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High Hopes and Limited Successes: Experimenting with Industrial Polices in the Leather Industry in Ethiopia

Girum Abebe* and Florian Schaefer**

Ethiopian Development Research Institute and
Department of Development Studies, SOAS
(University of London)

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Ethiopian Development Research Institute (EDRI)
P.O. Box 2479
Tel: 251-11-550-6066
Fax: 251-11-550-5588
Email: info@edri-eth.org
Website: <http://www.edri-eth.org>

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About the Author(s)

Girum Abebe: Ethiopian Development Research Institute

Florian Schaefer: Department of Development Studies, SOAS (University of London)

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Acronyms

CSA	Central Statistical Agency
DBE	Development Bank of Ethiopia
ERCA	Ethiopian Revenue and Customs Authority
ELIA	Ethiopian Leather Industries Association
ERHSSA	Ethiopian Raw Hides and Skins Suppliers Association
FDRE	Federal Democratic Republic of Ethiopia
GTP	Growth and Transformation Plan
IDS	Industry Development Strategy
LIDI	Leather Industry Development Institute
LLPTI	Leather and Leather Products Technology Institute
Mol	Ministry of Industry
MoT	Ministry of Trade
MoTI	Ministry of Trade and Industry
PASDEP	Plan for Accelerated and Sustained Development to End Poverty
UNIDO	United Nations Industrial Development Organization

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Abstract

In the presence of standardized production technology and the possibility of potentially unlimited market rendered by international trade, there is clear comparative advantages to be realized in experimenting with industrial policies in the leather industry in Ethiopia. This paper reviews wide arrays of policy interventions in the industry and, more modestly, attempts to link these interventions with the performance observed in the industry. We find that industrial policies in the leather sector have been largely effective driving strong growth. This growth, however, has not been in par with its potentials. Market problems along the supply-chain, liquidity constraint, limited processing and marketing capacity, inefficient regulations and enforcement capacity and coordination problem have culminated into below-potential levels of production and, hence, export earnings. We believe that, impressive results to date notwithstanding, important improvements still need to be made in terms of policy responsiveness and in ensuring growth is broad-based across relevant value chains. While building market institutions to bring down transactions costs will improve the effectiveness of industrial policies in the sector, policy makers should ensure that existing regulations are transparent, enforceable and do not impose undue burden on investments in the industry. Continuous channels of communication and information exchanges between the private sector and the regulatory organ would accelerate the understanding of constraints and their apt solutions.

JEL code: O25, L52, L67

Key Words: Industrial Policy, Leather, capacity, value chain, markets

1. Introduction

As early as the 1950s the Nobel Laureate economist Arthur Lewis (1955) claimed that 'No country has made economic progress without positive stimulus from intelligent government'. The roles governments assume in the economy have since been the source of heated debates among academics and policy makers alike. While many agree that the private sector is a driver of growth, there appears to have been little consensus on governments' ability to push the private sector to promoting growth and development; let alone on whether such interventions are necessary for industrial take-off. Proponents of neoliberal free-market policies argue that government interventions in the economy distort relative prices and therefore diminish the allocative efficiency of the economy overall. Based on this view they argue for a minimalist "night watchman" state which confines itself to setting the legal boundaries necessary for market interaction.

Yet both economic theory and historical evidence suggest that, with the right policies, governments in poor countries can systematically improve the welfare of their society through technological catch up and industrial upgrading. In fact, there have been almost no cases of successful structural transformation without strong government leadership (Chang, 2002). Given the ubiquity of market failures in developing economies, ranging from information externalities to high levels of transaction costs and co-ordination problems, many argue that government intervention in the allocation of productive resources is unavoidable (e.g., Lin & Chang, 2009). The presence of market failures of such magnitude would otherwise obstruct industries from being established in the first place, or else prevent them from taking off, even when established.

However the debate is wider than that. It is not clear that an economic analysis centered around the notion of market failures is especially useful to policy-makers in designing specific policy packages. Firstly, it is difficult to derive concrete policy recommendations from an analysis of market failures, as the exact locations and extent of market failures are difficult to pinpoint in practice (Rodrik, 2004). These problems become even more difficult when trying to identify ex ante market failures in markets - that is to say new industries - that do not even exist yet. Secondly, the concept of market failures continues to rely on underlying notions of general equilibrium, from which market failures are unfortunate but correctable departures. Belief in the existence of such a 'potential' equilibrium, which is attainable by 'correct' government action, confines the policy space available to developing country governments to only such actions that are defensible by recourse to the concept of market failures. Indeed, a close reading of the recent East Asian experience demonstrates the exceptional successes these states have enjoyed in bringing about the transformation of these economies, precisely by defying market based allocation in areas that go well beyond conventional notions of market failures (Amsden, 1989; Wade, 2004).

The Ethiopian government has therefore been very keen to discover how such industrial upgrading and structural transformation was possible in the span of only a few years. One insight that is gleaned from the East Asian experience is the importance of industrial policies to stimulate the formation and growth of profitable industries, which, in the absence of appropriate intervention, might not have happened¹. Since the inception of the first Industry Strategy Paper in 2002, the Ethiopian government has been actively promoting strategic

¹ In the economics literature there is no consensus as to what forms of government interventions and policies constitute industrial policy. Yet many, stretching back to Johnson (1982) and recently to Rodrik (2008) and Chandra, Lin and Wang (2012) agree that industrial policy spans several facets of public policy including an intricate web of public-private interactions. Direct or indirect, explicit or implicit government interventions and policy measures that are aimed at fostering industrial growth and competitiveness of industries thus fall under the realm of industrial policy. Noland and Pack (2002), for example, write that industrial policies include, but are not limited to, subsidized and long-term credit provision and credit rationing, differentiated tax, tariff and profit rates, barriers to firm entry and exit and subsidized provision of public utilities, such as electricity and water to selected sectors. Interestingly advanced economies, even when employing similar policies, rarely term these industrial policies (Lin, 2012).

sectors under the theme of an agricultural-led industrialization development policy (better known as Agricultural Development-led Industrialization, ADLI). The overarching focus of the strategy paper is to promote export-oriented and labor intensive industries in line with the country's current comparative advantage. It is clear that, textile and garment, food processing, floriculture and leather products have both production organizations and technological intensities that suit the labor abundant-capital scarce nature of the Ethiopian economy. These industries have continued to receive intense interest from policy makers as manifested by the two recent five-year national plans, "Plan for Accelerated and Sustained Development to End Poverty" (PASDEP) and "Growth and Transformation Plan" (GTP). Accordingly, several policy tools have been employed to attract and nurture investments in these areas.

Due to the availability of cheap raw materials including hides and skins as well as labor, the leather and leather products industry (LLPI hereafter) has been one of the sectors in which a range of industrial policies were introduced. This is because of the presence of wide ranging and mutually reinforcing problems at several stages of the leather value chain that have kept production volume and quality low (e.g. Altenburg, 2010). The government has thus devised policies to improve the supply and quality of raw materials and has sought to stabilize their prices. Efforts have also been made to upgrade the production facilities and techniques of leather processing units while attempting to improve the international marketability of leather products. In short, the government interventions in the industry range from the point of skin and hides collection to the leather production and marketing stages. These were problems that inhibit industrial transformation and growth of the LLPI and that the market, left to its own devices, cannot help overcome. Thus proactive state intervention were not only required, they are also now recognized to have brought about extensive progress in the leather industry.

Notwithstanding these interventions and recent successes in terms of improved export performance and employment, the potential for productivity growth, value addition and export revenue remains largely untapped². The industry is still fraught with supply side problems, limited and rudimentary processing capacity and technology, and weak marketing of leather and leather products. The regulatory environment also appears to suffer from inadequate oversight and enforcement capability. Incentives put in place to nurture existing investment and attract new ones appear to be abused in some instances, and are hardly accessible to others mainly due to bureaucratic and administrative barriers that undercut investors' willingness to take up the incentives. While there are platforms for information exchange and continuous learning in the industry, they are few and far between, and do not include major players in the industry, such as skins and hides traders.

The main objective of this paper is thus twofold. Firstly, we extensively review the existing policy landscape in the LLPI. More specifically, we provide a detailed account of industrial policy interventions and identify and profile key government institutions and sectoral associations in the industry. Due to the obvious absence of a counterfactual, an *attribution problem* arises in identifying the impacts (or lack thereof) of specific industrial policies on the overall performance of the industry. The limited size of the industry rules out quantitative methods of impact assessments as the required sample sizes are too large. With this limitation in mind, we attempt to identify possible outcomes associated with these interventions through in-depth semi-structured qualitative interviews. Secondly, we attempt to shed light on the main constraints that impede growth and structural transformation in the industry. In view of that, we draw policy implications and present recommendations to improve the performance of the industry. To our knowledge no systematic studies have been carried out to review and assess the policy interventions in specific sectors in Ethiopia (with

² For example, the GTP document set an export target for the leather and leather products industry amounting to \$206 million in 2011/12. The actual export figure stood at \$110.06 million in the same period, which is a mere 54% of the planned value.

the possible exception of Altenburg, 2010). Beyond contributions to the policy arena, we hope that the paper will add value to the academic literature on industrial development in low income economies on what works and what does not, and how to best design industrial policies^{3,4}. To this end we will compare the policies adopted on the LLPI with theoretical notions from the relevant literature which we lay out in Section 2.

The paper is based on both published documents and unpublished manuscripts that are gathered from a variety of relevant institutions, both in academia and policy circles. A desk review of relevant literature was then carried out. It was desired that the paper should be largely descriptive and thus mostly used figures and cited numbers using databases in the public domain. The report is also informed by a series of interviews we conducted with key players in the leather and leather products industry. We collected qualitative information from these respondents situated at various stages of the leather value chain. These included traders of hides and skins, managers and owners of tanneries and leather finishing enterprises. We have also met with the hides and skins traders association, the leather industries association and the Leather Industry Development Institute, a government institution responsible for the industry.

The structure of the paper is as follows. Section 2 lays out the conceptual framework. Section 3 presents a brief overview of the LLPI. Institutions involved in the LLPI, industrial policies introduced and outcomes observed in the LLPI are reviewed in detail in section 4. We identify the challenges and constraints faced by the industry in section 5, and, we attempt to address them in section 6. Section 7 offers a brief assessment of Ethiopian industrial policy and tries to situate it in light of the prevalent literature. The final section concludes this paper.

2. Conceptual framework

As we give a fuller account of debates around industrial policy in developing countries in a forthcoming paper on the development of such policies in Ethiopian cut flower, we limit our discussion here to what we call 'pragmatic' positions on industrial policies. By that we mean positions which accept the need for an interventionist state as a necessary condition of structural transformation. Debates within the 'pragmatic' field center around the appropriate *extent* of industrial policy, rather than rehashing the tired and false 'state vs. markets' dichotomy. We therefore neglect what we call the 'fundamentalist' position which rejects any state intervention in the economy as distortionary and denies the need for government involvement in bringing about structural transformation. The 'pragmatic' position on industrial policy can be further subdivided into two broad schools of thought: one which is based firmly on neoclassical economics and another which departs from these assumptions. The former maybe represented here by Rodrik (2004) and Lin (2012), while the latter can be found, for instance, in the work of Chang (2002, 2009, 2010). A key point of contention between the two camps is whether countries should follow their comparative advantage in choosing their industrial structure or attempt to defy it⁵.

Rodrik (ibid) makes a strong argument for interventionist government action based around the argument that processes of structural upgrading are characterized by a series of market failures which would lead to socially undesirable outcomes if capital allocation was left purely to market mechanisms. The two main areas where such market failures is in information externalities and in coordination failures, both concepts derived from neoclassical microeconomic theory. Information externalities are a necessary by-product of innovation,

³ While Pack and Westphal (1986) argue that the answer for "What are the determinants of industrial strategy under different circumstances" is not clear, in more recent paper Wade (2009), argues that we have still a lot to learn on how to design and make industrial policies more effective in developing countries.

⁴ We are also working on an accompanying research on the cut-flower industry, which is forthcoming.

⁵ See for instance the debate in Lin and Chang (2009) for a concise summary of both positions.

technological upgrading and industrial diversification (see also Lin, 2012). In a developing country potential entrepreneurs do not know if a particular good or service can be profitably produced in that country. Or to put it into Lin's (ibid) terminology, it is not clear to entrepreneurs ex ante if a country enjoys a (latent) comparative advantage in the production of a particular good or service. This information will only be revealed if entrepreneurs try to produce the good or service in question. Their success or failure will provide signals to the wider economy. The problem is the (semi-)public good nature of knowledge. Innovating entrepreneurs will face costs, both financial and otherwise, in discovering this information, but cannot reap the full benefits due to the public good character of knowledge, even while they face the full risk of failure inherent in being a first-mover (Rodrik, 2004). This situation is compounded in developing countries as their innovations and discoveries tend to lie inside the global technology frontier and therefore firms cannot be granted rent-bearing patents which would compensate them for the costs of generating this knowledge (Lin, 2012). In this situation a market-based allocation would lead to less-than-desirable entrepreneurial activity and there is an efficiency argument for states to compensate first-comer firms for the costs of generating socially-useful knowledge. Doing this will encourage firms to engage in the process of self-discovery that characterizes industrial upgrading (Hausmann & Rodrik, 2003).

A second area of market failures that prevent structural transformation is coordination problems (Rodrik 2004). This occurs when the profitability of an investment depends on other synchronic investments over which the investing firm has no control. Examples are economic clusters, which require minimum size thresholds to show productivity effects or infrastructure without which an investment project may not be viable. But constructing a new road, for instance, may be beyond the capacity of many private actors. There is then a case for governments to either make the necessary investments directly or to provide coordination mechanisms to ensure private actors make the necessary investments. Lin (2012) extends this argument by analytically separating 'hard' infrastructure, such as roads and airports, and 'soft' infrastructure, such as a functioning legal system, both of which may be subject to coordination problems requiring government action.

While this framework provides a theoretical case for government intervention, it is not yet clear in which sectors governments should intervene or how they should design the industrial structure of a country to generate growth. These issues are addressed by the 'new structural economics' promoted by Lin (2012), who was chief economist of the World Bank until June, 2012. New structural economics seeks to marry an explicit concern for structural transformation with strong foundations in neoclassical theory, the result being a framework which explicitly endorses government intervention in the economy as long as this intervention seeks to foster an industrial structure that is compatible with a country's current or existing comparative advantage.

The rationale underlying this framework is quite simple. To generate fast growth, and thereby create employment and reduce poverty, a country must build internationally competitive industries, as evidenced by the strong export-orientation of the East Asian Newly Industrialized Countries (NICs). Competitive companies will generate the greatest possible profits and therefore allow the fastest possible accumulation of capital. A given country's companies will only be competitive if the goods or services they offer are in line with the country's comparative advantage. The comparative advantage of a country is endogenously given by its factor endowments. The factor endowment here refers to land (incl. natural resources), labor, capital, as well as hard and soft infrastructure. The only way to ensure that companies choose activities that are in line with a country's endogenously given comparative advantage is if the relative prices of those factors reflect their relative scarcity. This in turn will only be the case in a competitive market framework without price distortions. As countries accumulate capital their factor endowments change, shifting relative prices, thereby inducing companies to move into different activities in line with the new comparative

advantage. These changes will tend to run from labor-abundant capital-scare endowment structures to ones that are labor-scare and capital-rich as countries develop towards advanced country status.

A government's job is then to ensure open market which will translate into relative prices that reflect relative factor scarcity and to step in to address market failures that will inevitably occur along the way. This explicitly activist role for government and the central concern with achieving structural change set new structural economics apart from earlier currents of neoclassical thought, while its insistence on open markets and an industrial structure that is at all times in line with comparative advantage differentiate it from older structuralist⁶ ideas in development economics. Historical failures of industrial policies can be explained as resulting from governments trying to create industrial structures that were not in line with comparative advantage.

While intuitively appealing in its diagrammatic simplicity, new structural economics suffers from several serious shortcomings. Firstly, beyond the rather mechanistic sketches outlined above, it offers no mechanism of how industrial upgrading happens 'on the ground'. Historically, industrialization and structural change have often been accompanied by social upheavals, conflict and dislocation on sometimes frightening scales, a reality which is rather blithely overlooked by Lin. Rather he presents upgrading as a seemingly frictionless process of firms shifting activities according to changing factor endowments. No theory is offered to explain how this occurs at firm level either. Secondly, and perhaps more seriously, Lin presents as evidence for his approach exactly those countries which in-depth case studies have shown to have been involved in heavily distortionary practices, ranging from outright protectionism to various forms of "picking winners" often in industries far out of line with current comparative advantage (Amsden, 2001; Chang, 2002; Lin and Chang, 2009; Wade, 2004)⁷. Amsden (ibid) famously insisted that the key to South Korea's success was "getting the prices wrong".

Based on such historical evidence heterodox thinkers argue that countries must defy their current comparative advantage if they are to change their position in the global division and catch up with advanced economies (Chang, 2009, 2010). To do this they must manipulate the structure of relative prices and protect infant industries to allow them to take off⁸. Such protection and intervention must be carefully designed to incentivize companies to constantly increase productivity and should be withdrawn when companies are internationally competitive. We will show in the following that while the Ethiopian government's support to the LLPI is indeed in line with Ethiopia's current comparative advantage and the choice of sector clearly conforms closely to Lin's (2012) ideas about choosing industries in line with current factor endowments. Following this choice though, the government has employed a pragmatic mix of both conventional and unconventional policies, some of which clearly contradict neoclassical notions of market-conforming policies.

3. The Leather and Leather Products Industry in Ethiopia

"Our strategy is to produce finished leather and leather products both for export and local market" Prime Minister Meles Zenawi (2006)

⁶ Structuralist ideas, which were prominent in the early days of development economics and contributed greatly to its emergence as a separate discipline, evolved around the necessity to achieve structural transformation of the economy and sought to remove barriers to this goal. Heavy state intervention in the economy seems as a necessary condition for overcoming barriers to structural transformation and economic growth. At ECLAC these ideas were extended to include barriers to transformation based in the structures of international economic interconnections. The neoclassical counterrevolution beginning in the 1980s lost view of the goal of structural transformation focusing instead on market efficiency, which was supposed to be achieved with minimal or no government intervention in free market systems.

⁷ Even more strangely, Lin (2012) actually cites these case studies without noting any contradiction.

⁸ Lin (2012) does make some, carefully framed, allowances for protection in cases where countries have developed industrial structures that are out of line with comparative advantage, so as to ease the social cost of transition.

3.1. Overview

Ethiopia is generously endowed with livestock resources. Its cattle population of more than 53 million, along with sheep and goat populations of 25.5 and 24.1 million, respectively, put the country first in Africa (CSA, 2013). With an annual off-take rate of nearly 10% for cattle, 33% for sheep and 38% for goats, the country is endowed with enormous potential for cheap supply of skins and hides. There is a clear recognition of this potential by policy makers in Ethiopia as indicated by the Growth and Transformation Plan (GTP)⁹ and several other national plans that preceded it. In the GTP document, the leather and leather products industry is one of the priority industries that is expected to contribute considerably to export diversification and foreign exchange earnings through greater value addition and productivity improvement (FDRE, 2010).

The leather sector is composed of raw hides and skins traders, leather tanneries, which source their supply mostly from the local market, and footwear producers, who use both local and international markets for raw material supply. The most important source of raw material for leather tanneries are hides and skins that are procured from skin collectors and traders. Larger tanneries that are fitted with machines and equipment to produce leather products higher up in the leather value chain buy semi-processed leather products from other tanneries. The industry produces a variety of types of finished leather, both for domestic use and for export, and leather products, amongst which the most prominent is footwear. More often than not, the footwear sector relies on imports for accessories, such as soles and laces. The largest component of raw material by both value and volume is, however, processed leather that is mostly obtained from local tanneries. Annex 1 describes products and participants at various stages of the leather value chain.

The leather and leather products industry has multiple linkages to the wider rural economy. It is also highly labor intensive in the raw material sourcing, transportation, processing and marketing phases. The industry thus possesses an enormous potential to create much needed non-agricultural employment, and looks set to play an important role in poverty reduction. Yet this potential has remained largely unexploited. In the presence of far reaching structural problems unique to the leather sector, ranging from ad hoc hide and skin collection systems to poor marketing infrastructure, it is not immediately clear whether the sector would take off without proper policy support.

3.2. The history of the LLPI in Ethiopia

Ethiopia has a long history of handcrafting and blacksmithing. The leather soaking and tanning industry emerged with the establishment of the then ASCO tannery (the current Addis Ababa Tannery) in 1918 and Darmar/Awash (currently ELICO) tannery by Armenian traders in 1927 (Mahmud, 2000). In the subsequent years, several local tanneries, such as Dire, Modjo and Combolcha were set up. Yet hides and skins trading systems remained largely traditional and inefficient, with quality and quantity ramifications on the raw materials supplied to these tanneries. Recognizing these problems, the government set up the Livestock and Meat Board (LMB) in 1964 by proclamation No.212/64 to improve the collection, preservation and trading of hides and skins (Mahmud, 2000). The LMB attempted to enhance the quality of raw hides and skins through technical assistance to skins and hides collectors including the preparation of manuals on hides and skins preservation and dispatching of trainers to different parts of the country where hides and skins is collected in large quantities. Government intervention also involved the introduction of hides and skins regulations and differential price systems whereby properly preserved hides and skins would command higher prices with the intent of driving out low quality skins and hides from the

⁹ GTP is a plan initiated by the Ethiopian government and developed in consultation with the private sector, and the public at large. The plan's main objective is to sustain the high and broad-based economic growth trajectory the country enjoyed from 2003-2010 with the aim of reducing poverty and ensuring high standard of living.

market. LMB was also involved in setting up market centers in different provinces as well in appraising and monitoring the erection of slaughterhouses (Mahmud, 2000).

The emergency of the modern leather processing industry also dates back to the 1930s, a period associated with the establishments of two shoe factories, Tikure Abbay and Anbessa, by Armenian merchants (Sonobe et al., 2009). Spin-offs from these pioneers were crucial in the spread of the shoemaking business. Despite the huge resource potential, however, commercialization of both finished leather and leather products was extremely slow and uneven, and consequently both production and exports of leather products have remained disappointingly low for several decades.

In the 1950s and the 1960s, for example, leather and leather goods production were small in volume and largely targeted the local market (Loop, 2003). Following the collapse of the imperial regime and its replacement by the state-socialist Derg regime in 1974, all private tanneries were nationalized. The government subsequently established the National Leather and Shoe Corporation, which assumed the responsibility of managing eight tanneries and six shoe factories. In 1986, the socialist regime banned the export of raw hides and skin in an attempt to encourage the domestic production of semi-processed leather articles. This ban radically altered the marketing structure of hides and skins by restricting exports to at least the wet-blue level. While the ban might have forced hide and skin traders to sell directly to tanneries for processing, it has also encouraged illegal cross-border trade in both live animals and hides and skins. It is by now evident that the ban had a limited impact in improving the local leather tanning and leather goods manufacturing capacity. For example, there were only about 6,000 jobs in large-scale tanning and manufacturing of leather products, such as footwear, luggage and handbags when the Derg regime was unseated in 1991 (CSA, 1994).

In the 1990s, the privatization policy adopted by the EPRDF government implied that all state-owned (SOEs) tanneries were auctioned off. The liberalization policy also allowed for the flourishing of private tanneries, leather garment and leather goods manufacturing industries. In the footwear sector, for example, the newly established private companies were able to quickly match the production capacity of the then existing large SOEs (some were privatized latter) in early 2000s (Sonobe, Akoten, & Otsuka, 2009)¹⁰. In 2008, there were 21 tanneries in Ethiopia with a combined tanning capacity of 4,000 pieces of hides and 30,000 pieces of skins per day. There are now 26 tanneries and more than 15 large export-oriented footwear producers and an untold number of micro and small shoemakers in Ethiopia. The tanneries have a combined tanning capacity of more than 170,000 pieces of skins and hides per day, and footwear producers can produce more than 20,000 pairs of shoes per day. By some estimates, the current annual capacity utilization of these tanneries is about 17 million pieces of skins and hides implying less than 50 % of full capacity.

Despite its long pedigree, the leather products industry has been struggling with limited processing capacity that explains not just the inability of local leather goods producers to penetrate the export market, but also their failure to withstand competition from imports once the economy was liberalized in 1991. Following the liberalization policy of the current regime, for example, the leather footwear sector was inundated with cheap foreign imports in the late 1990s. Perhaps not surprisingly, this had the immediate effect of driving out many footwear producers 'plunging the sector into a slump' in the early 2000s (Sonobe, Akoten, & Otsuka, 2009). Helped by improved local capability and effective industrial policies, the sector has since then registered impressive growth that enabled it to reclaim some of the domestic market and even successfully venture into the export market. In the process, several

¹⁰ Tikur Abay shoe factory was one of the oldest and largest shoe factories (SOEs) in the country that was established in 1927. It was acquired by a Saudi-born Ethiopian business mogul, Sheikh Mohammed Ali Al-Amoudi, with 60 % of the company's ownership, in 2006.

enterprises improved the quality, design and durability of their products by learning from their foreign-based trading partners. While the credit largely goes to the perseverance and resourcefulness of entrepreneurs, the role government policies played in restructuring leather and leather goods production and marketing cannot be overestimated. The next subsection presents the feature of industrial policies that were initiated to promote the LLPI.

4. Institutions, Industrial Policy and Performance in the LLPI

4.1. Institutions in the LLPI

Owing to its basic configuration, regulation of the LLPI is diffused across several institutions. The major institutions involved in different facets of the industry with ministerial portfolios include the Ministry of Agriculture, Ministry of Trade, Ministry of Industry and the Ethiopian Revenue and Customs Authority. The National Bank of Ethiopia is an important non-ministerial institution that is also involved in the sector. In addition to the leather industry, line ministries and authorities are responsible for regulation, monitoring and management of a wide array of other sectors and industries. In the interests of brevity and focus, we deal only with institutions whose major responsibility lies within the scope of the LLPI. These are the two sector associations, which represent private business interests of tanneries and producers, and of skin and hide traders, respectively, and the Leather Industry Development Institute, which is the government institution charged with providing technical assistance and formulating policy for the leather sector.

The Ethiopian Leather Industries Association (ELIA) is a business association representing diverse segments of the leather industry. In 1994, eight years before the industry strategy paper (IDS) was made public, the Ethiopian government helped organize six state-owned and two privately held companies to form the Ethiopian Tanners Association, which was later renamed ELIA in 2007. The establishment of this association was a first step to properly organize the markets for semi-processed leather and leather articles. Members of the association mainly produce wet blue, crust and finished leather products from sheep and goat skins. Today ELIA integrates privately owned tanneries, footwear, and leather garment and goods producers with the objective of initiating and coordinating capacity building activities through training programs, panel discussion and pilot project developments. ELIA, in partnership with the Ministry of Industry (Mol), also coordinates international trade fairs and organizes the All African Leather Fair (AALF) which has been hosted in Ethiopia every year since 2008. ELIA also provides marketing information to its customers and lobby the government on behalf of its members. The association now encompasses the largest 47 leather goods producers as members.

Another milestone in the government's effort to promote the leather sector is the setting up of the Leather and Leather Products Technology Institute (LLPTI) in 1998. In 2010, the mandate of LLPTI was significantly expanded and it was made the most important institute responsible for the development of the leather industry under the Mol, and hence, was renamed as the Leather Industry Development Institute (LIDI). The rationale for setting up LIDI was threefold. First, the institute is to act as a conduit for the absorption, improvement and diffusion of technologies in the leather and leather products industry. By working closely with tanneries and footwear manufacturers, the institute is tasked with conducting practical technology training that helps spread improved practices across the sector. LIDI assists in the preparation of investors' profile, conducting feasibility studies (from tanneries to shoemakers), helps with technology selection and then gives technical support up to and including machine erection and commissioning. Once installation is completed, LIDI provides high quality consultancy and training services in various technical and managerial skills relevant to the industry, "such as branding and marketing, effluent management and laboratory testing of quality parameters" (Altenburg, 2010).

Second, LIDI is expected to enhance the competitiveness of the leather industry by undertaking benchmarking studies and by introducing global excellence standards to domestic producers. LIDI's Quality Testing and Approval Laboratory is used not only to assess the quality and comfort of shoes produced but also to detect the presence of banned chemicals in the shoes. Third, LIDI conducts market research, looks at bi- and multilateral trade agreements to facilitate market entry into different and differentiated markets, and passes the information on to manufacturers.

Since the early 2000s the government has also placed emphasis on capacity building within LIDI itself. Several projects were designed in collaboration with international donors to enhance the capacity of LIDI. For example, from 2005 to 2008, foreign experts were invited to improve and strengthen the basic training programs offered by LIDI, by adapting the training manuals to international standards and best practice. LIDI's leather quality-testing laboratory has also received strong assistance from partners including UNIDO. More recently, LIDI is engaged in in-house capacity building through high-level training of its staff abroad.

Beyond these 'traditional' avenues of industrial promotion LIDI also plays a very interesting role in directly assisting firms to meet contractual obligations to overseas trading partners by offering production and design services directly to companies. LIDI's sizeable premises encompass an industrial-scale tannery, as well as a state-of the-art design studio, fully equipped to work with CAD and CAM. While ostensibly used for training and demonstration purposes, these facilities are placed at the disposal of Ethiopian tanneries and leather goods producers to help them meet delivery times in the case of production bottlenecks. These services are offered at nominal cost and appear to be widely used within the sector.

Unlike their private sector counterparts further along the value chain, skin and hides traders have, until very recently, been notable for their lack of organized representation which has surely confounded some of the coordination issues confronting this part of the sector. Realizing the benefits of collective bargaining, a group of traders gathered to establish the Ethiopian Raw Hides and Skins Suppliers Association (ERHSSA) in late 2012. ERHSSA is hoped to represent the interest of traders in dealing with various stakeholders in the LLPI. Traders also consider this as an invaluable instrument to "get their voice heard" when new rules and regulations affecting the trading of skins and hides are introduced. As any sectoral association, ERHSSA also seeks to lobby the government on behalf of its members for favorable policy treatments¹¹.

4.2. Industrial Policy in the LLPI

In addition to overall economic liberalization, the Ethiopian government has introduced several business friendly policies since the early 1990s. Investors are for example granted customs duty exemption, where import of capital goods and construction materials is completely exempted from import duty. Customs duty draw backs are also available for those who import raw materials and packaging supplies for processing exportable goods. To promote exports in the manufacturing sectors a voucher scheme and bonded manufacturing warehouse facilities were introduced in 2001¹². There is also a provision for income tax

¹¹ Since this institute is very new, we are not able to evaluate its accomplishments to date.

¹² The 'Export Trade Incentive Scheme Establishing Proclamation' enacted in July 2001 introduced these two schemes along with a range of other incentives. Investors engaged in the manufacturing sector with export licenses are eligible for the voucher scheme, and those who are wholly engaged in the exporting of their products but are not eligible for the Voucher Scheme can apply for the bonded warehouse facilities. The voucher scheme allows the investors to deposit the voucher with customs authorities and customs formalities to be carried out after raw materials (imported for producing exportable commodities) are kept in the private warehouse of the investor in the production site. This, while saving time on customs clearance procedures, enables duty free import and use of raw materials. Similarly, the Bonded Warehouse Facility provides duty free privileges for raw materials used for manufacturing exportable commodities and allows customs clearance activities to be carried out at the

exemptions ranging from 2 to 8 years depending on the area of investment, export volume and investment location. Investors are also allowed to forward losses incurred during the tax break period for half of the income tax exemption period.

All these are non-discriminatory general incentives that are available to all investors irrespective of the investment sector and the nationality of the investor. In addition to these incentives, there have been several other policy measures and direct government interventions to promote industrial upgrading and value addition in the LLPI specifically. These are motivated by the presence of huge exploitable potentials in the industry as manifested by the gap between the livestock resource base of the country and leather goods production. Further, the natural quality of Ethiopian leather, notably sheep skin, is especially distinguished and these skins are sought after in the international market for the production of high quality footwear, bags, cases, gloves and other leather articles.

The very first act of recognition of these potentials was marked by the government's decision to accord a priority sector status to the LLPI in the export promotion strategy drafted in 1998 and in the Industrial Development Strategy (IDS) in 2002. As the result, as in other priority sectors, the government strongly encourages investment in the leather and leather products industry. While specific policy menus were not articulated in these strategy papers, they broadly emphasized the need to work on problems associated with hide and skin production, collection and processing. The overall aim is the creation of a fully vertically integrated sector from slaughter to the export of high-quality leather goods. The sector is part of a wider push, which includes cut flowers for instance, to widen and deepen exports with the ultimate goal of generating sufficient foreign exchange to fund ongoing large-scale development projects in other sectors.

There are several interrelated problems that seem to explain the underperformance of the sector and especially its disappointing export performance. Two problems appear to be common in the input supply of the sector. First, the quality of skins and hides used in leather manufacturing is affected by the presence of parasitic skin diseases. This has reduced both supply and quality of raw materials that are crucial for the production of footwear and other leather goods. Second, commonly used traditional livestock husbandry practices including flaying, branding and curing greatly deteriorate the quality of skin and hides. These practices, combined with rudimentary post-mortem management of skins and hides including backyard slaughtering, poor and unorganized skin and hides collection, and sub-standard storage and transportation systems, result in both lower quality and an overall shortage of the raw materials required for leather processing. For example, 90% of sheep and goats and 70% cattle slaughtering is carried out traditionally in the backyard of residential and farming units (UNIDO, 2012). As the result, nearly 30% of hides and skins delivered to tanneries are rejected owing to poor quality (Bekele & Gezahegn, 2008). These problems are further compounded by the unorganized supply of skin and hides. Downstream, in the processing stage, challenges include, but are not limited to, rudimentary technology, insufficient capital, lack of skilled manpower and marketing.

Given that the production technology is standardized and markets are well-established, the leather industry can expand by solving these problems at various stages of the leather value chain. This in turn requires the coordination of several activities to upgrade skins and hides collection systems upstream and processing downstream. No private entity, however, has the capacity to simultaneously overcome these problems that appear at multiple stages of leather value chain, at least in the context of Ethiopia (Altenburg, 2010). Without the active involvement of the state, it is not clear that there is adequate private incentive or ability to improve the leather supply chain, which would involve properly reorganizing the livestock

warehouse of the investor. This requires the physical presence of a Customs officer whenever raw materials are removed from the warehouse for production.

sector and the leather manufacturing sector as well as several intermediary stages between the two. Recognizing the need for better coordination of the skins-to-leather value chain to exploit the potentials provided by the leather resource base, the government of Ethiopia has initiated several interventions. Since the drafting of Industrial Strategy Paper, the government has been actively trying to remove barriers that have stymied the growth of the leather industry.

To partly overcome problems associated with supply-side issues, the industry strategy paper had stressed the importance of collective slaughtering and skin gathering to enhance supplies of raw skin and hides at reasonable prices whilst improving overall quality. This was concertized by the 'Raw Hide and Skin Marketing System Proclamation No. 457/2005', which was ratified in the hope of disciplining and modernizing the market for raw hide and skin. In the processing stage, the industry strategy paper signaled that the government would be actively involved in establishing modern slaughter houses, improving the capacity utilization of tanneries and the skills of workers involved at various stages of leather processing.

Perhaps the second most influential strategy paper from the leather industry's point of view was a Master Plan prepared by UNIDO in collaboration with the then Ministry of Trade and Industry (MoTI, now MoI). In 2005 MoTI requested UNIDO to prepare "A Strategic Action Plan for the Development of the Ethiopian Leather and Leather Products Industry". This request resulted in two documents, a "Master Plan" and a "Business Plan" (UNIDO, 2012). The "Master Plan" emphasized the need for the tanning industry to continuously improve its value addition and improve the quality of its products to supply higher quality inputs to the leather goods industry, including the footwear sector. The "Master Plan" also introduced technical benchmarking of the Ethiopian leather and leather product industry against four countries with more technically advanced leather industries, namely Italy, China, Vietnam and India.

Drawing on the "Master Plan", the Ministry prepared a concrete action plan which mainly consisted of upgrading programs for tanneries and footwear producers. The Ministry has carried out several projects in partnership with UNIDO and other international donors to put into effect the capacity building and competitiveness programs articulated in the plan. Of these the 'Made in Ethiopia Project' that introduced "Taytu", the first luxury designer label to originate from Ethiopia, to the high-end European and American markets, has been a notable success.

The government's intervention in the leather sector was however not confined to large tanneries and footwear producers. There are more than 2,000 micro and small shoe makers clustered around Mercato area in Addis Ababa, where a plethora of shoe producers, parts suppliers, accessories retailers, machining and equipment service providers and product outlets are concentrated. Most of these enterprises lack proper business premises and are forced to operate out of small rented cribs in the back alleys of businesses and residential houses in the Mercato area. The government responded to this lack of both retail and production space, by offering fully constructed production sites at highly subsidized rental rates. A prominent example is the integrated shoe cluster development in six blocks of 4-story buildings situated in Yeka sub city, in Addis Ababa. These premises now house the Ethio-International Footwear Cluster Cooperative Society (EIFCCOS), the most important association of micro, small and medium shoemakers, which has more than 1000 members. This was a joint initiative by the government and an Ethiopian entrepreneur, who now is the chairman of the society, to unify the intermediate stages of shoemaking process in a modern cluster to exploit benefits from agglomeration economies.

In 2009, the Ministry of Trade and Industry, in collaboration with UNIDO, designed a project entitled 'Technical Assistance Project for the Up-grading of the Ethiopian Leather and

Leather Products Industry” to be implemented by UNIDO experts by 2012. This involved “a wide range of technical assistance from production layout to management and marketing” (UNIDO, 2012). The government has also adopted a benchmarking exercise to upgrade the leather and leather products industry. To this effect, the LIDI entered into a twinning arrangement with the Central Leather Research Institute (CLRI) and the Footwear Design and Development Institute (FDDI) of India for the practical execution of the benchmarking exercises at factory level. The government selected seven tanneries and seven footwear producers to implement UNIDO’s initial benchmarking study recommendations. This is an ongoing program which is yet to be evaluated.

4.3. More explicit interventions and outcomes in the LLPI

The government’s objective with respect to the leather sector appears to be the maximization of export earnings, which involves the highest possible domestic value addition at each stage of leather processing, i.e. transforming leather production from unprocessed hide and skin to wet-blue and then to crust in the short run and finally to finished leather products for the export market in the long run. To this effect, there have been several direct interventions in the leather sector. Figure 1 shows the time line of important events in the leather industry. Overall the sector has achieved strong growth on a variety of measures but remains severely below target. The low levels of capacity utilization and barely tapped potential for technological and organizational upgrading across the sector indicate the potential for faster growth in the future.

To begin with, the government has long banned the export of raw hides and skins to improve domestic value addition in the sector and enhance supply to the local industry. Recently the government has considered banning the export of crusted leather in December, 2011. Instead, however, the government levied a 150 percent tax on the export of crusted leather in April, 2012¹³. There was heavy opposition to the tax both from international buyers and from Ethiopian tanneries. International buyers viewed, and often still view, Ethiopia as a supplier of raw or intermediate stages of leather products and were loath to grant Ethiopia a higher share of the surplus created along the value chain. As a result some buyers even lobbied their government to raise the tax issue in the ongoing set of negotiations around Ethiopia’s membership bid at the WTO. The international opposition was overcome through persistent advocacy and repeated explanation of Ethiopia’s position. An important feature contributing to the success of such direct forms of interventions is that they, unlike many other regulatory measures taken in Ethiopia, did not take the private sector by surprise, as the government had announced its intentions in advance, long before this policy came into effect. For example, the government’s desire to tax the export of crusted leather “to discourage those who do not upgrade” was apparent as early as 2005 (Zenawi 2006).

These and a number of other government initiatives have greatly contributed to the solid growth of the leather and leather products industry in Ethiopia. For example, regular exports of leather footwear began with small volumes of export to Italian buyers in 2004/05. In the same year, total export revenue from the exports of leather footwear were worth less than half a million USD. Three years later, export earnings had increased nearly 20-fold to 8.1 million USD. By 2012 export earnings from footwear had reached more than 11 million USD. Export earnings from the leather and leather products industry in general have also steadily increased from 67 million USD in 2004/05 to USD 104 million in 2010/11 (see Figure 2). Correspondingly, formal employment has substantially increased from 7,900 in 2004/05 to more than 14,100 in 2010/11 (CSA 2006 and 2012). Recent data also shows that in the first eight months of this fiscal year (2012/13), export earnings from processed leather stood at

¹³ A year before that the Ministry of Industry had put a cap on market price of hides and skins at 47 birr and 80 birr respectively after prices rose steeply following the Ethiopian Easter

more than 66 million USD and close to 14 million USD from the export of footwear and gloves and other leather articles.

Figure 1. Time line of important events in the leather industry

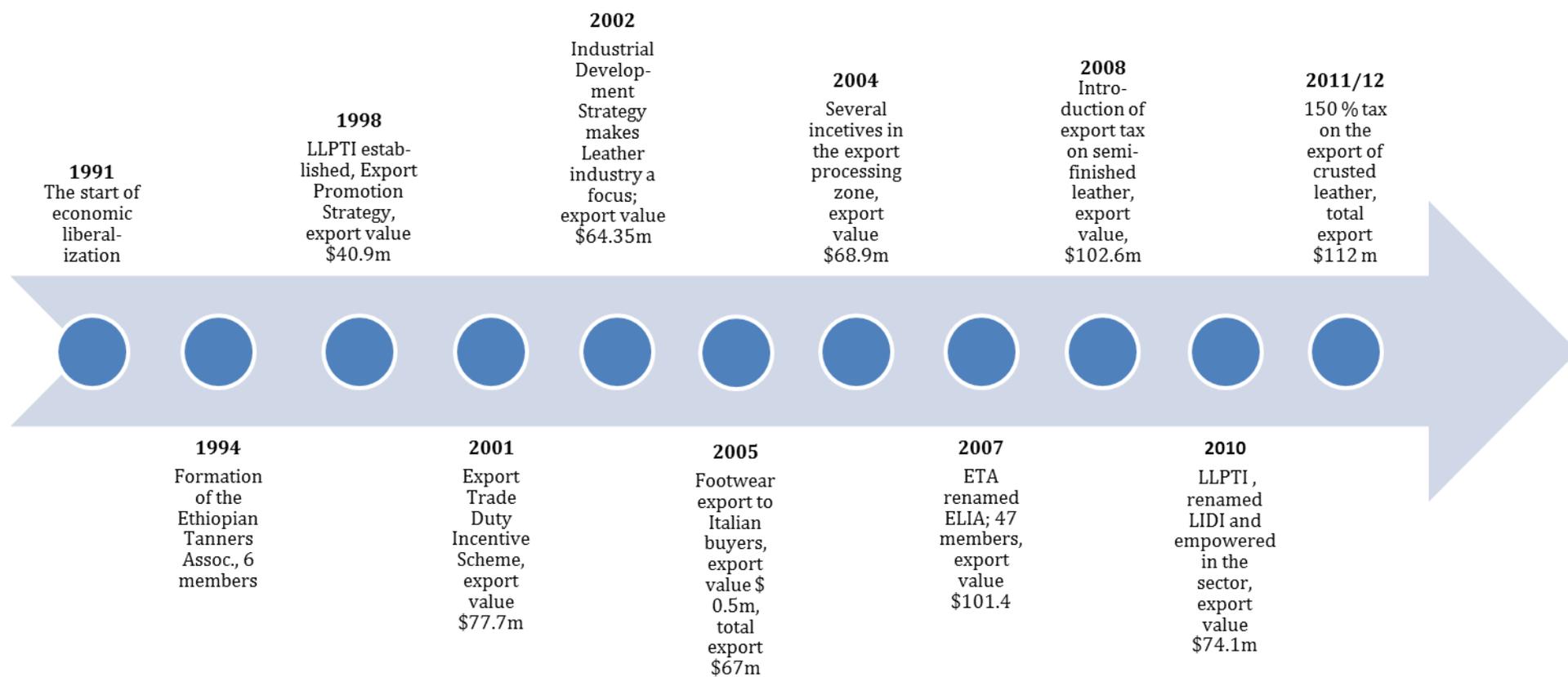
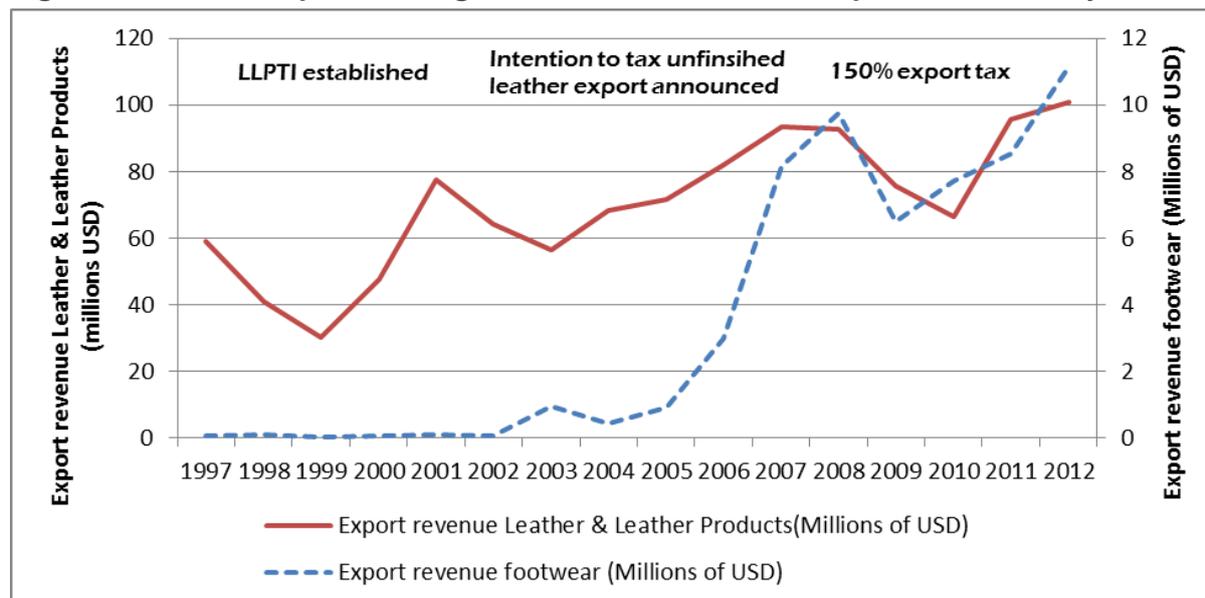


Figure 2. Trend in export earnings in the leather and leather products industry

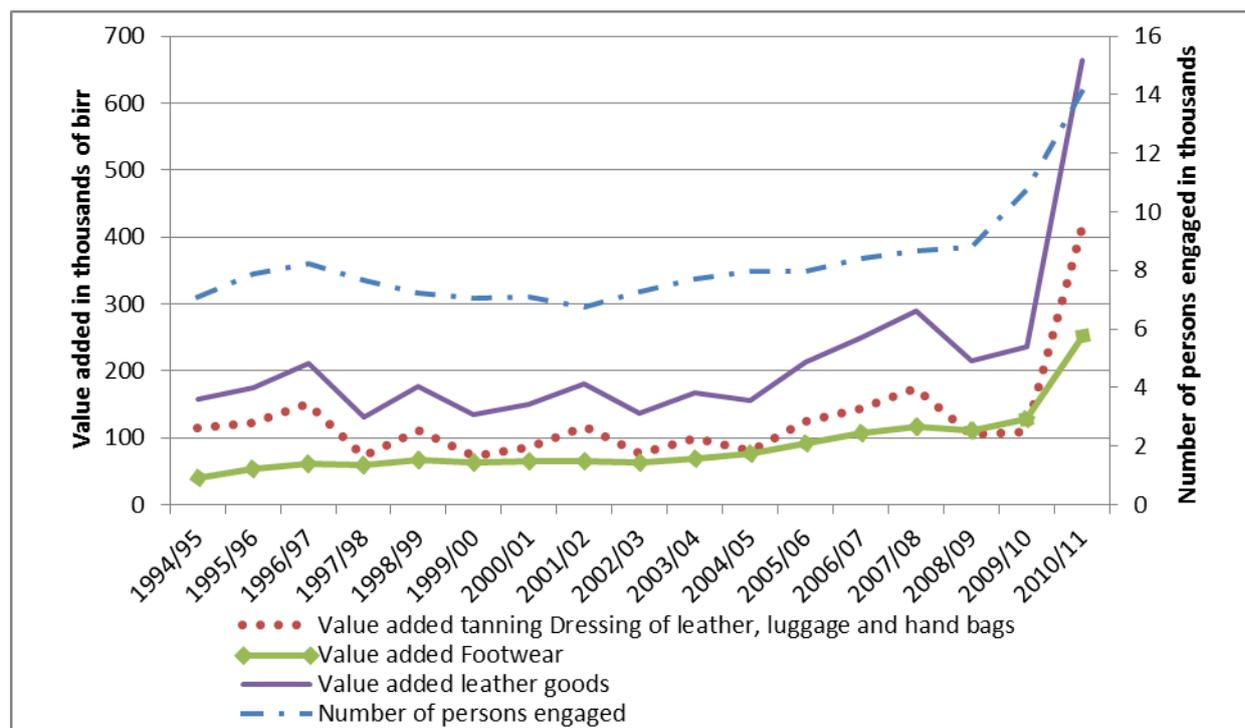


Source: Ethiopian Customs and Revenue Authority (ERCA), various years

Figure 3 shows that real value added in the tanning and footwear industries has recently shown a significant upward trend. A remarkable shift in value addition is observed in both industries since 2008/09 fiscal year. This is largely attributed to the policy intervention which levied heavy taxes on export of wet blue and pickle to promote production and export of finished leather. Indeed, the export value of wet blue and pickle has dropped drastically from more than 50 million USD in 2007/08 to very low levels in 2009/10. This also partly explains the decline in export revenue from 2008 through 2010 seen in Figure 2, as parts of the sector struggled with the challenges presented by upgrading their production. The year 2009/10 also shows a significant spike in formal employment in large and medium scale enterprises engaged in the leather processing business. Informal employment and employment in micro and small enterprises engaged in the leather industry is estimated to be much higher than these numbers, although precise figures are difficult to obtain. EDRI's micro and small shoemakers' surveys conducted in 2008 and 2009, for example, suggest that there could be more than 12,000 individuals working in the shoemaking business in the Mercato area of Addis Ababa alone.

Although it takes time for the full effects of the fiscal policies (combined with other interventions) to materialize, they appear to have had the effect of pushing producers to move up the leather value chain within a short period of time. This is confirmed by interviews with private sector actors. Moreover, McMillan (2012) reports that these interventions had the immediate effect of inducing four larger foreign-owned companies to procure machinery and equipment for production in Ethiopian and the subsequent export of finished leather products. All of these companies had previously exported only semi-processed leather products. Our interview also suggests that producers were forced to improve their production process towards greater value addition. We noticed that local tanneries were initially forced to cut their export due to limited capacity to produce finished leather products. Recently, however, there is evidence suggesting that some have upgraded their machinery, and, as a result, are increasingly moving from selling semi-processed leather to other tanneries to involvement in the more lucrative export market.

Figure 3. Value addition and employment in the leather and leather products industry



Source: Authors’ compilation using CSA’s various large and medium enterprise reports

In earlier periods, the local tanning industry was protected from competition for raw materials as foreign-based companies were not permitted to operate in marketing of hides and skins and in the tanning industry. Due to lack of sufficient local capability, however, the ban on new foreign investment in these areas was removed for many years before it was restored in 2011 (McMillan, 2012). During this time, there were considerable numbers of new foreign investments in the leather sector. McMillan (ibid) interviewed six new foreign investors that established tanneries in Ethiopia. Of these, four were Chinese and two were Indian investors. One striking feature that emerged from the interviews was that all of these companies were long time buyers of unprocessed Ethiopian leather, and that facing the export tax, they decided to invest in Ethiopia because they wanted to “secure their leather supply”.

Tanneries have received a wide-ranging package of support to improve the quality of their products. The LLPTI (now LIDI) has offered training on production and managerial skills for workers and managers of tanneries free of charge. The government has also co-financed the employment of foreign experts and consultants who helped improve the production facilities of tanneries. Regarding land and finance, the government has offered land at reasonably low lease rates, and provided export credit guarantees and loan facilities for capital investment at highly subsidized rates.

The story is similar in the leather manufacturing sector. In the footwear sector, for example, while the importance of improving conditions for existing investors and attracting new investors has been high on the agenda, the government has largely shunned away from direct protectionist policies¹⁴. Instead, the government decided that the long term

¹⁴ The onslaught from foreign competition in early 2000s was certainly the result of the liberalization policy that fostered competition with imports to the initial detriment of Ethiopian producers.

sustainability of the industry hinged on upgrading the capability of local producers through skills formation and technology adoption. Consequently, enterprises that survived the intense competition from imports were those that were able to improve their supply chain management, improve quality and delivery time of their product, and, in general, upgrade their machinery and equipment as well as labor and inventory management.

That said, the government has not simply let the industry fend for itself. A range of incentives were instituted including, but not limited to, the provision of land in an export processing zone, the provision of low interest credit for capital investment, highly subsidized training for workers and managers at LIDI, and co-financing of the employment of foreign experts to temporarily work in the local shoe factories. Regarding the former, the government freely provided semi-constructed factories located in an industrial zone to firms that sought the production and export of footwear and other leather products in 2004 (Redi 2009). This was accompanied by a further incentive package that allowed for tax breaks for importing of machineries to be used in these plants. And, more recently, the government has granted three shoe producers, one Ethiopian, one Turkish and the other Indian, huge tract of land (approximately about 2800m² each) for building industrial zones.

The government also appears to recognize the importance of attracting large-scale investment from global leaders in the footwear industry. A high profile case is the Huajian group from China. The Huajian group is a leading global footwear manufacturer that uses its massive production site in Dongguan, Gaungdong province, to churn out more than 20 million pairs of shoes annually for western markets. The former Prime Minister head-hunted the group as he had taken a personal interest in seeing the formation of industrial clusters with massive export and job creation potentials. After the group's representative met the PM in August 2011, in China, Huajian decided to invest in Ethiopia. This company now employs around 1600 workers and produces more than 2000 pairs of shoes per day for designer labels such as Guess, Naturaliser and Clarke's. The company also intends to expand its production greatly to generate export earnings equivalent to 4 billion USD a year within a decade. As part of the expansion scheme, it has recently acquired 300 ha of land on the outskirts of Addis Ababa, and plans to erect factories for the production of footwear, handbags and accessories.

What sets this company apart from the other FDI in the footwear sector is that it has selected and sent more than 130 young Ethiopian university graduates to China for training, with another batch of nearly 300 trainees soon to follow¹⁵. Such forms of training have immense importance in building local technological and managerial capability. For example, many studies attribute the rapid growth of the export-oriented garment industry in Bangladesh to young trainees who received intense training in production techniques, factory management, international procurement and marketing in South Korea (e.g., Mottaleb and Sonobe 2011). It remains to be seen whether such types of positive externalities will become significant in the leather goods industry in Ethiopia.

5. Challenges in the LLPI

Addis Fortune, the leading English-language newspaper in the country, recently ran a feature story entitled "Leather on the Scene: Focus on Poor Performance at leather fare" (Addis fortune, February, 24, 2013). This was not to discount the progress the sector has achieved of late, as the recent performance of the industry, as discussed above, has been very positive, particularly in comparison with only a few years ago. Yet the story is indicative of the less than exciting performance of the sector particularly in relation with meeting the

¹⁵ Similarly, a German company that set up a glove manufacturing plant in Gonder town recruited young individuals with no prior experience in the leather industry and offered them intensive on-site training in leather production technologies.

export targets set by the government¹⁶. As discussed earlier, there are several, intricate and mutually reinforcing problems at various stages of the leather value chain that require coordinated action. In this section, we examine these challenges in depth, mostly relying on the information we gathered through series of interviews we conducted in the LLPI. While these challenges are overlapping and in many cases mutually re-enforcing, we opted for the discussion of each constraint separately in the interest of clarity and focus.

5.1. Market problems in the hides and skins trade¹⁷

To our knowledge the hides and skins trading sector thus far attracted limited research and policy interest. While information on the mechanisms employed to collect hides and skins is glaringly lacking, we also have limited knowledge concerning how prices are formed and inventories are kept as well as how skins and hides are distributed to tanneries. The difficulty associated with gathering systematic data partly explains the paucity of research in this area. At the same time, the traditional way of hides and skins collection, storage and distribution is hardly amenable to analytical treatment. Further, the common stereotypical attitude towards traders as mere middlemen, who simply capture surplus rather than add value, has removed policy interest from understanding how the trading sector operates. This is surprising given that about 60% of working capital of tanneries is spent on the procurement of hides and skins and price rises have often been translated directly into higher prices for finished leather.

Our interviews with tanneries suggest that they have been facing acute shortages of raw hides and skins. As the result, most are utilizing far less than their full production capacity. A possible reason cited for these shortages is the high levels of soaking capacity of tanneries compared to the input supply of skins and hides¹⁸. On the other hand, upon talking to hide and skin traders we learned that their major complaint is the lack of a market for raw hides and skins¹⁹. To better appreciate this apparent contradiction, it helps to understand the structure of the hide and skin market well. Figure 4 presents the marketing structure of hides and skins. As seen in the figure, the supply chain is stretched and involves several players.

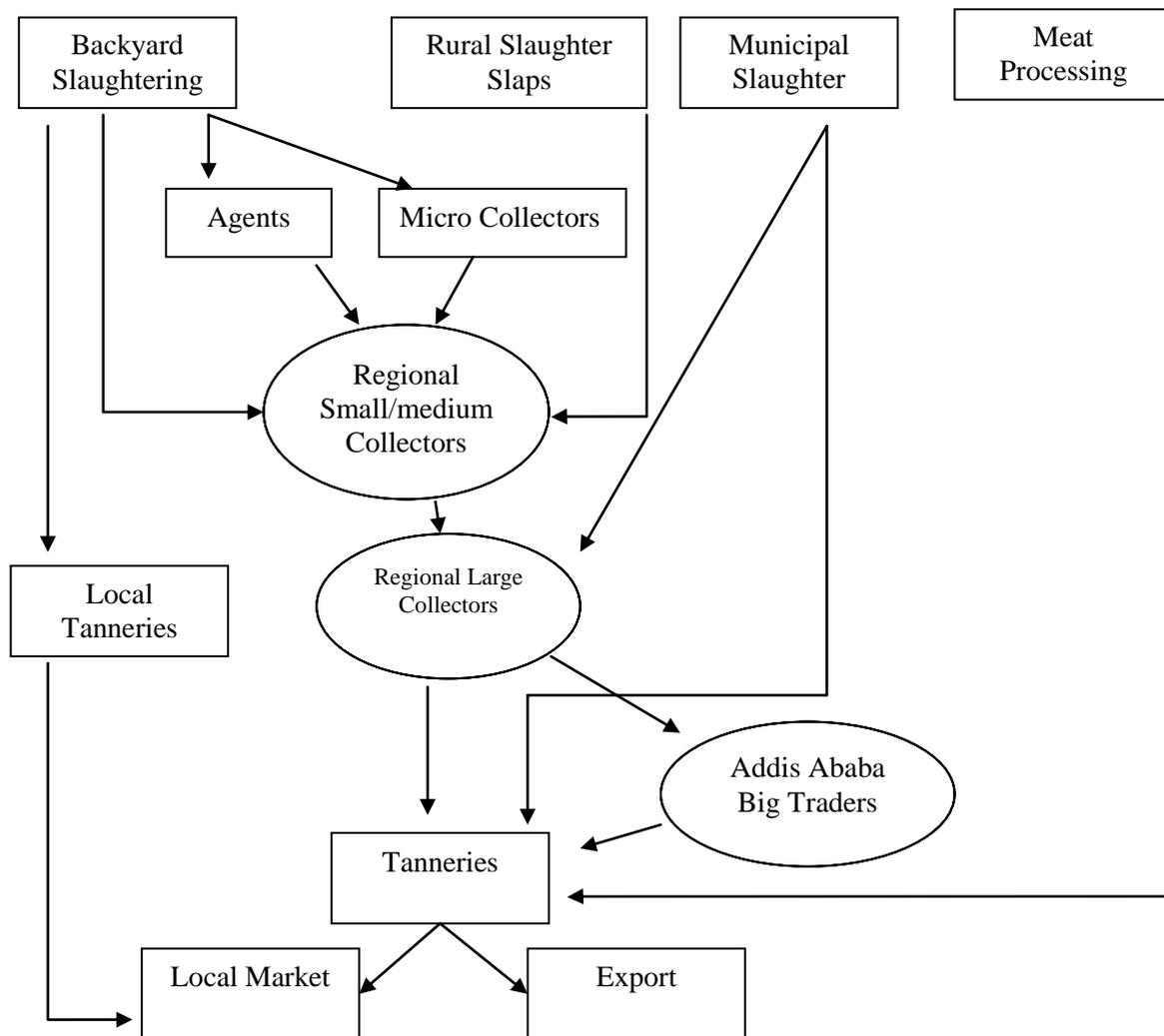
¹⁶ Export targets are set by LIDI and the MoI. LIDI has a formula for target setting which is populated with information supplied by the companies themselves. Possible targets are discussed with stakeholders at MoI and then passed down to companies. Targets are annual and in USD, but evaluated monthly.

¹⁷ The problem with the hides and skins market reverberates into the processing of higher value added leather products as well. A leather finishing company we interviewed for this report, for example, uses semi-processed leather, wet-blue or crust, as inputs rather than raw hides and skins. However, the limited supply of semi-processed leather has forced the company to operate at very low levels of capacity utilization.

¹⁸ A key expert at the Ministry of Industry reckons that the problem of excess capacity is the result of inefficiencies at several layers of the raw hides and skins supply chain. If the efficiency problem is resolved, the supply of raw hides and skins would more than satisfy the existing installed capacity of tanneries.

¹⁹ In fact, we saw an official letter written by the Ethiopian Raw Hides and Skins Suppliers Association (ERHSSA) to concerned government authorities to help traders find markets for huge volumes of raw hides and skins stored in the warehouses of several prominent traders.

Figure 4. Outline of marketing channels for hides and skins trade



Source: Mahmud (2000), adjusted for information gathered through authors' interviews with traders and tanneries.

Many varieties of traders are involved from the point of skins and hides collection to the point of delivery to tanneries, with implications for both quality and quantity of supplies. The major sources of hides and skins in Ethiopia can be categorized into four distinct types. The first is individual producers in rural and urban areas that include slaughtering in urban and rural areas for personal consumption (particularly on the holidays) and for the hospitality business. Agents and micro-traders go door-to-door to collect hides and skins produced from individual producers, which then supply to small regional traders. The second sources are rural slaughtering slabs which mainly supply to small and mid-sized regional traders. Municipal slaughtering houses are the third sources of raw hides and skins that directly supply to tanneries in addition to large regional traders. Direct supply of raw hides and skins to tanneries also takes place through a fourth source, namely meat processing plants. According to information from ELIA, nearly 80% of raw hides and skins transacted in the formal market are derived from rural areas, and only 20% is collected from abattoirs and slaughter houses in large cities and towns.

The importance of big traders has increased over time as tanneries seem to prefer to deal with big collectors than small traders. Because of economies of scale, this should have helped shorten the supply chain and improve the amount and quality of raw hides and skins

that reach tanneries. In practice, however, this has not taken place, mainly as the result of liquidity problems faced by the major clients of traders, i.e. the tanneries (see section 5.2). As tanneries are not able to pay large traders on time for the supplies they deliver, large traders started delaying payments to small traders leading to long overdue arrears that create liquidity problems in the entire industry²⁰. Because of asymmetrical market and political power distribution between the two, traders are reluctant to take legal action even in the face of “blatant abuses by tanneries”²¹. Moreover, large collectors, despite being relatively cash starved, often have sufficient capital to withstand such liquidity crises, whereas smaller traders do not. The supply from municipal slaughter houses appears to be much lower than the demand; the latter being due to the excessively high soaking capacity of large tanneries. A key informant told us that it takes his tannery nearly 200 days to secure orders he places for raw hides and skins at the Addis Ababa Municipal Slaughtering House.

Traders also claim that tanneries often dictate the prices at which hides and skins are transacted. The export ban on raw hides and skins implies that traders have no legal alternatives except to sell to local tanneries. Traders feel that the odds are stacked against them in price determinations as they are often accused (sometimes publicly) of being engaged in price gouging and fixing as well as hoarding large inventories. Added to this is the current practice of setting prices based on the size, extent of deformity and petrification. While these could be a more or less universally accepted, albeit informal, system of quality assessment, there appears to be no objective quality grading rules in the hides and skins trading system. For each delivery, quality and prices are negotiated on eyeball to eyeball basis, which has sometimes led to bitter disagreements between tanneries and traders on the actual quality of supplies. This appears to have created rampant mistrust between sellers and buyers that substantially reduces the number and volume of transactions in raw hides and skins leading to supply problems.

The outcome is that huge volumes of skins and hides illegally leave Ethiopia to neighboring countries. For example, contraband trade in skins and hides is widespread in the towns bordering Ethiopia to Somali and Kenya. One trader went so far as to claim that most skins or hides originating from an important livestock trading town located more than 400km south of Addis Ababa are smuggled into neighboring countries. This makes domestic prices for finished leather higher than in competing markets, which undermines the competitiveness of finished goods and footwear manufacturers²². For example, a leather finishing company interviewed for this paper used to supply markets in Hong Kong and was at about 30-40% capacity at the time, but had to cease this business due to the escalating costs of inputs and is now operating at 18%.

²⁰ Ironically some of the prominent traders we interviewed for this paper claim that after the privatization of tanneries in the 1990s, the sector has become less disciplined in that payment contracts are frequently breached. As the result, traders are often cash starved; i.e. they are now rarely getting 100% of the value of their delivery, payments are often delayed, sometimes for more than a year. Further, some tanneries have stopped supplying salt to traders, partly owing to a significant increase in the price of salt over the past five years. Salt is a major preservative agent in the raw hides and skins trading sector. We later learned that tanneries funnel salt supply to traders through the Ethiopian Leather Development share company, a share company founded jointly by tanneries. When such supply arrangements are not available, traders can agree with tanneries to buy salt themselves from the market and get refunds on agreed amounts. Yet many of the traders we talked to appear to use none of these supply arrangements. We thus are not sure the extent to which such supplies mechanisms are available for all traders and hence have alleviated the salt problem. This certainly is beyond the scope of this paper and remains to be an empirical question for future research.

²¹ Hides and skins traders are many in number and are less formalized and organized, have thus limited scope to lobby for favorable public action. On the other hand, tanneries are fewer in number and are tightly organized and are run by better educated individuals who find it easier to get access to the highest echelons of power.

²² A key informant claims that the price of finished sheep skin in Ethiopia is 20-25% above prices in competing countries.

5.2. Working capital and liquidity problem in tanneries

One of the biggest crises affecting the sector, or more precisely the Ethiopian owned companies in the sector, at present is the severe lack of working capital brought on by the lack of available finance. This lack is rooted in two problems, one driven by supply and the other by demand.

On the supply side, as in many low income economies, access to credit is generally constrained in Ethiopia²³. Commercial banks seem to have limited understanding of the inner workings of the leather sector and still evaluate loan requests based on outdated input cost models. Moreover private banks, lacking experience in the sector, are often unaware of the long lead times (on average 1.5 months from hide to finished leather) and the high upfront costs (for inputs) leather manufacturing entails, and are therefore unwilling to lend against what banks then consider inappropriate credit requests, as they still base their assessment on the production of pickle and wet-blue leather. These are technically much less demanding and are faster to produce and easy to sell. Even when banks do approve loans they can take months to release the funds. These are delays which clients, especially in international markets, are not willing to tolerate.

Against this background, the demand for loans has greatly increased in the face of the aforementioned price rises in the industry that have driven up input costs. In addition to the leather prices, the prices for preservative agents including salt and chemical inputs, which are almost entirely imported, have also doubled in recent years. The cumulative effect has been an inability to secure the required working capital which has the potential to “cripple the industry”, with large parts of it operating at less than 30% capacity, particularly in the tannery sub-sector. This also partly explains the delays in payments for supplies discussed in section 5.1.

The long payment lags in export market also impacts stocks of working capital. This is because payment against Letter of Credit is usually with either 60 or 90 days delay²⁴. In the meantime producers face chemical and other costs. In addition producers face selection costs on raw hides and skins, as only fractions of the purchased skins and hides are suitable for the trade at hand, and the remainder will have to be sold elsewhere.

5.3. Limited regulatory and enforcement capacity

We sensed that investors in the LLPI are generally welcoming of the wide-ranging incentives that are put in place. However, some regarded the bureaucracy involved in accessing these incentives difficult to navigate and highly risky as a result. According to sector actors, this compares badly to the relatively un-bureaucratic incentive systems found for instance in India and Nigeria, where exporters simply receive a voucher for a certain percentage of their exports.

Implementation of existing rules and regulations is also a problem. For example, traders feel that the ‘Raw Hide and Skin Marketing System Proclamation No. 457/2005’, which was put in place to create a “modern” skin and hide marketing system, has not been fully implemented in practice²⁵. Similarly legal provisions that reserved the lower rungs of the leather supply chain to local producers are allegedly violated through the continuous engagement of foreign companies in hides and skins soaking and the production of dry-blue

²³ The LLPI is one of the priority sectors and is thus entitled to preferential access to finance at the Development Bank of Ethiopia (DBE). DBE, however, lends only to newly established projects and does not extend loans for either for working capital or for the expansion of existing businesses.

²⁴ While this is standard in many industries in advanced economies, producers there have access to supplies credit and short-term credit lines from banks, which are lacking in Ethiopia.

²⁵ Recognizing the limitations of the ‘Raw Hide and Skin Marketing System Proclamation No. 457/2005’, the government is drafting a new proclamation that would significantly amend many of the provisions in the existing proclamation.

and crust leather. These companies purportedly furnish supply of raw materials to their parent companies overseas. To promote value addition and militate against such types of abuses, the government levied the aforementioned 150% tax on semi-processed leather. However this tax appears to have only been partially effective in halting exports of semi-processed leather as the policies are not being implemented consistently. It is alleged that foreign companies continue to export semi-processed leather, even at prices that are under the raw material price. If these allegations are true, it would imply serious cross-subsidizing of foreign-based leather processing companies' engaged in processing of leather at the higher rungs of the leather value chain²⁶. This in turn shows how little value addition occurs at the early stages of production. As a result the domestic industry would continue to miss out on foreign exchange, value addition and technology transfer.

The weak export performance is partially an artifact of fraudulent practices and in particular under-invoicing by some exporters. For instance the average selling price for one of the local tannery we visited is around USD1.65/sqft, while the average price of all exports from Ethiopia is USD 0.85/sqft. These are raw material prices, meaning that exports are under-invoiced to artificially and illegally increase the profits of exporting companies with the effect of preventing much-needed hard currency flowing to Ethiopia. Especially foreign companies apparently use such practices to "feed" mother companies abroad. This is possible due to lax controls in exporting. LIDI gives export certificates against samples delivered to LIDI premises rather than performing checks directly at the companies involved. Customs then do not check actual consignments due to seemingly misplaced trust in the LIDI certificates.

5.4. Limited processing capacity

Section 5.1 argued that many of the tanneries and leather finishing enterprises are operating at significantly less than full capacity due to shortages of raw hides and skins and semi-processed leather. This section presents the argument that, even with the existing capacity utilization, the industry is plagued by low levels of technical efficiency, production quantity and quality. To its credit, LIDI has done extensive work in the provision of quality and capacity enhancing services to the LLPI, ranging from the point of entry to the industry to assisting in product market search and reach (discussed in detail in section 4.3). Yet the current leather processing capacity of the sector still remains far below its potential.

Beyond formal support by LIDI, the acquisition of knowledge and technology transfer appears to happen mostly through two avenues. On the one hand foreign companies, who sign contracts to have their goods produced in Ethiopia, send over production engineers to assist the Ethiopian companies in producing to the required specifications. On the other hand, input suppliers are often keen to support local producers. Machine suppliers send over technicians to train local production workers and engineers, albeit only for short periods of time. More valuable is the training provided by chemical suppliers, who of course have a vested interest in their clients reaching and remaining at the technological frontier so that they will order the chemicals that the latest production techniques require. To this end chemical suppliers maintain sizeable research capacities to stay ahead of changing fashions and environmental regulation. They then train their customers in product development.

In general, however, many Ethiopian companies, especially in the finished goods sector, are shackled by low production capacity, sub-standard facilities and bad management. The latter, for example, implies that supply chain and inventory management, labor and finance and international marketing practices are not up to international standards. Some of the local tanneries, for example, were set up by former skin and hides traders with limited experience in running a modern manufacturing plant. Such companies are mostly small with low skills

²⁶ One foreign company was recently caught red-handed trying to smuggle 100,000 pieces of semi-processed leather "under the guise of fully processed and finished leather for export" to its home country (Ethiopian Reporter, May 11, 2013). This is not the first high-profile case to become public.

and low levels of production technology. They therefore cannot compete in international markets, which have the adverse effects of not exposing them to such markets, which in turn may put off upgrading of their practices. This is especially true for leather garments and glove makers.

5.5. Constraints on international market penetration and competitiveness

The Ethiopian LLPI continues to suffer from an image problem in international markets due to its long association with raw material and semi-processed leather supplies. Image problems, whether based on real or perceived underlying issues, are real problems faced by many low income economies and tend to lower or even preclude the flow of new investments in the production and marketing of high value-added products for the global market. For this reason, the Ethiopian leather processing enterprises are at a disadvantage when it comes to marketing, as Ethiopia is generally still regarded as a provider of raw and semi-processed materials rather than high quality finished leather and leather goods, a perception that is changing only slowly. For instance, a few years ago Italian tanneries tried to preclude Ethiopian finished leather producers from exhibiting at the leather industry trade show in Italy, the most important market globally, as they saw Ethiopian producers as invading a market that they had no place in, wishing instead to confine them to their “proper” role of being simply intermediate goods suppliers..

Poor trade logistics also impose additional costs on the competitiveness of the leather industry in Ethiopia (e.g., Dinh et al., 2012). In this regard, the biggest challenge is the long lead time in imports. Timely imports of chemicals and other inputs are vital to the smooth running of the production process²⁷. A key respondent in the tannery sector stated that imports coming from Italy to Ethiopia, for example, can take one to two months. To overcome these types of problems, the recent export promotion regulation has allowed foreign-based chemical and other input producers to utilize the Bonded Supply Warehouse Scheme. This is predicated on the provision that FDI firms utilizing these schemes would set up production facilities in Ethiopia in five years time. This certainly is an appropriate inducement to promote the local production of chemicals and accessories. Working out the practical details to harmonize the investor’s interest with that of the intricate rules governing the operation of the bonded supply warehouses and the objectives and administrative capability of main players, such as ERCA, would largely determine to what extent such forms of interventions would be successful.

Along with the limited supply of complementary inputs, the low and unpredictable quality of hides and skins constrain producers in competing effectively for large contracts in international markets. This is because sales in the international market generally go to established brands that are able to capture a huge amount of total value added through their branding activities. Even when products are internationally marketed, buyers are keen to push prices down, narrowing the profit margin accruing to value addition by Ethiopian producers.

Moreover, given supply problems of finished leather, a few companies use significant quantity of imported leather, which is heavily taxed, thereby eroding their international competitiveness. While the government does support chosen companies in participating in

²⁷ The recently introduced ‘Export Trade Duty Incentive Schemes Proclamation No768/2012’ has several instruments to minimize the problems of inventory stocking and lead time for establishments that import inputs, such as chemicals, for the production of commodities for the export market. Bonded input supplies warehouse scheme is one of such instruments whereby exporters are allowed to store inputs without duty payments under the supervision of the customs authority. This reduces customs clearing time, overstocking of raw material inventory and lead time. However, very few investors appear to utilize this scheme. Some of our informants think that such forms of incentives are highly complicated and require significant levels of trust between the investor and the Customs Authority.

international trade fairs, this is deemed insufficient compared to the kind of marketing support that competing countries, such as India, Pakistan and China enjoy.

6. Resolving the challenges

Notwithstanding the impressive results recorded so far, we reiterate that the levels of export growth and jobs creation in the leather industry have been far below potential. The challenges presented in the preceding sections appear to have stood in the way of higher value addition in the LLPI. These are however not insurmountable obstacles, and thus addressing these challenges would further help improve the international competitiveness of the LLPI. In this section, we present recommendations that will go to some length in overcoming these constraints.

We find that the market for hides and skins suffers from ranges of intricate problems. Long supply chains, the lack of quality grading system and illegal cross-border trade have culminated in the tightening of the supply of raw hides and skins. To our knowledge, no institution exists to properly coordinate the markets for raw hides and skins, and responsibilities appear to be diffused among several public institutions. The Ministry of Agriculture and Rural Development (MoARD) is naturally well placed to monitor and evaluate the construction of slaughterhouses, oversee hides and skins collection, preservation and distributions processes and enhance the capacity of hide and skins traders through training and consultations.. Such forms of assistance are, however, hardly available for traders. During the imperial regime, these functions were carried out exclusively by the Livestock and Meat Board (LMB), a practice which was discontinued during the military Derg regime. The experience with LMB should be explored further to assess the importance and the viability of similar forms of institutions in the present day.

Recently the government decided that most of these services and regulatory tasks should be provided by the Ministry of Industry. In fact, the Meal Processing and Dairy Development Institute will soon move from MoARD to the Mol. Similarly, issues related with the marketing of hides and skins will also fall under the purview of the Ministry of Trade. Clearly straightening out institutions responsibilities for service provisions and defining their legal mandates on regulatory and adjudicating power is a move in the right direction. Yet the mere diffusion and restructuring of authorities might not still solve the problem of coordination that runs deep in the LLPI. We thus think that greater synergies between service providers, sector regulators and the business community should be created through continuous engagement. Setting up platforms, whereby the groundwork for close partnerships between sector experts at the Mol (and LIDI) and MoT and representatives from the two business associations, ELIA and ERHSSA, could be laid, are key to overcome the coordination problem.

We also think that the establishment of central marketplaces where regular transaction in hides and skins trade could openly take place is key to shortening the supply chain. By enabling frequent and anonymous transactions, township marketplaces would help reduce transaction costs associated with the trading of hides and skins. Indeed, marketplaces were important institutions that stimulated industrial growth at the early stage of industrial development in China (Sonobe et al., 2002).

We also learned that the quality of raw hides and skins is determined through one-on-one negotiations between traders and tanneries. In such negotiations sellers often felt that tanneries misrepresent the quality of their products in the hope of undercutting prices, while tanneries suspect that traders mix bad quality raw hides and skins with good ones to unscrupulously extract higher profits from tanneries. This is reminiscent of Akerlof's (1970) work that emphasizes that supplies of uncertain quality goods would result in the reduction of the average quality of goods and, eventually, the size of the market. This is a classical

case of market failure where government intervention is warranted. A starting point would be to set up raw hides and skins grading and certification systems, which would introduce objectivity in quality determination and ease the discontentment and mutual distrust involved in price negotiations. Given its capacity, LIDI can add this to its existing services it provides to the industry.

In the longer term, the leather industry would benefit from the commercial production and sale of high quality hides and skins through a modern animal husbandry system. Yet this would require a transformation of the smallholder sector, a process that will take many years and of course has societal implications far beyond the LLPI. The short term focus should then be on upgrading the existing soaking and tanning technology, as there are tanning technologies that can overcome quality issues. Naturally, this should be complemented with the improvement of finishing technologies so that the end-product would be of high quality. For instance, European buyers have been buying Ethiopian raw materials for years and have been producing premium quality final products using them. Similarly, the recent entry of Chinese investments in the tanning sector has demonstrated that low grade skins and hides, conveniently dubbed “rejects”, for which no local demand existed previously, can be profitably utilized with the right technology. Such types of technologies will help in optimizing use of the existing supply by creating a market for raw hide and skins types that otherwise would have been thrown away.

Better production technologies would also strengthen the production capacity of tanneries. The tanneries have certainly benefitted from various services and training facilities offered by LIDI. The objective is to gradually improve value addition so that local producers can generate more jobs and secure greater export earnings. However the production of finished leather is more complex and requires more professional company procedures, especially in management. In contrast, at the early stage of leather processing, such as pickle and wet-blue, production and marketing is not complicated. As higher value addition requirements are introduced, the premium associated with product quality, delivery time, safety and pollution requirements become more stringent. To meet these obligations steeply and continuously improving product designs, the management of production lines, inventory, labor, production waste and most importantly, the identification and penetration of lucrative export markets are invaluable elements. Such types of improvements, bordering on “multifaceted innovations”, cannot be carried out in the absence of adequate managerial capital (Sonobe and Otsuka, 2006, 2011). This is consistent with the recent emerging literature that suggests that scarce physical capital in low incomes economies would remain unproductive and firms stagnate in the presence of widespread poor management practices (Bloom et., 2010, Bruhn et al., 2010).

Urgent improvements in both the stock of managerial capacity and production technology are thus desired. LIDI is actively expanding and building on its stock of staff capabilities and physical assets, especially in production, testing and design to meet the new challenges it faces in the finished leather sector. A capacity building program involving high level training (2nd and 3rd degrees) to LIDI’s staff is currently underway. This is the right long term approach that will help ease the capacity problem faced by the regulatory arm of the government as well as tanneries and finished leather producing companies. For the same reason, the existing schemes of ‘skills co-financing’ should be strengthened further.

In the short run, the government could also help link up tanneries with lower technical capacities to supply semi-processed product to higher capacity tanneries in an integrated system. This will have two benefits. First, it helps them overcome the supply shortage and quality deficiency of raw materials as the latter would have a vested interest in ensuring that the former improves its lead time and product quality. We have already shown how learning from technologically more sophisticated buyers has continued to play an important role in building competitive companies. Second, over time, the semi-processed leather producers

would acquire the necessarily skills to add more value to their products, which will eventually allow them to enter the processing industry to capture more of the value created. Another way this could be done is through integration with global brands. Selling to established brands will not only leverage the marketing of final products but also augments production techniques including product design, input choice, shop-floor management, packaging and just-in-time delivery. Again, the buyer-seller linkage is likely to be a driver of technology transfer and skills upgrading.

Probably the most important constraint facing the sector at present is the severe lack of access to working capital²⁸. If this situation is not urgently improved upon it has the potential to cause firm closures on a massive scale and derail the growth plans for the sector. The hugely negative effects for capital accumulation and employment do not need elucidating. It is worth noting that the lack of working capital does not appear to be the result of incompetent firm management. While some firms in the tannery sector do indeed mismanage their inventories, by holding far too much stock which of course depletes their working capital, this is not true for many of the better organized firms, which tend produce finished leather. Rather the severe shortages of working capital seem to be the result of a financial sector that is not accustomed to lending for industrial activities of this kind. In other countries, supplier credit and long-term credit lines, available at short notice from 'house banks', enable companies to manage their liquidity positions. In Ethiopia private banks at present appear unable to fulfill this vital role. As provision of short-term loans is, understandably, outside the remit of the DBE, there is no one left to fill the gap. The consequences of this lacuna are potentially disastrous for the sector.

Government backed short-term loans might help ease the strain on day-to-day activities of the companies. In parallel an educational drive aimed at private banks, perhaps administered by DBE in association with LIDI, could improve the willingness of private banks to lend, allowing government guarantees to be phased out in the medium term. While the necessary analysis is beyond the scope of this paper it is worth investigating the possibility of a revolving fund for the sector, backed by a time-limited government guarantee. Such a system would also minimize the potential liability of the tax payer. To prevent the mis-targeting of such assistance, guarantees should be made conditional on signed export contracts. The loan disbursement process would then have to be very fast, as lags at this stage could threaten the timely production and dispatch of the agreed goods. Of course, with some of the firms the problems are made in-house and are the result of poor management of inventory, cash, receivables and payables. Thus, LIDI could expand its scope to provide proper guidance on the management of the firm's current assets and liabilities. As a last resort, tanneries could be allowed to supply semi-processed leather to foreign firms, although this is evidently the least-best option as it works against the current drive to upgrade.

We also feel that there is some scope for improving the existing modes of regulations and their enforcement. For example, lessening the "burdensome bureaucracy" with respect to the administration of incentives would encourage more investors to take-up these incentives. There is also a wider issue with sector regulation. The ban on the establishment of new tanneries appears to be controversial among stakeholders in the sector. While the ban was enacted to combat the substantial overcapacity in soaking that currently characterizes the sector, it has an important exemption for the entry of investments that integrate production process from hides and skins soaking to leather finishing. However, while intuitively sensible, we believe the ban could be potentially counterproductive. To understand why, it is important to note that Ethiopian tanneries tend to be fully vertically integrated, meaning that they operate across the value chain from soaking to finished leather. This apparently is not how

²⁸ Recognizing the gravity of this problem, ERHSSA initiated a Terms of Reference to identify the sources of the problem and suggest possible policy recommendations.

the rest of the world operates. Other countries, such as Italy, have large tanneries that supply semi-processed leather at various stages to finishing tanneries. This reduces the stress on working capital as sales at various stages can be hedged to ensure liquidity. Finishing tanneries can even be “studio tanneries” which can be set up with minimal amounts of capital. The advantages of specialization this would bring to the sector would outweigh the diseconomies of scale. It would therefore make sense to maintain the ban on the establishment of new soaking capacity but to allow finishing tanneries to be established. Such a differentiation of current policy be supportive of the broader aim of product upgrading and increase Ethiopia’s competitive position in global markets by increasing its product palette.

Rather than being sources of technology transfer, foreign tanneries overall are regarded as unwelcome and unfair competition who skirt around existing rules and regulation in ways that Ethiopian companies cannot. We strongly feel that FDI in this sector should be seriously and critically evaluated to determine how beneficial it is to the sector and the wider economy. Ethiopia remains an attractive investment destination and is fully able to negotiate a more beneficial ‘bargain’ with foreign investors. While international trade policy regimes have of course somewhat limited options in this regard, Ethiopia can use its current status as low income country to open up policy space in this regard. In a similar manner, given that the number of exporting tanneries is small, effective monitoring against existing rules and regulations should be regularly carried out to preempt abuses of incentives and provisions by both local and foreign businesses.

Finally, we gathered that there are a variety of issues that the sector is seeking to discuss with government. While representatives have met with PM Hailemariam and presented issues and also received solutions for some of them, other issues remain unsolved. For example, some investors complained that application for VAT refunds is not straightforward and may thus take considerable amount of time to process. Hides and Skins traders particularly feel that they are intentionally left out in the conversations and exchanges that take place among stakeholders in the sector. It is very difficult to restructure the market for raw hides and skins while overtly dismissing or covertly excluding traders from discussion of policies that influence their interest. As with other economic agents, we believe that continuous dialogue and consultation with traders can improve not only the design of the rules and regulations in the industry but also enhances ownership, and hence, potency and widespread acceptability of interventions. To this end, institutionalizing the mode of communication between various stakeholders and the government would greatly facilitate effective and high-level communication. Such an institution would then act as a regular platform where sector specific problems would be aired and addressed in a timely manner. It is vitally important that communication in such a setting is genuinely two-way. An important function of such an institution would be to discuss forthcoming policy changes with regards to unintended side-effects. Similar recommendations are in fact made across the spectrum of the literature on industrial policy. At the same time, however, this can be employed as an instrument for close monitoring and evaluation of businesses in the industry. To prevent abuse of such systems, which can become inroads for corruption and rent-seeking, meetings should be public and transcripts of the meetings should be available to public scrutiny.

7. Assessing Industrial Policy in the LLPI

This section attempts to very briefly situate the industrial policy mix pursued in the Ethiopian LLPI in the wider global discussion on which *type* of industrial policy countries should pursue. As previously noted the sector does comply broadly with Ethiopia’s current factor endowment, needing relatively little capital outlay and being quite labor-intensive. This conforms to Lin’s (2012) prescriptions on how a country should choose its optimal industrial structure. Of course critics of Lin’s approach do not argue that every sector chosen for

government support should defy factor endowments, rather they argue that a country will upgrade more successfully if it *also* chooses high value-added sectors that do not conform to current comparative advantage. It is clear though that the Ethiopian government chose to support the LLPI as it saw a current comparative advantage in that sector, especially in terms of Ethiopia's huge livestock endowment.

However, the government did employ policies that do not sit easily within a strictly market-conforming framework. For instance the ban on the export of raw skins and hides constitutes a contradiction of free market principles, while the ban on foreign companies engaging in the soaking stage of leather production is clearly a protectionist measure. The 150% export tax on semi-processed leather is designed to manipulate relative prices to induce companies to upgrade their production processes. Ethiopia's industrial policy in the LLPI then constitutes an inventive mix of unorthodox policy measures being used to support a sector in line with the country's comparative advantage. The lesson appears to be that policies are designed pragmatically to assist the economy and do not necessarily follow the fault lines of academic debate.

8. Clearing bottlenecks: an assessment and a way forward

Section five discussed the main challenges in the LLPI and section six provided some possible mechanisms that can be employed to resolve the challenges. In this section, we seek to broadly assess the constraints that the LLPI face and link these with the conceptual framework we put forth earlier. There have been several forms of industrial policies the government has adopted to overcome the constraints the leather sector has faced. While there is no one silver bullet to quickly redress these constraints, tackling the issue of coordination failure is of urgent importance. Coordination failure arises in the raw hides and skins production and supply due to the strategic complementarities among various facets of production, distribution and trade. Strategic complementarities are best illustrated by the high level of dependency of the product quality of leather processing companies on the quality of raw hides and skins supplied by traders. In a perfectly competitive market set up with thick markets, price signals would reward high quality and hence, producers and traders of sub-standard quality would either be driven out of the market or would be relegated to a distinct low quality-oriented market. Alternatively, in situations with asymmetric market power distribution, there will arise private enterprises that would "ensure coordination of upgrading activities throughout the value chain" (Altenburg, 2010).

In the Ethiopian context, however, the market is neither 'perfectly competitive' nor is there any large private entity with manifested interest in coordinating activities along the leather value chain. To start with, the market for raw hides and skin appears to be highly segmented with a large number of unorganized producers and traders in different regions. More precisely, the vast majority of raw hides and skins production comes from non-commercial individual producers and traders in rural areas and both producers and traders are highly unorganized and operate outside of the formal business sector²⁹. Transactions are thus conducted on an ad hoc basis with no stated contractual obligation to either party regarding hides and skins production and trade. Under such circumstances, securing coordination among market participants with the aim of reducing wastage and improving quality is difficult. This is typically because; first, lack of organization itself precludes the possibility of moving from individually-based decision making to coordinated decision making, and second, low levels of literacy and entrepreneurial education in the livestock sector implies that individuals often do not recognize that they are operating sub-optimally and that there could be better arrangements that would mutually be beneficial if actions are coordinated.

²⁹ Producers are often smallholder farmers, and distributors and traders are informal micro and small scale traders who supply large regional traders (see Figure 4 for the detailed illustration of raw hides and skins marketing)

A related concern is how effective price signals are in inducing behavioral changes among smallholder livestock farmers. To the extent that price signals reflect rewards for quality improvement, we normally expect that higher prices encourage the application of animal husbandry practices that would eventually improve the quality of hides and skins. In Ethiopian context, raw hides and skins are often treated as of secondary importance among livestock farmers; i.e. as by-products of meat harvesting. In addition, many farmers that supply hides and skin are not even livestock farmers per se, but rather proprietors of small mixed farms that only occasionally supply to the market. Furthermore, in many parts of Ethiopia, cultural or traditional norms coupled with awareness deficits mean that livestock is treated as a non-commercial property; the meat off-take value is seriously discounted let alone the by-product hides and skin. For example, in pastoralist communities livestock is often kept for its stock value as perceptions of wealth, prestige and social status are highly correlated with herd size and not with the market value of the livestock products. Not surprisingly, the marginal effect of a rise in raw hides and skins prices will thus have a negligibly small effect in inducing behavioral change conducive for improving the quality of raw hides and skins.

Even when livestock producers attach greater value to the production and marketing of raw hides and skins, it is not immediately clear whether and how they will be able to capture the benefits from improving quality. Long supply chains imply that higher retail prices do not necessarily translate into higher producer prices. In principle, the price margin livestock farmers' capture should be sizable enough to incentivize them to supply improved quality raw hides and skins. We are not aware of any empirical studies that attempted to explore how price margins at several layers of the chain are appropriated or how large the distance between producer and retail price is. This is a fruitful ground for future studies.

Notwithstanding structural problems at distinct rungs of the leather value chain, theoretically the presence of a large private firm (or group of firms) can help improve the skins-to-leather supply chain. This is simply because the processing of poor quality raw hides and skins negatively affects the quantity and quality of leather and leather products produced by private companies, which erodes their profitability. Managing and improving the supply chain would thus be an incentive compatible strategy for a profit maximizing enterprise. Yet neither upstream suppliers nor downstream producers have the capacity (or will) to coordinate their activities to bring about a mutually beneficial trade. As the result of these complementarities, the full benefit of investment for improving the quality of raw hides and skins cannot be realized; i.e. livestock producers and tanneries cannot move out of a low return equilibrium.

The failure of various elements in the LLPI to overcome rampant coordinate failure provides the government with an opportunity to step in with a coordinated growth strategies. These strategies are wide-ranging. Given the capacity and information constraints, it is important to prioritize interventions in the LLPI. A good starting point would be to resolve the puzzle that apparently suggests the presence of acute shortage of raw hides and skins for tanneries to work with while at the same time traders are facing market problems due to lack of demand. This cannot be dealt with separately from the liquidity crisis the sector has recently faced. A better understanding of the structure of the leather supply chain and the mode of interaction between producers and traders can provide a useful insight as to how policy should proceed.

A more structural issue is the low quality of raw hides and skins. We believe that the existing veterinary and extension services are inadequate. Improving the reach and quality of these services would help tackle not only the technology and knowledge gap that is apparent among smallholder farmers but would also help induce behavioral change that can potentially lead to a paradigm shift in the ways in which raw hides and skins are produced, collected and distributed. This should be part of the already existing livestock extensions services with the option of the retraining of the extension agents.

Markets are important institutions for smooth transmission of quality and price signals along the supply chain. In addition to significant reductions in transaction and information costs, by reducing entry barriers even for novice entrepreneurs, markets also foster competition which induces greater quality improvement.³⁰ We believe that there is a critical shortage of local markets for raw hides and skins in Ethiopia. Markets that respond to changing circumstances, such as prices and quality, are important to upgrade the leather supply chain. The way such markets work will also have serious implications on the distribution of price margins among different participants in the leather value chain. The signaling attribute of prices can be enhanced with complementary state interventions in the form of raw hides and skins quality grading services. This would move the prevailing incentive structure to one that rewards quality and consistency at all levels.

9. Summary

Ethiopia is endowed with the resource base required for the commercial production of leather and leather products. As far back as late 1920s and the 1930s, there were several leather processing and shoe manufacturing enterprises in the country. The resources, however, still remained largely untapped due to a host of reasons ranging from poor hides and skins collection to limited technology knowhow at the leather processing phase. The nature of problems in the leather sector are multifaceted and without a critical market size it is not clear that large private enterprises would emerge to improve the skins-to-leather value chain (e.g., Altenburg, 2010). This would require coordinated action that only states with long-term visions are willing to accommodate. Understandably, the Ethiopian government appears to be extensively employing multiple forms of industrial policies. In addition to non-discriminatory general incentives that are available to all investors, this paper indicated that there are several interventions aimed at upgrading the leather and leather products industry. These interventions can be characterized into four forms of industrial policies.

First, the government is aggressively engaged in building the local production and marketing capacity through technology learning from abroad. The LIDI is used as an instrument to facilitate technology diffusion and upgrade the skills of workers and managers in the industry. LIDI has organized several training programs in collaboration with development partners that often involved the employment of foreign consultants. The government has also encouraged enterprises to use foreign experts by subsidizing the costs involved in their employment. Benchmarking exercises have also been carried out in the hopes of emulating more successful countries in the industry. Capacity building also meant improving the institutional capacity of LIDI itself. As a result, LIDI has received multifarious support from the government and development partners to enhance its capacity.

Second, due to its priority sector status the leather and leather goods industry has had a better access to finance from the Development Bank of Ethiopia (DBE). The familiar 70/30 credit modality accorded to industries in the priority sectors implies that DBE would avail loans amounting to 70% of the total project cost once the investor raises equity equivalent to 30% of the investment cost.

Third, the government has provided land and semi-constructed factories to large and medium sized tanneries and footwear producers at highly discounted lease rates. The government has also erected several buildings that are given out to micro and small shoe makers at nominal rental fees. Both local and international investors are also offered huge tract of land along with basic infrastructural facilities in the industrial zones strategically located in different parts of Ethiopia.

³⁰ Sonobe et al. (2002), for example, find that the establishment of markets by township officials was critical for the expansion of garment production in China.

Fourth, the government has extensively used its tax and regulatory policies to encourage upgrading along the leather value chain. The export of raw hides and skins, for example, is banned to push local processing of leather. Similarly, the export of semi-finished leather products was subjected to a 150% export tax in 2008. In 2012, the same level of tax was imposed on the export of crust leather products. While limited local capacity might have attenuated the benefits of these interventions, our findings (as well as other studies) suggest that they have encouraged the production of high value leather goods. Such types of pre-announced interventions are enormous disincentives to producers who are reluctant to move up the leather value chain, and help push more innovative and efficient producers up the value chain.

All these interventions had the combined effects of improving value addition, export and employment in the leather and leather products industry. Further, the provision of land at highly discounted lease rate, duty free import of raw material and capital goods as well as access to subsidized credit has attracted both foreign and domestic investors by reducing entry costs. These achievements are not, however, very large, particularly when measured against the sector's potential. There still remains much room for policy to improve several facets of livestock management and hide and skin collection. This would greatly improve raw hides and skins supply and quality for the leather processing enterprises. Instituting formal means of communication whereby all stakeholders are fairly represented can facilitate dialogue and bring instant solutions to issues impacting the industry. In addition, this would help build greater trust among various stakeholders in the industry while enhancing the quality and ownership of regulations. Indeed, we completely agree with Rodrik's (2004) point that emphasizes the importance of continuous collaborative engagement between investors and the government, "[the]...task of industrial policy is as much about eliciting information from the private sector on significant externalities and their remedies as it is about implementing appropriate policies". One such piece of information is the lack of working capital which threatens to undermine all achievements made if it is not urgently addressed. Our paper aims to be wide-ranging and therefore cannot provide the necessary depth on all details of policy, present or future. Further research will be needed to flesh out the various recommendations we have made above. Given the potential of the sector and the government's willingness to use both conventional and unconventional policy measures to support and guide its growth, it seems all the basic ingredients are there to achieve the stated aim of an internationally competitive fully-integrated leather sector. However the sector's growing pains are real and could cripple it if they are not alleviated by concerted and considered action.

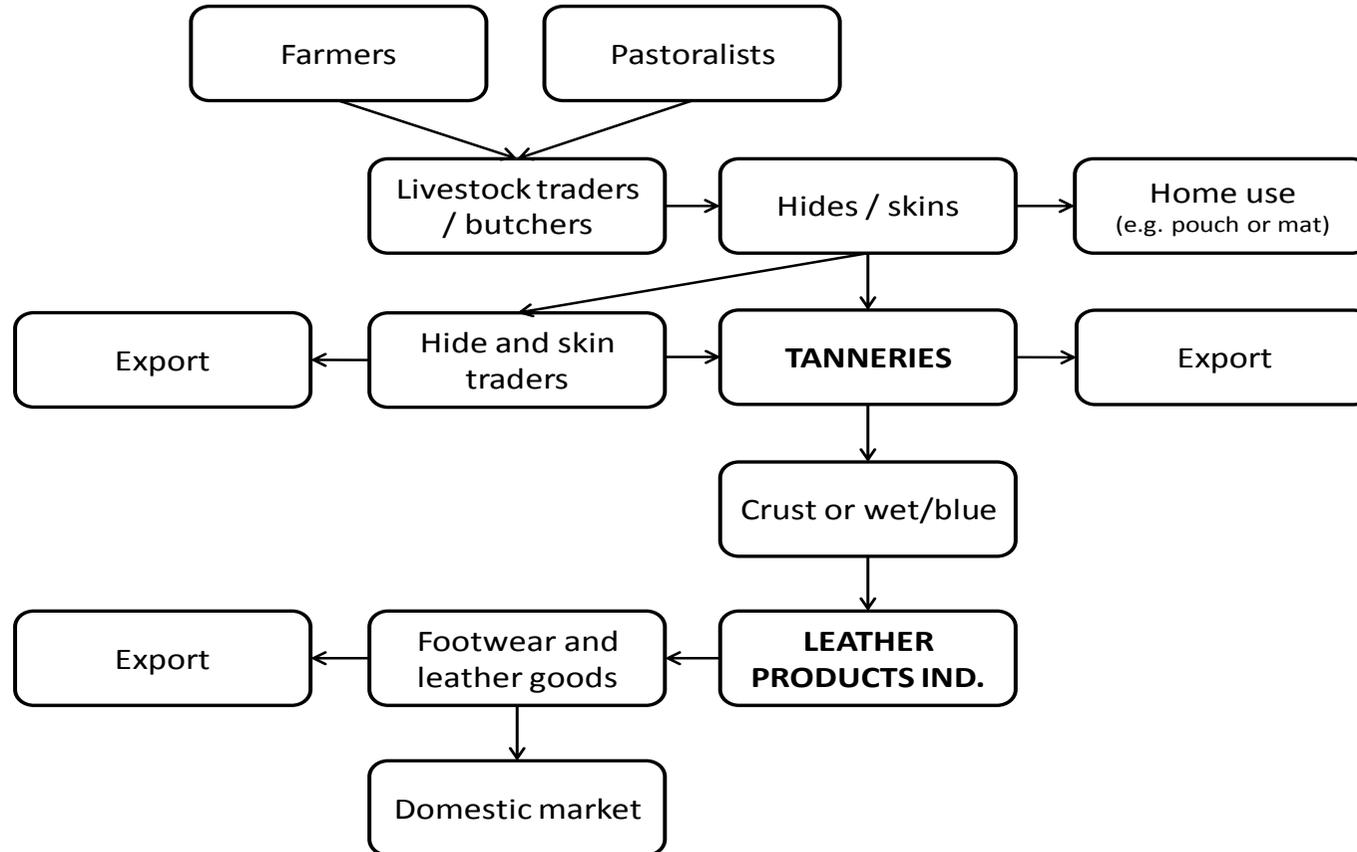
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Annex 1. Products and participants in the leather value chain



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