of married women own land with only 19.5 percent holding a land title. Women are over represented in the agricultural and domestic workforces, which are associated with low wages. Unpaid family work in the informal economy is still the largest category of employment for women and male-female wage gaps are considerable across all sectors. These disadvantages are compounded by negative social norms that hold back women's voice and participation in community life and traditional practices such as child marriage and female genital mutilation (FGM), both declining in their incidence but still significant concerns[31]. In the latter case, 25 million girls and women have reportedly undergone FGM in Ethiopia, the largest absolute number in Eastern and Southern Africa; and, overall, 65 percent of girls and women aged 15 to 49 years have been subjected to FGM, and 47 percent of adolescent girls aged 15 to 19 years have experienced the same[32].

Ethiopia loses much from women and girls being left behind. Economically active women invest in their children's health, food and education through their enhanced economic freedom. Experience from other countries, however, not least in South and Southeast Asia, shows that women make a vital difference - stimulating entrepreneurship, creating a motivated and productive labour force, promoting equity, and generating important social returns in terms of re-investment of their earnings in the health and education of their children, including girls. This often triggers important inter-generational gains in well-being across genders, overturning a long history of discrimination and, sometimes, repression. There is every reason to believe that Ethiopia can follow the same trajectory.

27 In 2019, 58 percent of disability-adjusted life years were due to maternal and neonatal conditions, communicable diseases and malnutrition, 35 were due to non-communicable diseases and 7 percent to injuries). See https://www.moh.gov.et/site/fact-sheets and HSTPII (2021).

28 About 21 percent of children are born underweight and 37 percent are stunted by the age of five due to nutritional deficiencies (Ministry of Health, 2019).

29 Food and Agricultural Organization of the United Nations, *Ethiopia National Gender Profile of Agriculture and Rural Livelihoods*, 2019.

30 United Nations Entity for Gender Equality and the Empowerment of Women (UN-Women) and CSA, *Ethiopia Gender Statistics Report*, 2017.

31 https://www.unicef.org/ethiopia/media/1516/file/Child%20marriage%20in%20Ethiopia%20.pdf

32 https://www.unicef.org/ethiopia/media/2261/file/A%20Profile%20of%20Female%20Genital%20Mutilation%20.pdf

C. Policy area 3: Risk and Resilience

As the context for development changes dramatically in the early 21st century – and, concomitantly, a wide range of risks become more acute in their prevalence and effects – development policy and management also need to adapt accordingly and radically. This holds for Ethiopia and, indeed, for all countries, whether developing or developed. Macro risk management – at an economy-wide and societal level – must become a core concern of government. It deserves the same, if not a higher, level of investment in analysis, instruments, institutions and general preparedness as macroeconomic management. The multiple and connected shocks that have battered Ethiopia over the past few years have confirmed this need. These shocks have led to losses of lives, well-being, assets, current and future output, and confidence. Such costs would be difficult for a rich country to bear, let alone a least-developed one. **Unless addressed actively and effectively, these risks pose a clear threat to Ethiopia's development success and deserve a dedicated policy response.**

Box 3: Ethiopia's Productive Safety Net Programme (PSNP)

Ethiopia's success will depend on how it treats the most vulnerable members of its population. To promote resilience, the country developed the Productive Safety Net Programme (PSNP). It is one of the largest social safety net programmes on the African continent and is jointly coordinated by the Government of Ethiopia and the donor community. It aims to build livelihoods through three mechanisms: 1) establish cash and food transfers to smooth consumption effectively and avoid asset depletion; 2) create productive community assets and rehabilitate degraded areas; and, 3) use a risk financing mechanism so that the programme can scale up during transitory crises or shocks. The programme supports close to 8 million chronically food insecure and poor people in more than 400 rural *woredas* (districts) (figure 14). It has been successful in increasing resilience, improving food security and reducing deforestation. However, its significant shortcomings include very low graduation levels among beneficiaries (figure 15), exclusion of some extremely rural poor people, delayed and inadequate transfers, and accountability issues.

Figure 14: PSNP beneficiaries by region and gender

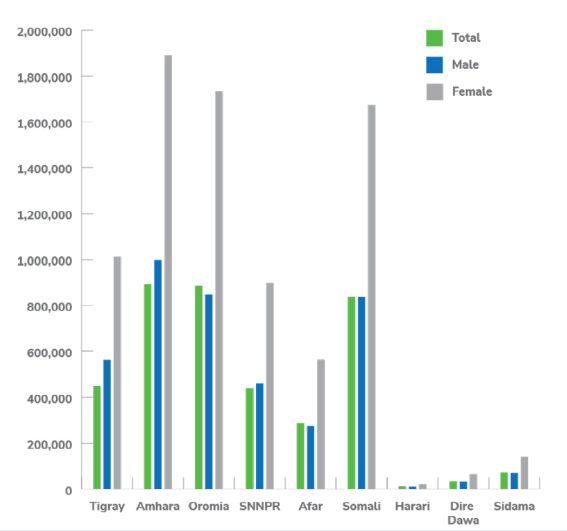
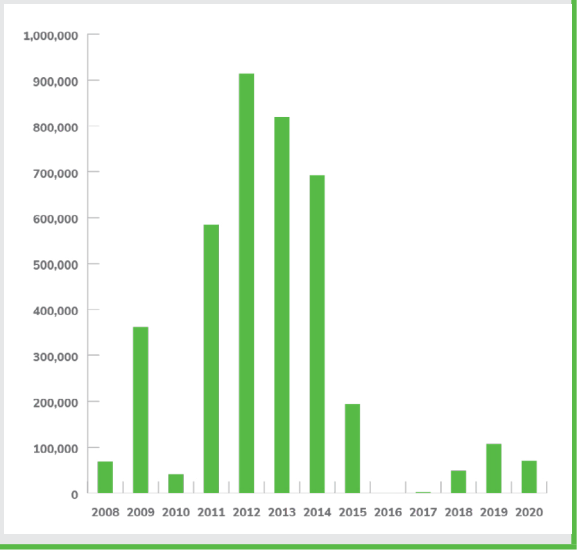


Figure 15: PSNP graduating beneficiaries



Source: Ministry of Finance

D. Policy area 4: Public service, institutions of democratic governance and fiscal federalism

Ethiopia has an inadequate public service system, which does not fully support the country's development. On the one hand, the civil service has been expanding in size and role over time. With an estimated 2.5 million employees, it is much too large for a country of Ethiopia's size.[33] On the other hand, the civil service is characterized by low productivity, low wages, uncertain impact, insularity (inability to respond to the populations' needs and concerns), and capacity constraints. The challenges facing the civil service are more acute when it comes to frontline service delivery. A recent study finds significant satisfaction with basic health services, but varying levels of satisfaction with access to education services and supply of drinking water (UNDP, 2016). [34] Moreover, it is not clear that the current configuration of the civil service, across federal and regional levels, helps to strengthen national unity in the same way that it is designed to do in other multi-ethnic and federal countries such as India with its Indian Administrative Service (IAS).[35] In addition, a wider array of legal, regulatory and standard- and norm-setting institutions are crucial to the success of a nascent democracy – and have some distance still to travel to effectively fulfil their mandates. These include legislatures at federal and regional levels, the National Electoral Board of Ethiopia (NEBE), the Ethiopian Human Rights Commission (EHRC), the Ethiopian National Dialogue Commission (ENDC), and the judiciary.

Based on international measures, the quality of governance and institutions in Ethiopia remains low. However, ongoing reforms, implemented fully in spirit and substance, could make a difference. Indicators such as the Global Competitiveness Index 2019, Corruption Perception Index 2021 and Ibrahim Index of African Governance (IIAG) 2020 identify the country's challenges. The World Economic Forum's Global Competitiveness Index ranked Ethiopia 126 out of 141 economies in 2019. In 2021, Ethiopia ranked 87 out of 180 in the Corruption Perception Index. The 2020 IIAG rating places Ethiopia in 31st place out of 54.

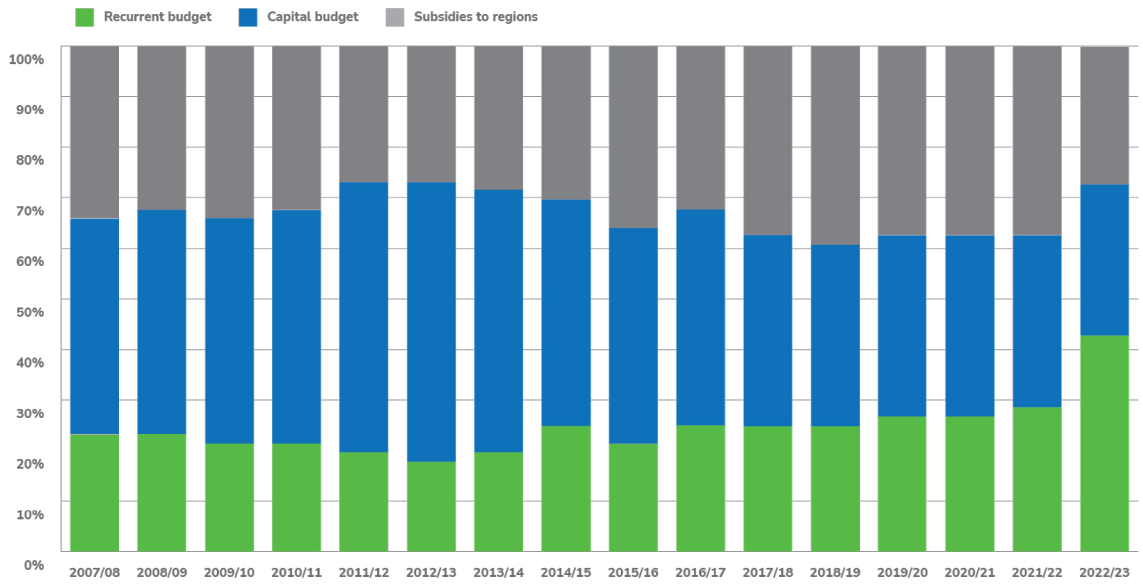
Ethiopia's system of ethnic federalism, enshrined in the 1995 constitution, increases its institutional complexity. The Constitution divides powers between the central government and regions. The federal government is responsible for foreign affairs, defence, finance, immigration and interstate commerce. Regions are responsible for regional administration and economic policy, land administration, and collection of certain taxes. Federal and regional governments share responsibilities in areas including health, education, water and sanitation. The decentralization of services to the district level, which began in the early 2000s, has progressively empowered local governments. The power to tax, whether direct or indirect, is concentrated largely at the federal level, suggesting a significant imbalance in the control of resources between the country's two main levels of government. Nevertheless, transfers (grants) from the central government to regions are designed to address vertical imbalances, that is, the gap between regional expenditures and regional revenues. These grants are calculated on the basis of a well-developed fiscal formula that is overseen by the House of Federation (the upper house of the country's parliament). The block grants (subsidies) have normally constituted one-third of the total federal budget (figure 16). These grants have been increasing in nominal terms; the three largest recipients are Oromia, Amhara, and the Southern Nations, Nationalities and Peoples' Region (figure 17).

33 FCSC, verbal briefing, 2022. The World Bank (2019) estimates a lower number at 1.1 million.

34 UNDP (2016)

35 The Indian Civil Service is based on the meritocratic principle of deploying staff across the regions of the country to foster both national cohesion and sharing of ideas.

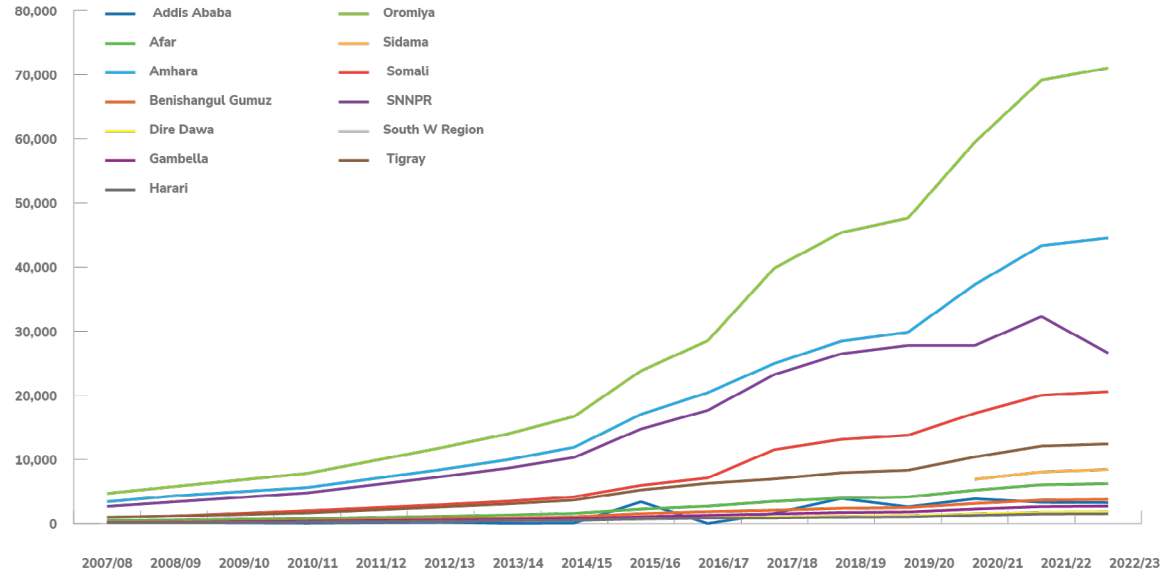
Figure 16: Federal budget share of subsidies to regional states (%)



Source: Ministry of Finance

In addition to the regions' lack of power to generate revenue, their resource allocation and management challenges are exacerbated by a lack of effective public expenditure planning and management systems, limited transparency regarding resource use, and almost no public input or view into budgetary and investment programming processes other than through the limited oversight provided by Regional Councils. It is, thus, notable but not surprising that the vertical imbalance among regions increased between 2014-2020. Furthermore, the econometric evidence does not show a robust association between the current fiscal federalism model and regional economic development.[36]

Figure 17: Trends in Subsidies to Regional States (million)



Source: Ministry of Finance

36 Henok (2023), forthcoming UNDP Working Paper.

The system does offer some clear advantages. First, the intergovernmental fiscal transfer formula is fair and reflects a participatory and consensus-based political process. Although complex, it has been updated to reflect capital and recurrent spending needs in the regions and their revenue potential. Second, as in other federalist models, the central government provides significant support for regions, and this support is ringfenced even during periods of economic downturn.[37] Third, some fiscal equalization has been achieved among regional governments in terms of providing basic public services. Although disparities remain and can be quite significant, research points to reduced interregional disparities in the provision of many basic public goods and services that regional governments are constitutionally mandated to provide. Other findings point to reduced interregional disparities, particularly in health services and access to safe drinking water and education services, although disparity has increased in access to rural roads.[38] In addition, econometric evidence shows that fiscal transfers have deepened economic interactions among neighbouring regions of Ethiopia.

E. Policy area 5: Trade and FDI

Ethiopia's value of exports is very low for a country of its size, totalling $4.1 billion in nominal terms in 2022. Its export base is narrow and almost entirely dependent on commodities, and has diversified only minimally in recent decades. By comparison, Cambodia, with a population of 17 million – barely 14 percent that of Ethiopia's - had exports totalling $28.7 billion in 2020 compared to $3.5 billion for Ethiopia in the same year.[39] Ethiopia exports smaller volumes and fewer products than its competitors and its export basket is dominated by coffee, legumes, cut flowers, oilseeds and gold. Less than 15 percent of Ethiopia's exports are manufactured products. The structure of Ethiopia's exports in terms of firms, products and destination countries has not changed compared with countries at a similar stage of economic development.[40] The World Bank Country Private Sector Diagnostic notes a lack of dynamism and innovation in Ethiopian export industries. It suggests that the high fixed costs of exporting (including high-cost logistics, uncertain access to forex, cumbersome regulations and a complex bureaucracy) constrain entry into exporting sectors.[41]

Ethiopia has been an inward-looking country, although this is changing. It has not joined regional trade groups such as COMESA. Although it has not joined any preferential trade agreement, it does grant preferential access to major suppliers of goods from Africa. It is not yet a member of the World Trade Organization (WTO), but is actively involved in a WTO accession process. The key outstanding points in entry negotiations are: the percentage of tariff lines that will be covered on the day of accession; the persistence of tariff peaks for key agricultural and industrial products; and liberalization of certain services sectors.

37 In most federations, the fiscal transfer (grant) model is the main model of intergovernmental fiscal relations. For instance, in Brazil, fiscal transfer (including performance-based transfers) is the primary model to assist regions in alleviating their vertical imbalances and accounts for 50 percent to 80 percent of regional spending. Tax sharing is the main model in India, while in Malaysia, financial subsidies primarily take the form of tax sharing and grants.

38 Henok (2023), forthcoming UNDP Working Paper.

39 https://oec.world/en/profile/country/khm.

40 Brulhart et al. (2018).

41 World Bank (2019b).

Early empirical evidence regarding the benefits of the African Continental Free Trade Agreement (AfCFTA) for Ethiopia is mixed, although it may be too soon to reach firm conclusions. According to 2018 data from the United Nations Economic Commission for Africa, the value of intra-African trade could increase between 15 and 25 percent (between $50 billion and $70 billion) by 2040, depending on liberalization efforts, compared to a situation with no AfCFTA in place. However, other sources find more modest benefits, projecting that Ethiopia's imports would increase by 0.2 percent if the country adopts full liberalization under AfCFTA and by 0.1 percent if the country excludes revenue sensitive products.[42]

Ethiopia has become one of SSA's largest recipients of FDI and could increase those investment amounts. According to the United Nations Conference on Trade and Development's World Investment Report 2021, FDI inflows to Ethiopia totalled $2.4 billion in 2020 and $3.3 billion in 2022, making it one of SSA's top five recipients.[43] In total, 2022 FDI stock was estimated at more than $30 billion, most of which is directed to infrastructure and manufacturing (especially textiles). China was the largest investor in Ethiopia in 2019, accounting for 60 percent of newly approved FDI projects, and remains the dominant investor. The other main sources of FDI, measured by stock of investment (from largest to smallest in terms of capital), are Saudi Arabia, Turkey, India and the USA.

Box 4: The European Business Forum in Ethiopia: Business Climate Report 2021

The European Business Forum's Business Climate Report 2021 was prepared based on survey data collected from more than 80 European businesses operating in Ethiopia. The Report provides an up-to-date assessment of the Ethiopian business environment and investment climate by the international community. The survey found the following:

- The level of overall positive perception of the business climate is disappointingly low.
- Despite this, prospects for turnover and investment are assessed positively.
- Being an international business is viewed as a significant factor contributing to business success in Ethiopia.
- Five main keys to unlock business competitiveness were identified: staff development and training; improving cost efficiency; collaborating with customers; improving sales competence; and enhancing brand awareness.
- Forex consistently emerges as one of the core problems facing international businesses.
- Regulatory burdens, inefficient infrastructure and a worsening security situation are also identified as key problems.

42 Mulugeta (2020).

43 UNCTAD (2021).

This paper aims to set out options for the way forward that can:

> accelerate recovery from the multiple shocks experienced by Ethiopia over the past 3 years;

> establish the foundations for broad-based and inclusive development to 2030 that lifts wellbeing, measured by gains in human development and a sharp reduction in multi-dimensional poverty;

> inject new dynamism into the economy, driven by structural transformation in output, employment and exports; and,

> increase the resilience of Ethiopia to future shocks.

This approach is not meant to be prescriptive or lay out a detailed reform programme. Rather, it seeks to contribute to thinking about a second generation of reforms, following from the first phase of the HGER and taking the goals of the TYDP as a point of departure. Moreover, the goal is not to identify and list every desirable action that could be considered but, rather, to focus on the ones that: (i) are the most urgent and transformative; (ii) offer high rates of social and economic return on investment; (iii) contribute to future growth and inclusive development; and (iv) are feasible based on a realistic view of Ethiopia's likely resource and institutional endowments as well as access to external capital for investment over the short- to medium-term.

Four aspects will be crucial to policy success. First, the design of policies will be a factor given the choices facing Ethiopia and their varying outcomes. Second, it will be vital to recognize and address strong connections or interplay among choices. Policies and investments are almost always carried out within one or more interrelated systems which makes it vital to understand how these connections can be tapped to yield the highest returns from any given set of choices. **Third, policy execution could be make or break, drawing attention to the importance of institutional factors. Fourth, consistency and predictability in policies matters greatly but is often overlooked.**

Finally, **the role of women in the economy and society – and the treatment of the girl child - need to be kept firmly in focus and at the core of planning and investment.** This is justified on the grounds of equity as well as economic sense, to ensure that no one is left behind and to unleash the productive potential of half of the population. Countries that have done so, in Asia and Latin Amercia, in particular, have experienced significant gains in both societal wellbeing and economic growth. Seven key changes could usher in a step change in this regard:

1. The legal basis for women's economic, social and political rights can be strengthened substantially, whether in the household, as mothers and wives, or as farmers, entrepreneurs, factory workers, managers, civil servants, or political leaders.

2. Women's representation in politics, business and public service needs to be advanced through specific targets and measures rather than left to 'organic' social change.

3. Educational access and outcomes for girls and women deserves to be improved, especially at secondary and tertiary levels (including TVET) and in terms of greater numbers involved in science, technology, engineering and mathematics (STEM).

4. The ecosystem of assistance for MSMEs should make specific and targeted efforts to reach women even as that system itself is overhauled. Efforts should address business development services/enterprise support services, access to finance and the ability to benefit from capital markets, with clear targets set – and enforced - for access. Experience from the work of Government with UNDP in response to the socio-economic impact of COVID-19 shows that this is feasible.

5. To increase the numbers of women working in manufacturing, access to housing and child care facilities needs to be improved and legislation that expands and protects access to maternal leave adopted. These will be essential to attract and retain women, in increasing numbers, in the workforce.

6. The relative invisibility of women farmers – as evident in their lack of access to assets, including land, and services - needs to become a thing of the past, recognising that they could well become among the most dynamic players in the rural economy, both on- and off the farm.

7. Sustained advocacy – working with traditional leaders, elders, religious entities and civil society - is essential to loosen the hold of harmful traditional norms and expectations that limit women's role in society and the status of girls, including dealing with early marriage and female genital mutilation (FGM), which are still sources of significant concern in Ethiopia.

Levers to Unleash Development Transformation

1. Investing in People: Human Capital and Capabilities for a Dynamic Economy

A large, growing and young population on the cusp of a demographic dividend could be a game changer for Ethiopia. But, as in other parts of sub-Saharan Africa (SSA) - and bearing in mind lessons learned from the most dynamic Asian economies - this will not be automatic. If specific policy measures are not implemented to address this phenomenon, then a burgeoning population could become a source of risk to social cohesion and stability in the future rather than a catalyst for development progress.

> **Updating Ethiopia's population policy:** A debate on Ethiopia's demographic future and a reassessment of its policy goals is long overdue. The country's national population policy dates from 1993[44], designed for an entirely different stage of its development. With significant drops achieved over the last thirty years in the country's total fertility rate (TFR) as well as maternal and child mortality, combined with a rise in life expectancy, the time is right to take another look at the desired demographic profile of Ethiopia over the medium- to long-term. While a rapidly expanding – and young – population has its advantages, this needs to be weighed against the costs of providing the services and delivering the jobs-rich growth without which sheer numbers will prove to be a burden rather than a blessing for the country.

> **Improving educational offerings tailored to meet the needs of a changing economy:** Ethiopia's human capital needs a leap forward to play its full role in spurring inclusive growth and development. The main policy shift would be to balance the still valid concern with access to education, thus, quantity – after all, 8 million children of school-going age are not in school – with greater emphasis on quality of instruction and learning outcomes. In line with its aspirations, Ethiopia may want to consider the Organisation for Economic Co-operation and Development's (OECD) Programme for International Student Assessment (PISA) as a benchmark for gauging progress in primary and secondary education. This assessment framework for 15-year olds examines outcomes in reading, mathematics, science, life skills and innovation as a way to measure the success of schooling and identify key areas of future reform.

44 National Population Policy of Ethiopia, 1993.

In addition, there are steps that can boost quality of learning: introduction and regular monitoring of national standards; improved teacher training and compensation; targeted improvements in physical infrastructure, especially to reduce over-crowding in classrooms; community participation in school supervision and management; special measures to attract and retain girls, for example, through conditional cash transfers, school feeding programmes and separate sanitation facilities; and steps to close the gap between rural and urban schools and between schools in high and low income areas through fiscal initiatives that spur action at regional and local levels.

In terms of higher education, Ethiopia has too many universities for its current stage of development. The current network of 50 universities generates more than 150,000 graduates annually. Many lack the skills to compete in the formal sector job market that is, in any case, too small to absorb them. Further university expansion would, thus, be both unaffordable and inadvisable. Rather, the emphasis needs to shift to ensuring a better match between higher education graduates' qualifications and the needs of the labour market through closer links between universities and private and public employers. This also calls for changes in the content of higher education, as described in the next paragraph.[45] In this regard, it may be appropriate to strengthen and improve the standing of a second tier of higher education centred on TVET institutions, based on robust and broadly recognized certifications, that builds technical skills that are likely to be both necessary and relevant to the labour market. Training that focuses on skills for agriculture, manufacturing and the digital economy will be particularly useful.

> **Modernizing outdated curricula and pedagogic methods:** At least five important future-focused shifts in the content and methods of instruction would better prepare Ethiopia's youth for the economy of the future. First, the teaching of science, technology, engineering and mathematics (STEM) throughout the educational system needs to be re evaluated at all levels. This should also include measures to close the gender gap in STEM, for example, through scholarships, mentoring and other special initiatives. Second, shifting from rote learning towards creative thinking will be essential in instructional methods and assessment. Third, approaches that spur independence, innovation and entrepreneurship, especially in secondary and tertiary education, would create the mindset and soft skills necessary for a dynamic economy. Fourth, a phased and sustainable programme to bring the digital world into classrooms and instruction would generate high returns, especially in and around areas of growing economic and tech activity. Finally, a new generation of young women and men need to be much more sensitive to environmental sustainability, both in theory and in practice. This could involve greening of school areas through 'Green Clubs', participation in community sustainability activities such as tree planting and conservation, perhaps as part of the Green Legacy Initiative, and involvement in social outreach and mobilisation.

> **Fostering a healthier population:** A healthier population is vital to building human capabilities and boosting productivity and well-being. Ethiopia has made major progress over the past 25 years in expanding access to health care and improving health outcomes whether measured by life expectancy, maternal and child mortality, or disease prevention and control. Nevertheless, a substantial amount of work remains, captured comprehensively in the Health Sector Transformation Plan II (HSTPII). Six key issues stand out in that plan: dealing with the still substantial burden of communicable diseases and the growing significance of non-communicable diseases; tackling major disparities in health outcomes by region, rural and urban location, income and gender, which reinforce similar patterns observed in education; the considerable effort still required to expand universal health coverage from the current 43 percent and raise the quality of health services; increasing the quality of the health workforce;

45 UNDP is collaborating with GIZ and FCDO to provide financial and technical support for the Government's Higher Education and Training, Research Institutions, and Industry Linkage (HETRILL) programme that looks at this issue from a practical perspective.

reducing the continued high reliance on out-of-pocket expenses and donor financing as a percentage of total health expenditures (31 percent and 35 percent, respectively); and, improving preparedness to manage health emergencies and significant changes in disease profile and prevalence that could be triggered by climate change.[46]

2. Revolutionising Agriculture and Achieving Food Security: A Climate Smart and Sustainable 'Green Revolution'

In the short term, a stronger agricultural sector is key to addressing food insecurity and improving Ethiopia's trade balance. Over the medium- and long-term, agriculture and agro-industry can inject much needed dynamism into the rural economy, including by increasing off-farm employment, ensuring national food security on a sustained basis and boosting inclusive growth. **What Ethiopia needs now is its own Green Revolution, at a pace and scale that matches or exceeds what has been achieved in Asia, including LDCs in that region, bringing to the sector a level of sustained attention and investment that has often been missing in other parts of SSA.** The chance to leap frog are considerable, benefiting from what has been learnt from the Asian experience on institutional models, technology development and diffusion and long-term financing and investment whilst also addressing concerns about inclusiveness, sustainability and adaptation to climate change. **Recent efforts to boost production, especially of wheat, are encouraging and necessary but much more will need to be done across a broad front and over a decade or more to transform the agricultural sector.**

In July 2020, the Ministry of Agriculture formulated the Agriculture Sector Ten-Year Plan guiding its strategic interventions over the medium term. The Plan focuses on four areas:

1. Enhance irrigation capacity, increase the amount of irrigated land under crop cultivation and reduce rainfall dependency.
2. Expand agricultural mechanization to increase both quantity and quality of grain production.
3. Provide support to model farmers to increase their access to cultivable land and help them become agricultural investors.
4. Increase market-oriented production and agricultural productivity to ensure national food self-sufficiency, provide inputs to domestic industries and expand exports.

To unleash the full potential of the agriculture sector, five policy priorities would be worth highlighting as the Plan unfolds and is reviewed and amended:

1. Assess comprehensively the impact of climate change on Ethiopian agriculture and adapt accordingly.
2. Create a single national or country-wide agricultural market connecting food surplus and deficit areas, to reap the benefits of scale, efficiency and equity, reduce disparities and volatility in prices across different regions and boost food security.
3. To do the above, optimize the roles of the public and private sectors in infrastructure development, research and extension, input provision, credit, storage and marketing, to create an appropriate and well-functioning ecosystem for farmers, underpinned by better and more timely data to improve the efficiency and effectiveness of public policy and market operation.
4. Maintain a balance between supply-side and demand-side measures to ensure that sustained expansion in production moves in lockstep with improved household food security.

46 All data from MoH (https://www.moh.gov.et/site/fact-sheets) and HSTPII (2021).

5. Focus on nutritional outcomes, which are essential for better health, cognitive development and learning and labour force productivity. There is a risk that excessive focus on cereals, for instance, without commensurate attention to complementary food items could compromise nutritional wellbeing - such as through micronutrient deficiencies – and prove costly in economic and social terms.

Sustained and consistent policy prioritization of agriculture will be the key ingredient for a revolution in agriculture, as structural transformation will unattainable solely through crash programmes or in three to five years. It will require a decade or more of attention, adjustment and investment.

Specific measures to tackle the policy priorities proposed above could include:

1. **Reforming property rights** to allow farmers to lease lands and for a land market to emerge to permit trading of such leases and gradual consolidation of holdings to boost productivity. Any resulting labour displacement would be best handled through alternative off-farm employment in agro-industry and manufacturing. In this regard, cluster farming, in which small farmers are aggregated in a group, whilst showing some promise, may not be a complete long-term answer across the agricultural sector and agro-ecological zones of Ethiopia.
2. **Spurring a much-needed technological revolution in agriculture** whether through use of higher yielding and drought/pest resistant seeds, changes in planting methods, increased use of fertilisers, more frequent crop rotation or sustainability measures to protect and conserve soil quality and forest and water resources. A question in this regard is whether Ethiopia has a sufficiently robust institutional basis – in universities and agricultural research institutes – to sustain a continuous flow of innovation, development and adaptation that boosts productivity and sustainability at the farm level.
3. **Expanding irrigation appropriately**, as planned already, to reduce dependence on rain-fed agriculture whilst avoiding distorted incentives such as a high level of subsidies that do not reflect the true economic and environmental price of water, thus, encouraging overuse and waste as well as inappropriate choice of crops and animal husbandry. In this connection, the balance between large-scale, capital- and management-intensive irrigation schemes versus smaller on-farm options needs to be evaluated more carefully on the basis of their economic, social, and environmental sustainability.
4. **Adapting and prioritising natural resource management in light of climate change**, relying on drought-resistant crops, efficient water management, afforestation and reforestation, and protection of biodiversity.
5. **Undertaking or accelerating fundamental institutional reform**, with the public sector focusing on public goods such as research and extension; market-enabling infrastructure and services, for example, a growing network of rural feeder roads, data quality and availability, and on- and off-farm storage, all of them to boost output and employment, reduce post-harvest losses, improve market operation and reduce price volatility; and, last, where the case is strong on the grounds of market failure, equity, sustainability, innovation or inclusion, offer targeted subsidies to encourage technological uptake and broader participation and action than might have been possible otherwise. In this scheme of things, much greater institutional space would be created for the private sector to play a key role in technology diffusion, input and output marketing, provision of financial services, and transportation.
6. **Dismantling the legal, policy, regulatory and institutional bottlenecks that are stymying the emergence of a national agricultural market**. This is likely to require considerable action across the federal level and between the latter and regions to ensure that a panoply of rules, regulations, taxes, subsidies, fees and licensing requirements are harmonised to promote an integrated country-wide market that enables effective intermediation and benefits both producers and consumers.

While this list may seem daunting, it is doable. Experience elsewhere - particularly in Asia - has demonstrated this clearly.

3. Spurring a 'Take-Off' in Manufacturing and Services: Can Ethiopia Emulate Asia?

Ethiopia needs a breakthrough in manufacturing. Much of its aspirations for higher productivity, growth, exports and inclusion, including reaching middle income status, hinges on this. Unlike many countries in SSA, Ethiopia starts with significant advantages relative to its peers: sustained prioritisation of manufacturing in public policy; a generally good track record in macroeconomic management that has diminished volatility and unpredictability; a large and young population, offering both latent comparative advantage in labour-intensive production and a substantial domestic market; and an almost ideal geographic location, close to major export markets in Asia, Europe and the Middle East, astride major shipping lanes and with Africa's premier air cargo hub in Addis Ababa. **There are also distinct disadvantages** as explained earlier in this paper: the state of the financial sector, infrastructure shortfalls, high logistics costs, recent macroeconomic stresses and the resulting scarcity of forex, and a small and fragmented private sector. But other countries, including LDCs, have started from a similar base and managed to spur structural transformation. **As with regard to agriculture, the task ahead for Ethiopia, while demanding, is far from impossible.**

The linchpin may be **a rethink of the current approach to manufacturing and the adoption of an acceleration strategy that turns Ethiopia into the first country in SSA to industrialize production and exports**, setting aside the special case of South Africa. While some might point to the risks of an explicit industrial policy, experience in Asia[47] and Latin America, in particular – and, indeed, in several OECD countries – shows that market forces alone will not necessarily guarantee desired outcomes. A heterodox approach that leaves the State with a core enabling function may be necessary, even essential, provided the focus remains on boosting the private sector as the main motor of rising growth and employment.[48] It needs to be stressed, however, that such an approach demands a sophisticated and skilled bureaucracy able to navigate technical and operational complexity on a sustained basis whilst avoiding downside risks of inefficiency and corruption.

The elements of an acceleration strategy could include the following:

> **Promoting more dynamic industrial parks.** The industrial park-based industrialisation and export growth strategy deserves to be reviewed carefully to eliminate de facto discrimination against domestic investors, encourage the development of local supply chains, and boost local value addition. A directed effort, combining public sector effort with investor engagement, to build an ecosystem of enterprises that forges backward linkages, in particular, to boost local content could pay major dividends. In addition, peace and political stability, an improved business climate (including licensing, one-stop, and after care services for investors), opening-up of the logistics sector to private participation, less arbitrary and slow customs and tax administration, and enhanced coordination between federal and regional authorities to harmonise rules, regulations and incentives will be critical to attracting foreign *and* domestic investors, both inside and outside industrial parks. Addressing the stringent forex constraint will be vital and, hopefully, feasible as well with external financing rising, especially from official sources, following what is expected to be a permanent end to hostilities in northern Ethiopia.

47 Wade, Rober H., Escaping the periphery, the East Asian 'mystery' solved, WIDER Working Paper 2018/101.

48 Please see Mariana Mazzucato's extensive research on this subject.

> **Building the 'missing middle' of MSMEs.** A major, directed, effort is needed to support smaller firms – both to increase their numbers and help them grow in size – and strengthen their role in entrepreneurship, expansion of markets for products and services, productivity growth, value addition, and acceleration of jobs-intensive growth. This category of enterprises also needs a clear institutional champion who can galvanize whole-of-government action at both federal and regional levels across a broad front:

1. reducing and/or eliminating legal and regulatory bottlenecks, including taxation and tax administration and inconsistent rules and regulations across regions that impede market expansion and functioning;
2. substantially boosting access to finance by taking advantage of telecoms and financial sector liberalisation, to introduce and innovate in the area of financial instruments tailored specifically to MSMEs, including non-collateralized lending and credit scoring based on data mining rather than traditional methods;
3. developing next-generation business development or enterprise support services geared to the needs of different classes of entrepreneurs and sectors, including the specific requirements of women entrepreneurs;
4. planning deliberately for MSMEs access to capital markets over the medium-term; and,
5. as emphasised earlier, linking MSMEs to supply chains built around investments in industrial parks.[49]

UNDP, among others, is working with the Government, specifically the National Bank of Ethiopia (NBE), the Ministry of Labour and Skills (MoLS) and Ministry of Innovation and Technology (MiNT) to comprehensively address these issues through an Innovative Finance Lab (IFL) launched in October 2022.

> **Transforming the financial sector.** As recognised by the Government, the financial sector needs to be liberalized to improve financial inclusion, boost services for farmers and businesses (including MSMEs), integrate domestic markets, and improve the mobilization of domestic savings to fuel investment, not least to divert the flow of funds from residential and commercial construction in Addis Ababa and a few towns to manufacturing, agriculture and services. Consolidation of the sector may be an inevitable – and necessary – part of this process to realise economies of scale, reduce costs, strengthen balance sheets, adopt new technologies, improve risk management and experiment with new products and services. An important question will be the Government's policy position with regard to the dominant incumbent in the sector – the state-owned Commercial Bank of Ethiopia (CBE) – and what might be seen as its privileged access to public business. Equally important, to avoid market distortion and manipulation as well as poor social outcomes, is the extent to which liberalisation of the telecoms market will create (or not) platforms that enable the emergence of contested or competitive rather than closed markets for fintech services, based on low cost of access, common standards and interoperability of systems. This will be crucial to the growth of Ethiopia's small but increasingly active domestic fintech sector and its competitiveness vis a vis strong regional and international rivals.

In parallel to the banking sector, capital markets need to be developed to avoid a market designed mainly for large cap domestic and multinational firms, by creating access for start-ups and MSMEs. Use of regulatory sandboxes to test and then roll-out new or revised policy and

49 The National Bank of Ethiopia and UNDP jointly launched an Innovative Finance Lab (IFL) in October 2022 to address several of these issues.

regulatory options will be a vital instrument in the policy toolbox. The creation of the Ethiopian Securities Exchange (ESX) and the establishment of the Capital Markets Authority (CMA) offer Ethiopia a unique opportunity to take global and regional experience and good practice into account to boost manufacturing (and services) to an extent that was unattainable in the past.

> **Engaging with the private sector.** An element that is missing at present in Ethiopia is an institutional arrangement for a sustained and well-structured dialogue between government and the private sector (both foreign *and* domestic) to systematically address policy, legal, regulatory and administrative issues which constitute major impediments to the ease of doing business in the country.

4. Reinforcing Institutions: Public Service Reform, Deepening of Democracy and Federalism

> **Ethiopia cannot create a modern economy based on its current public service**. While plans for reform are being developed, policy and development assistance have not focused sufficiently on this issue. Left unaddressed, it could quickly become a major impediment to economic reform, if this has not happened already. The main outlines of a reform agenda are clear, although execution will be politically sensitive given the scale of required reforms, the time needed and potentially high transitional costs. The payoff, however, will outweigh the costs.

Key elements of public service reform include:

1. **Comprehensive regulatory reform** to reduce and/or eliminate legacy 'gate-keeping' and 'control' functions of the public bureaucracy, in keeping with the move to an open, market-driven and private sector-led economy. This can be concentrated, at least initially, in those sectors deemed a priority and in areas identified most often by investors, foreign *and* domestic, as key impediments to doing business.
2. **Substantial downsizing** of the public service in keeping with the shifting role of the State and to release funds to address very low levels of compensation and digitalisation.
3. **A directed effort to create and fast-track a merit-based and politically neutral 'development corps'** in the public service aimed at attracting the best and brightest, balanced between women and men, that possesses the core skills required to manage a modern economy and improve the efficiency and effectiveness of public policy and investments. Major areas of professional competence could include statistics, economic and financial analysis, development planning, public finance, project management and public procurement. Members of this development corps could be outposted to federal and regional governments and rotated between them.
4. **Review and reform of public service compensation levels**, which are far below those of regional peers and unlikely to attract and retain top talent. This generates major losses in performance and creates perverse outcomes that see substantial amounts of compensatory and unsustainable funding from development partners to government entities for experts and advisors designed to plug gaps in staffing and skills. The bill for this, if monetised fully, could run into the hundreds of millions of US Dollars per annum and yet this has not been fully understood or addressed as a major inefficiency and a significant misallocation of resources.

   An option, accompanying and sustaining public service reform, maybe to **establish a 5-year Transitional Facility, funded jointly by Government and development partners (potentially through budget support), to allow public service compensation levels to rise steadily over time** to levels that, if not comparable to those in the private sector, are

at least sufficient to attract and retain talent. Such a facility would give the Government sufficient time, through savings generated from reform and an increase in the tax base, to take full responsibility for the civil service wage bill over the medium-term.

5. **A major shift to e-government**, which is severely under-developed in Ethiopia, based on the National Digital Strategy, to reduce costs, improve access and quality, raise the speed of delivery, and increase transparency. The potentials gains in efficiency, equity and overall performance are likely to be considerable, more than offsetting associated capital and training costs. The benefits will be most obvious to people in parts of the country – rural, far from urban centres – that are currently cut-off from many public services, and to businesses that could see substantially reduced transactions costs with Government service providers. Another major benefit from e-government will be reduced scope for corruption.

6. **Greater emphasis on open government**, which would overcome decades if not centuries of disconnection between citizens and the State in Ethiopia. Part of this would entail increasing the bureaucracy's accountability to the public through regular, mandated, use of public consultation processes (such as green and white papers), public perception and/or user surveys, as well as implementation of freedom of information measures. UNDP has already supported the Federal Government to adopt a Civic Engagement Framework that could provide the initial impetus for action in this area.

Given the scale of this task, one option may be to proceed in phases by focusing on those institutions vital to managing the second generation HGER and TYPD, for example, the Prime Minister's Office, Ministry of Finance, Ministry of Planning and Development, the Federal Civil Service Commission and the Ministry of Revenue. At the centre of government, in particular, the Prime Minister's Office could benefit from an institutionalized council of economic advisers, independent of the government, that is tasked to provide evidence-based and timely input into economic decision-making. Furthermore, establishing think tanks connected to but separate from government that could provide a steady stream of high quality, impartial and technical advice to policymakers, modelled on successful examples from Asia such as the Korea Development Institute (KDI), is another possibility.

> Beyond building technical expertise, Ethiopia must also pursue an institutional agenda to embed democratic governance, to build confidence, stability and peace. This would entail making a **continuing and patient commitment to securing the space for, and investing in, the emergence of independent and credible institutions**. A comprehensive, multi-year, reform programme on justice and the rule of law that encompasses both federal and regional bodies is overdue. The programme could help reform laws, procedures and systems that impose high costs on the economy and society, whether in terms of entrenching gender inequality, increasing the cost of doing business, creating uncertainty about property rights or, generally, contributing to a business climate that discourages private investment.

> Parallel to this, the National Electoral Board of Ethiopia (NEBE) needs to acquire the capacities required to manage the 2026 general elections without relying substantially on international assistance. It is worth noting in this connection, that both Government and international partners still lack a complete understanding of the level of public funding required to build and maintain an electoral management system in a country as large and diverse as Ethiopia, compared to peers in the region (such as Kenya) and those beyond (for example, Nigeria). Another core body, the Ethiopian Human Rights Commission (EHRC), which is still at a relatively early stage of development, needs further support to become a fully skilled and operationally sustainable entity. Reinforcing strengthening of NEBE and EHRC, a national peace building architecture is another missing piece of Ethiopia's institutional puzzle when it comes to governance. This architecture, which does not exist at present, needs to be built from the grassroots up and can

provide a first line of defence against crises and conflict, whether in addressing local disputes or larger systemic issues, complementing the work of the newly-established Ethiopia National Dialogue Commission (ENDC), which has a mandate for three years.

> Building on important legal and regulatory changes in recent years, **the time has come to let Ethiopian civil society finds its place in the institutional framework of the country**. Signs of increasing activity among domestic civil society organisations (CSOs) offer a good launchpad to expand their role in enabling citizens to access services, improve participation in governance processes, promote human rights, hold government (whether local, regional or federal) to account, and play a role in changing societal norms and expectations that can boost development, for example, on the issue of gender equality. Non-governmental organisations (NGOs) can also be an effective complement to government in the delivery of public services, given capacity and resource constraints in the public sector. There is significant experience of NGO participation in service delivery in SSA and across the Global South, including cases where they have been contracted by government and/or given access to donor-supported sectoral investments. Finally, the localisation of massive humanitarian assistance to Ethiopia, which has been limited to-date despite multiple international and national commitments to do so, offers a major opportunity to build the country's ecosystem of transparent, well-managed and effective CSOs and NGOs that can share in the heavy lifting of development progress.

> Accompanying these efforts, strengthening social cohesion, respect for diversity and national unity deserves to be a priority. **Ethiopia's embryonic youth volunteer service, the country's closest equivalent to national service**, could contribute significantly in this regard. Given its focus on attracting higher education graduates, it could help to build cohesion and unity by tapping into the larger number of universities in Ethiopia. The first few cohorts have already completed the programme, but the effort can be scaled up considerably and incentives offered to participants – for example, through preferential treatment in civil service recruitment and, perhaps, even private sector employment – to improve reach and effectiveness. Experience from elsewhere in SSA, including Ghana and Nigeria, shows that programmes of this nature can strengthen life skills, improve understanding of diversity in multi-ethnic societies, overcome gender stereotypes and build qualities for good citizenship.

> Finally, while the aim of this paper is not to analyse Ethiopia's federal character, there is scope for reform under the current arrangement that could strengthen development performance and inclusion. The key one is **better management of fiscal relations between the centre and regions**. This could involve introducing an additional channel of funding from the federal level beyond block grants which by their nature are unearmarked and can be used as needed by regional governments. This complementary channel could be in the form of challenge or matching grants that would offer incentives for action across the country on shared development priorities. Under these arrangements, regions could compete for funds based on their willingness to pursue objectives such as the reduction of gender/rural-urban/income disparities in access to basic services, prioritization of agriculture, sustainable management of natural resources, or success in mobilizing local resources. Or they could see their commitments to the same issues matched by additional funding from the federal government based on a mutually agreed formula. Even as resource allocation improves in the federal system, realizing its full benefits, however, will demand better resource planning and expenditure management at the regional level. Important aspects of this effort would be to improve data quality, development planning and public financial management (PFM) systems at the regional level. This has not so far received the level of attention that it needs, whether from government or from development partners.

5. Recalibrating State Participation in the Economy: SoEs Reform and Privatisation

SoEs reform remains key in transforming Ethiopia's economy as it will open up space for the private sector and reduce demands on the public purse. While Ethiopia has privatized significantly since the 1990s, SoEs continue to have a significant presence in the economy. Some profitable and well-managed firms, such as Ethiopian Airlines, suggest that state participation in some sectors does not pose an issue although even here, there is an argument to be made to allow other players to enter Ethiopia's aviation market in the medium-term. Reform, though, is urgent in other sectors. Setting clear timeframes to open-up key sectors to private operators will be helpful, including finance, logistics and power generation. This could anchor and guide policy, send an important signal to investors and offer predictability for them as well, thus, reducing risk. In other sectors, such as sugar and manufacturing, a privatisation roadmap setting clear targets would help, although some loss-making enterprises may not be viable candidates and may need to be liquidated or closed.

The government can pursue other reform elements. First, it can provide transparent disclosure and a consolidated picture of the public sector balance sheet. Second, it can ensure full disclosure of SoEs debt at the Liability and Asset Management Company, the entity created in 2021 to consolidate and manage some SoEs debt. Third, the government can push to improve the governance and management of SoEs under Ethiopian Investment Holding (EIH) by introducing commercial standards and practices. This could potentially include bringing in external management and technical expertise (for example, in the case of Ethio Power). Finally, privatization and liberalization are much more likely to yield higher levels of domestic and foreign investment if accompanied by explicit and stable policy changes that boost the business climate and offer prospects for solid returns on investment across targeted sectors, including on issues of licensing, taxes, subsidies, pricing and tariffs.

6. Opening the Economy: Trade Reforms and Regional Integration

Ethiopia could gain substantially from trade reform, especially if it has ambitions to become a major if not the main manufacturing and services hub for East and Central Africa. The main arguments favouring such a move rest on the possibility of improving the competitiveness of domestic firms and farmers and offering them access to a much larger market; attracting investors based on the possibility of market scale and reach; and offering more choice at lower prices to domestic consumers. This will, however, not happen automatically. Many of the reforms proposed in this paper will be essential to ensuring that Ethiopia is in a position to take advantage of greater opening, especially as a small economy that is a price-taker in global markets. Additional actions will be necessary. First, to reap the benefits, Ethiopia can pursue both WTO accession and AfCTA membership. Joining the WTO has been shown to have a strong positive impact on trade globally, amounting to about 120 percent of additional world trade (or $8 trillion in 2000 alone). The impact, however, can be uneven, depending on how the country uses its membership, with whom it negotiates, and which products the negotiation addresses.[50] Second, Ethiopia could deepen its regional integration in East Africa and work with its neighbours to develop a harmonised regional regulatory policy for transport, telecom, insurance and other key sectors. Third, Ethiopia will need to carefully consider how its trade policy regime deals with potential priorities related to the growth of domestic industry and services ('infant industry' rationale) and credible grounds for import substitution. Fourth, simplified customs procedures and trade facilitation would offer huge payoffs.

50 Subramanian and Wei (2003).

Fifth, Ethiopia could reduce supply chain bottlenecks for packaging, logistics and transportation in cross-border trade, prioritising its current and potential future trade corridors (through Eritrea, Kenya, Sudan and Somalia).

7. Preparing for Shocks: Resilient Institutions and Finances

Ethiopia's development trajectory is likely to unfold against a backdrop of heightened risk, volatility and uncertainty, whether at global, regional or national levels. Making sure that development goals and plans survive contact with reality and can remain on course will demand the design and implementation of a purposeful strategy of risk management and resilience building. How can this be done? Several aspects stand out:

1. Plan explicitly for risks and make provision in development plans for contingencies. This will mean investing in better data and analytics (including foresight and scenario planning) to enable improved and timely surveillance of critical risk factors, both economic and non-economic, and identification of effective responses.
2. Build a dedicated capability for risk management at the centre of government, pulling together resources, including staff, from across ministries and entities and offering a platform to 'fuse' data and analytics from multiple sources.
3. Develop the policy and institutional levers or instruments for risk management. Prudent macroeconomic management is a key part of it, already well developed in Ethiopia, and it could go further to ensure sustainable debt loads as well as an increased level of forex reserves and fiscal space to respond to future crises. But it will be important to build 'buffers' beyond the macroeconomic to minimize possible harm to society, the economy and the environment and to maximize the speed and efficacy of the rebound from shocks. Such 'buffers' include a well-functioning health system, disaster risk management capacities, strategic food reserves, and well-targeted and sustainable safety nets. They also go beyond these measures. Prevention efforts such as social cohesion and peacebuilding, steps to reduce economic and non-economic forms of inequality and discrimination, development of independent and credible institutions of justice and the rule of law, open civic spaces, mechanisms for dispute resolution through peaceful political means, and political representation and dialogue are all part of the policy mix when it comes to risk management, revealing that the effort is one that demands a whole-of-government and whole-of-society focus and approach.

On the issue of safety nets, given experience to date and high levels of investment, this **may be the time to reexamine the Productive Safety Net Programme (PSNP)**. Reform may be warranted, given growing risks from internal and external factors and the increasing frequency and severity of shocks. One option may be to distinguish between safety nets designed to deal with transitory shocks and those meant to tackle structural poverty by supporting a minimum level of consumption and well-being. The former relates, for example, to phenomena such as the socio-economic impact of COVID-19 or a natural disaster that calls for quick action to support incomes, enterprise/farming and employment. Responses to these events do not need to be permanent, thus, designs and systems can be in place to roll them out quickly – almost 'off-the-shelf' – when needed. With regard to structural poverty, the PSNP could be redesigned to improve targeting to the poorest and raise graduation rates and/or to introduce conditional cash transfer programmes that tie assistance to recipients' actions, such as sending children to schools, visiting health clinics regularly or getting vaccinated. Ethiopia could rely on considerable global experience in this area to design a programme that meets its requirements. A variant of this approach could involve deploying social action funds – particularly where structural poverty is concentrated geographically – to support community-level action on health and education tied to performance against agreed deliverables. This approach offers the added benefit of stimulating local economies by injecting much-needed funds.

Progress on three essential issues would greatly improve the targeting, efficiency and transparency of safety nets, as well as a vast array of other government programmes. These are: **rolling out a digital national ID**; as noted earlier, undertaking a major effort to **digitalize government services (or e-government)**; and enabling **telecoms services to expand by creating a Universal Service Provision Fund to support service extension into rural areas**.

8. Managing the Political Economy of Liberalisation and Reform

When economies liberalize, the impact of that process on a country's political economy is often overlooked even though it has a strong bearing on how well, how quickly, how fairly and how peacefully the process unfolds. The initiatives currently underway in Ethiopia, and those that may be implemented in the future, will undoubtedly redistribute capital and assets, alter the accumulation of wealth and distribution of income, change the economic fortunes of different socio-economic groups and regions, and affect gender relations across a broad front. They will, therefore, play a significant role in shaping voice and participation in the country's governance and generating the legitimacy and acceptance of change among Ethiopians that will be required to sustain reforms. Serious risks also exist: the emergence of state-dependent capitalism organized around patronage and increased, perhaps systemic, corruption.

Some of these effects can take time to reveal themselves fully. Others may emerge quickly, especially if accelerated by internal or external shocks, thus, destabilising reform programmes and, more broadly, the economy and polity. The development economics and political science literature has examined this phenomenon across the world, in both developing and developed economies, and points out critical lessons. These lessons show that a host of issues determine how well (or not) transitional costs and benefits are handled and how this, in turn, impacts on the viability and durability of change, especially when the latter involves fundamental shifts in the economy and society. These lessons include: the speed or pace of change; the extent of inclusion; the level of vulnerability to economic and social shocks; the extent of political stability; the 'brittleness' of institutions, that is, their ability to adapt and change as conditions evolve (or the lack thereof); and the extent to which social capital is accumulated (or expended) and social cohesion reinforced (or eroded). **While this aspect of the liberalisation process and reform programmes cannot be characterized as either technical or economic in nature - and, thus, may not be seen as deserving of policy attention - it demands close scrutiny and could make the difference between success or failure.**

9. The Macroeconomy: Stability and Predictability as Vital Preconditions for Success

Ethiopia has managed its macroeconomy well in comparison to its SSA peers until the multiple and severe shocks of the 2020-2022 period compromised its performance. Policymakers in Ethiopia clearly recognize the value of a stable, predictable, prudent and development-friendly macroeconomic environment that builds confidence and spurs investment, enterprise and job creation. This paper underlines the importance of maintaining this posture moving forward and of finding the shortest paths possible away from the considerable stress that the economy is experiencing at present. This poses both a political and economic challenge – and a complicated one at that – but is key to finding the route to high, inclusive and transformational growth and development.

To contribute to the policy debate, the boxes below present a baseline macro outlook to 2030. This is purely a thought experiment as projections this far into the future are inherently speculative. Moreover, as pointed out earlier, the actual choice, design and sequencing of policies and investments will undoubtedly generate their own dynamics that will substantially alter trajectories and numbers. Nevertheless, simulating the future can improve understanding of the potential policy frontier and its implications.

Ethiopia's total investment-to-GDP ratio was estimated by government at 25.3 percent during the fiscal year 2022; IMF data put the figure at 23.6 percent.[51] This is substantially below the figure recorded during 2017 - 2022 (31.7 percent) and much too low to achieve faster and inclusive growth. A long-term goal could be to reach 35-40 percent. In the medium term, as an intermediate step, Ethiopia could reach 30 percent, with public investment still dominating but private investment growing significantly. Similarly, Ethiopia's current savings-to-GDP ratio is 19.6 percent. This too is below the level achieved in 2017 - 2022 (27.3 percent) and too low to mobilize a sufficient level of domestic savings to fund investment that would accelerate and sustain a higher rate of growth. A long-term goal could be 35 percent, but an achievable intermediate target could be 28 percent by 2030. With further reforms, as proposed here, the TFP trajectory could also reverse and return to its pre-2014 levels.

Box 5: A macroeconomic journey to 2030

UNDP has tried to outline a long-term macroeconomic assessment to 2030 that is fundamental for economic stability as well as inclusive and accelerated growth. Macroeconomic stability is a vital precondition for inclusive growth and human development. Macroeconomic instability can place a heavy burden on the poor, especially when inflation is high or fiscal space is lacking for social programmes. Cross-country empirical work finds that the more equal a country's income distribution, the greater the impact of growth on the number of people in poverty.[52] In this context, policymakers need to define a set of macroeconomic objectives and produce fiscal, monetary and exchange rate policies that are consistent with these objectives. This paper articulates a mid case macro framework that would correspond to a 'basic' reform programme in sectoral and cross-cutting areas. The key elements of such a macro framework are described below.

Overall

- **The external economic environment** is expected to remain subdued and to return to pre-COVID-19 conditions only around the middle of the decade.
- Following the 2 November 2022 signing of the peace agreement in Pretoria, ending the conflict in the north, the **domestic outlook** will improve. Implementing the agreement will help address fiscal problems and support a resumption of external financing.
- Similar to the situation in 1991, **macroeconomic policies** will initially have to focus on addressing existing imbalances. These policies will need to be complemented by a strong commitment to, and progress towards, structural reform to allow the private sector to become the growth engine later in the decade.
- The **savings-to-GDP ratio** is expected to increase to 28 percent, while **investment-to-GDP** is expected to reach 30 percent. **TFP** is expected to reverse its decline.

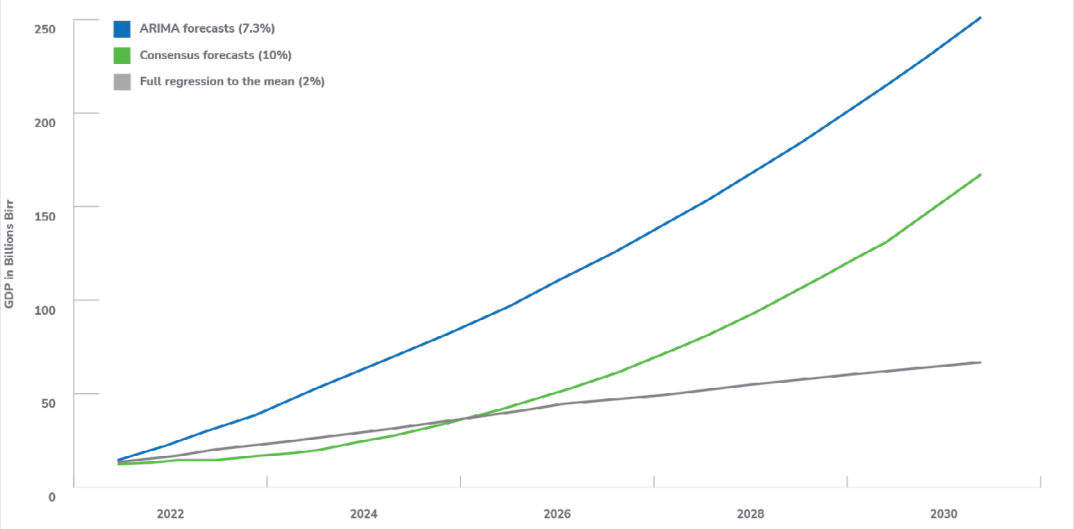
Internal balances

- **Growth** is projected to increase gradually during the period 2022/2023-2024/2025 based on an adjustment effort, and to stabilize at a high level of between 7-8 percent annually during the second half of the decade. This projection shows considerably lower growth rates than anticipated under the TYDP. However, it can still be considered optimistic because by the end of the decade, the Ethiopian economy would have grown at a rate comparable to the best performers in SSA over the period 2004-2019.
- **Inflation** is projected to decline after 2022-2023 as the international situation improves and the domestic liquidity overhang and monetary financing of the budget fall, declining to single digits by the middle of the decade.

51 Ministry of Planning and Development, IMF (2022).

52 Ravallion (1997).

Future growth trajectories for Ethiopia



Source: UNDP modelling projections

Fiscal situation

- **Fiscal projections** are based on the need to minimize domestic bank financing and external borrowing to reduce debt vulnerabilities. Domestic financing is thus projected at around 1 percent of GDP for all years except 2022-2023. This amount is expected to be raised from non-bank sources without fuelling inflation further. These projections allow for a small annual increase in (concessional) external financing.
- **The monetary projections are based on the need to raise international reserves**. Under this framework, gross official reserves are targeted to rise from one month of imports coverage in 2021-2022 to two months' coverage in 2022-2023, and gradually thereafter to three months' coverage by the middle of the decade and 3.5 months by its end.
- **The revenue projections assume a return to a more normal revenue effort by 2023-2024**. Revenues averaged more than 13 percent of GDP during 2003-2004 to 2015-2016, before starting a gradual decline to 11 percent by 2020-2021, followed by a very sharp drop to almost 7 percent in 2021-2022. Starting in 2023-2024, reform measures are assumed to be implemented to strengthen revenue collection. This would gradually raise the revenue-to-GDP ratio from 10.5 percent in 2023-2024 to 12.3 percent by 2029-2030.

External balances

- **The external current account deficit** is projected to further increase in 2022-2023 but to decline thereafter and stabilize below 3 percent of GDP in the second half of the decade.
- **The balance of payments projection shows considerable financing gaps during the period 2022-2023 to 2029-2030**. Reflecting the projected developments on the current and capital accounts, the overall balance of the balance of payments is projected to remain at considerable deficit throughout the period of the TYDP.
- **In the projections, government external debt** declines from an estimated 31.4 percent of (dollar) GDP in 2021-2022 to less than 25 percent by the end of the decade.[53] Total debt, including domestic debt, however, would not be expected to change substantially from the current level. The government may also benefit from debt relief under the Common Framework.

53 The government should develop a clear debt strategy aimed at maintaining debt sustainability and anchor the budget against the targeted debt limit derived from that strategy.

Box 6: Data Underpinning Ethiopia's Journey to a More Promising Future

Fiscal projections 2019-2030 (percent of GDP)

	18/19	19/20	20/21	21/22	22/23	23/24	24/25	25/26	26/27	27/28	28/29	29/30
				Estm.	Projections							
Revenue and grants	12.8	11.7	11.0	7.3	7.3	11.3	11.6	11.9	12.2	12.5	12.8	13.1
Revenue	11.5	10.5	10.2	6.9	6.9	10.5	10.8	11.1	11.4	11.7	12.0	12.3
Grants	1.2	1.2	0.8	0.4	0.4	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Expenditure	15.3	14.5	13.8	9.6	7.8	12.4	11.9	13.3	13.6	13.9	14.3	14.6
Overall deficit (inc. grants)	-2.5	-2.8	-2.8	-2.3	-0.5	-1.0	-0.2	-1.4	-1.4	-1.4	-1.5	-1.5
Financing	2.5	2.8	2.8	2.3	0.5	1.0	0.2	1.4	1.4	1.4	1.5	1.5
External financing (net)	1.3	1.8	0.5	0.0	-0.2	0.0	-0.8	0.4	0.4	0.4	0.5	0.5
Domestic financing (net)	1.3	1.2	2.5	4.0	0.7	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Residual/financing gap	-0.1	-0.2	-0.2	-1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:												
General government debt	29.6	28.2	29.9	31.4	31.8	32.8	32.8	30.8	29.1	27.4	26.0	24.7
External	16.6	16.7	17.5	16.7	16.4	16.3	15.3	14.0	12.8	11.8	10.8	10.1
Domestic	13.0	11.5	12.4	14.7	15.4	16.5	17.5	16.8	16.2	15.7	15.2	14.7

Balance of payments projections 2019-2030 (in percent of GDP)

	18/19	19/20	20/21	21/22	22/23	23/24	24/25	25/26	26/27	27/28	28/29	29/30
				Estm.	Projections							
Trade balance	-12.9	-10.1	-9.6	-12.3	-12.4	-10.9	-10.6	-10.4	-10.3	-10.3	-10.3	-10.4
Exports	2.8	2.8	3.2	3.6	4.1	4.2	4.5	4.3	4.2	4.0	3.9	3.8
Imports	15.7	12.9	12.8	15.9	16.4	15.1	15.1	14.7	14.4	14.3	14.3	14.2
Services account	-0.6	-0.2	0.0	0.5	0.6	0.7	0.8	0.8	0.8	0.8	0.8	0.7
Private transfers	6.2	4.8	5.5	6.6	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Official transfers	2.2	1.4	1.2	1.0	0.4	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Current account	-5.1	-4.1	-2.9	-4.2	-5.4	-3.4	-3.0	-2.8	-2.7	-2.7	-2.8	-2.9
Capital account	4.2	3.3	3.1	2.3	1.4	1.7	0.5	1.6	1.7	1.8	1.8	2.1
Official long-term capital (net)	1.7	2.4	0.8	0.4	-0.2	0.0	-0.8	0.4	0.4	0.4	0.5	0.5
Other public long-term capital	-0.3	-0.7	-0.8	-0.9	-1.1	-1.0	-1.4	-1.3	-0.9	-0.7	-0.5	0.0
Foreign direct investment	3.1	2.2	3.6	2.9	2.8	2.8	2.8	2.7	2.3	2.1	1.9	1.7
Other capital account	-0.4	-0.7	-0.4	-0.1	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Overall balance	-1.0	-0.8	0.3	-1.9	-4.0	-1.7	-2.5	-1.2	-1.0	-0.9	-0.9	-0.8
Financing gap					-5.4	-2.1	-3.1	-1.5	-1.4	-1.4	-1.4	-1.3
Gross official reserves (in months of imports)	2.7	2.8	2.4	1.0	2.0	2.5	3.0	3.1	3.2	3.3	3.4	3.5

Source: National Bank of Ethiopia and team estimates.

Of all the shocks that Ethiopia has endured in the past few years, the northern Ethiopia war has been the most devastating, followed by the outbreak of conflict in Ukraine[54]. The main direct impacts of domestic conflict include loss of lives, displacement, social crisis, damage to institutions and infrastructure, and deterioration of the twin deficits (fiscal and current account), depleting the reserves buffer. Indirectly, the war caused the IMF programme to expire and ODA to decline sharply, putting pressure on the exchange rate and leading to a decline in investment and slowing growth. **Shocks have also slowed, though not halted, the political and economic reforms that the country has been implementing for some time.**

Ethiopia, however, has significant potential to overcome these shocks and achieve a strong growth and development trajectory in the medium term. With a peace agreement in place to address the conflict in northern Ethiopia, **the time is right to look ahead and make bold reforms**.

The following **reform scenarios** peer into the future to offer three forecasts of what might happen ahead. This is strictly a thought experiment, without any predictive purpose or value. Rather, the aim is to help think through the implications of different pathways and improve the sensitivity or robustness of policies and investments to handle uncertainty and risk. What happens ultimately will depend on the choices Ethiopia makes, the stance and actions of its partners, the global and sub-regional context and the evolution of the climate emergency.

Best Case: Rapid Progress and Good Results – 'Promise Achieved'

- High level of trust, commitment and political will for effective implementation of the Pretoria Peace Agreement yields desired results, despite some challenges.
- Insecurity diminishes in other parts of the country.
- Ethiopia's humanitarian case load drops significantly.
- Mobilization and support for rehabilitation, recovery and reconstruction of the war-torn economy is high among the diaspora community, development partners and the private sector.
- Both domestic and external resource mobilization support the design and implementation of a second generation of reforms, including through the G20 Common Framework on debt restructuring and an IMF programme.
- Key reforms in health and education unfold to accelerate human development and poverty reduction.
- A revitalized industrial strategy gains traction, a green revolution takes root and financial services are transformed.
- Institutional development, including public service reform, proceeds apace.
- Ethiopia's political and civic space continues to evolve in a favourable direction for its ongoing democratic transition.
- Macro stability is restored and enables investment and growth. Buffers are built up to boost resilience to shocks.
- The benefits of liberalization and reform are shared broadly, costs (such as corruption) are kept under control, social capital is developed and social cohesion is reinforced.

54 UNDP, Crisis, Resilience and Opportunity: Poverty, Human Development and the Macroeconomy, 2020-23, Working Paper Series, No.1, October 2022.

- Internal and external conditions – commodity markets, investment flows and global growth – are generally facilitating, if not ideal. The politico-economic situation in the Horn of Africa stabilizes and, in some key respects, improves with growing cooperation and integration.
- Climate change effects are significant but not severe.

Middle Case: Progress but at an Uneven Pace with Significant Risks – 'Promise Delayed'

- Uneven implementation of the Pretoria Peace Agreement.
- Conflict hotspots remain a concern across parts of the country.
- Ethiopia's humanitarian case load remains at an elevated level.
- Economic reforms only partially address structural bottlenecks.
- Institutional reforms take place but are halting or incomplete.
- The democratic transition encounters challenges.
- Significant external financing constraints persist although they are not as severe as at present, with some limited progress on debt, ODA and FDI.
- The macro economy remains under stress, although it is less severe than at present.
- Vulnerability to shocks, internal or external, remains relatively high.
- The politico-economic situation in the Horn of Africa remains fragile with crises persisting.
- Climate change effects are significant and worsening.

Low Case: Progress is Limited, Major Risks Begin to Materialize – 'Promise Unrealized'

- The peace agreement falters.
- Significant threats to internal stability.
- Ethiopia's humanitarian case load rises substantially.
- Reform momentum falters.
- Institutional development is limited and falls well short of desired outcomes.
- Downside effects of liberalization, such as disparities and corruption, become serious.
- Macroeconomic uncertainty and unpredictability become chronic.
- External conditions are difficult almost across the board.
- The Horn of Africa experiences increased instability and remains the least integrated subregion in SSA.
- Climate change effects become acute and increasingly unmanageable.

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