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Corporate governance and ownership structure: The case of Ethiopia

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Abstract: *This paper examines the reform issues that relate to corporate governance in Ethiopia. We examined Ethiopia's large business sector using theories developed in the capital structure literature. There are five findings. First, we find that Ethiopia's large business sector can be classified into three groups of enterprises. They are State Owned Enterprises (SOEs), political party owned companies and family owned and controlled private limited companies (Plcs). Second, when control is invoked and cash flow rights are considered, we find that the ruling party exercises control over the resources of both the SOEs and the party owned enterprises. Third, when related party transactions are considered, one finds an interesting set of associations between few family-owned businesses and the ruling party. Fourth, when the large business sector is examined using the definitions for public interest entities, all three forms of enterprises can be classified as public interest companies. Fifth, we observe that the absence of separation of powers in the institutional settings of the country and weak corporate laws are serious voids for complying with international corporate governance standards.*

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1. Background

This paper examines the reform issues that relate to corporate governance in Ethiopia. After the death of its long time Prime Minister in August 2012, the country has continued to undergo through major changes that involve ownership rights rearrangements. There are major dispositions of State controlled assets that include land, finance and physical capital. The winners and losers of this ownership rights rearrangement have become clearer as the governance system continued to be devoid of public accountability, and success and failure in wealth accumulation continued to be associated with the perceived or actual relationship with those who control the levers of political power. Using theories based on capital structure and ownership concentration and a qualitative research method, the paper attempts to make a dispassionate analysis of the problems of corporate governance in present day Ethiopia and provides specific reform options.

De Silanes, La Porta and Shleifer (1999) examined corporate financial structures in 27 wealthy countries, and reported that firms in these countries are not widely held.[1] In contrast to the Berle- Means (1932) image of modern corporations, which appears to be characterized by diffused ownership concentration, corporations in wealthy countries where shareholder protection is not strong, are typically *controlled* by families or the State. Ownership structure and concentration relate to the level of *control* one has over the assets of the company, and sets the basis for the governance of the firm. In this respect, the International Accounting Standards Board (IAS # 27, now superseded by IFRS #10) defines the term *control* as "*the power to govern*" through either holding fifty or more percent of the voting rights or through having significant influence on the appointment/removal of directors, and of the financial and operating decisions of the firm. The financial economics literature however works on much lower thresholds. More recent works on the association between ownership concentration and corporate governance distinguish control through voting rights (shares) from control through cash flow rights.

International variations in corporate governance practices are associated with a number of firm specific, macroeconomic, industry, market microstructure and country variables. At the firm level problems of governance introduce resource misallocation while at macro level it creates impediments to growth, innovation, investment and distorts public policy regarding the allocation of property rights (Morck, Wolfenzon, and Yeung, 2005). Glaeser, La Porta, De Silances and Shleifer (2004:26) also confirm that human capital is key for both growth and democratization; and state that the current measurement strategies of the quality of governance have both conceptual and measurement flaws. Indeed, the econometric approach of finding conclusive evidence on the association between quality of governance and finance has had little success (Kirch, Mateus and Terra, 2009). Glaeser et al (op cit) noted that growth in many poor Asian countries was achieved when they were/are under dictatorships (unaccountable governance system) that respected property rights.[2] In sum, firm specific corporate governance standards cannot be examined without taking into account the general state of governance in the country and the prevailing ownership structure in the economy.

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[1] Jensen and Meckling's (1976) distinguish between capital structure and ownership structure and note that the former refers to the quantities and values of debt securities held by the firm while the latter suggests the distribution of equity securities among the various owners of the firm. The Financial Times lexicon (http://lexicon.ft.com) relates ownership concentration to the shares owned by individual investors and block holders of the shares of listed companies.

[2] Unaccountable governance system suggests the absence of separation of powers and the presence of conflict of interest. Separation of powers is a constitutional concept that evolved from the *trias politika* doctrine, where government is the sum of the legislative, the executive and the court system. The concept of separation of powers is therefore different from the concept of separation of ownership and management.

To determine ownership structure in the firm the analyst can examine the relationship between debt and equity capital on one hand and the ownership pattern within the equity structure on the other hand. To assess the equity structure various proxy variables can be used:-individual block-holders ownership, director ownership, top 5 shareholders ownership and the extent of the use of nominee companies (Demsetz 1983; Demsetz and Lehn 1985; Rajan and Zingales 1995; Mahrt-Smith 2005; Srivastava 2011).The direction of relationship (positive or negative) is omitted from this discussion as they have been giving mixed results. Furthermore, previous research has documented an association between ownership concentration and firm profitability. Krivogorsky and Burton (2012) for example examined corporate ownership concentration in seven European countries to understand the performance of 1533 European corporations during the 2005 and 2007 period. The form of ownership they examined were dominant owner as represented by an institution (mutual fund, pension fund), block holder, family/individual, or a bank and firms with unidentifiable dominant owners. They find that form of ownership concentration is significantly associated with financial performance of the firm.

Bhaumik, Driffield and Pal, (2010) indicated that ownership concentration is widespread in emerging economies. Al-Fayoumi and Abuzayed (2009) for example examined Jordanian industrial firms during the period 2001 to 2005 and reported that the debt ratio is negatively related to managerial ownership and inconclusively related to individual shareholders' ownership. Letsoenya and Negash (2013), using panel regressions for 95 non-financial and non-mining firms data listed on the Johannesburg Stock Exchange between 2000 and 2010, reported concentrated ownership structure in the South African stock market as measured by the equity ratio of the top five shareholders. Furthermore, this ownership concentration has had an inverse relationship with the debt levels that firms assumed. Evidence also shows that family controlled firms have competitive advantage and public companies with large family controlling owners and professional outside managers increase the performance of the firm. However, excessive family control is known to reduce performance and to systematically expropriate minority shareholders (Gama and Golvago, 2012).

Ownership concentration therefore relates to corporate governance in a number of ways. At the heart of the theories lies the age old Adam Smith's question of trust:- the relationship between the capital provider (principal) and the agent (management) on one hand, and between different groups of capital providers on the other hand. Information, market microstructure, uncertainty, cost of capital, crisis, bankruptcy, corporate laws, ethics and audit (Jensen and Meckiling, 1976; Akerlof, 1971) are at the centres of the contemporary debate on corporate governance. In the United States, where the market size and complexities are unique, various forms of regulations (Sarbanes Oxley Act of 2002, the Dodd Frank Act of 2010) are promulgated as responses to the various forms of dysfunctional behaviours of managers. The key features of these regulations get transmitted into the rest of the world through financial markets and global financial reporting and auditing standards.. The present crisis in Britain's banks and the Euro Zone countries is also a prelude to a series of policy reforms that aim at repairing systemic failures of governance. Similarly, for the 1997-1998 Asian crisis, poor corporate governance, lack of competition and close knit relationship between government and business were blamed. In this respect, Morck et al (op cit) and Rajan and Zingales (1998) alluded that the Asian crisis was a product of the system of "crony capitalism".[3]

Another important dimension for the study of corporate governance is the link between corporations and the general public. Setting aside the political costs of corporations (Watts and Zimmerman, 1986), for Pigov-ians public interest falls into an economic welfare theory which views regulation as a response to inefficient, incomplete and or inequitable market outcomes. In the accounting literature public interest is

[3]. Morck et al (op cit) defined crony capitalism from the perspectives of control, as exerting control over the large part of the assets of a country by a small group of families. For wei (2001:16) crony capitalism is an economic system where the court system and the allocation of resources are generally made in favour of those that have close relationship with political leaders.

examined from the perspectives of defining the accountability of managers and the ethical standards and professional responsibilities of an external auditor. Its historical linage is the relationship between the entity and its internal and external stakeholders (employees, management, government, customers, etc.). In this respect, the International Federation of Accountants, IFAC (2006) defines *public interest* entities along the lines of "listed entities plus others with revenue/assets over x amount". For the European Union public interest entities must have "significant public relevance because of the nature of their business, their size or the number of their employees".

Using case analysis and qualitative research methods, and following a mix of functionalist and interpretationist paradigms, this paper extends the capital structure, ownership concentration, corporate governance and public interest literatures to the study of the corporate sector in one of the small economies of Sub Sahara Africa (SSA). Ethiopia is selected as a case study because (i) it is one of the low-income and growing economies; (ii) its institutional settings are different from many SSA countries; (iii) Ethiopia's large business sector has not been included in previous cross country capital structure and ownership structure studies; (iv) it has no stock exchange and its financial deepening is shallow; and (v) corporate information disclosure through financial statements is not the norm, and institutions of accounting and accountability are weak.

We find that Ethiopia's large businesses can be easily classified into three groups of enterprises. They are State owned enterprises (SOEs), political party owned companies and family owned and controlled private limited companies (Plcs). In other words, except for very few share companies, Ethiopia does not have a corporation that is worthy of its name. Second, when the IAS # 27 definition of *control* is invoked and cash flow rights are considered, we find that the ruling political party exercises control over the resources of both the State owned enterprises and the political party owned and controlled enterprises. Third, when the companies are examined from IAS # 24, related party transactions perspective, one finds an extreme form of conflict of interest. Fourth, when the large business sector is examined using IFAC's definition of public interest entities, all three forms of enterprises can be classified as public interest companies. Fifth, unlike what is premised in most corporate governance studies, absence of separation of powers in the governance system of the country and systems and processes that curb conflict of interest make matters more difficult.

The rest of the paper is organized as follows. Section 2 reviews the literature on ownership structure, ownership concentration, corporate governance and public interest entities in the context of SSA and Ethiopia. Section 3 discusses the state of ownership patterns and corporate governance in Ethiopia in more detail. Section 4 outlines the reform debates and provides policy options. Section 5 contains concluding remarks.

2. Relevant Literature

Corporate governance is an eclectic subject and the relevant literature is found in several disciplines, including in accounting, business management, economics, finance, law, psychology, political science and sociology. Though there is no widely accepted definition of corporate governance, the topic is often discussed in the context of the institutional settings of wealthy nations. Despite the divergence amongst the wealthy nations' legal systems, the separation of powers principle is at the cornerstone of the political governance and public administration systems. From this premises most textbooks define corporate governance as "a process conducted by independent (outside) board of directors to authorize, direct, and monitor management towards the achievement of the organization's objectives" (Reding et al 2007:4; Sawyer et al 2003).[4] King III (2011) also outlines the key elements of corporate governance as follows.

[4] For details see the website of the Institute of Internal Auditors at http://www.iia.org.uk/en/Knowledge_Centre /Resource_Library/corporate-governance.cfm

They are ethical leadership, corporate citizenship, independent boards, independent directors, independent audit committee, the governance of risk, governance of information technology, internal audit, shareholders relationship and integrated financial reporting and disclosure. Similarly, the academic papers on corporate governance use analytical tools that attempt to resolve the problems of trust in a separation of powers institutional setting. Agency theory, managerial hegemony, stewardship, external pressures and shareholder-stakeholder (see Clarke, 2004 for reviews), all attempt to examine the problems of corporate governance under the institutional (organizational) settings of constitutionalism and separation of powers. Corporate governance studies that are made by accountants often take a financial reporting and auditing perspective, and follow a check list procedure (McGee 2009, 2008).

The predominant institutional settings (both political and economic) in SSA are different from the institutions of wealthy nations and democracies. In other words, corporate governance in SSA countries cannot be studied in the conventional way simply because of institutional differences and voids. The scanty literature on SSA economies replicates the research done in wealthy countries when in fact, most of SSA has been and continues to be under unaccountable dictatorial rule. There are few credible elections, and peaceful power transfers are rare. The constitutions are not enforced, and most of the institutions of the State are captured through violence and citizens are deprived of the rule of law.[5] The corporate governance surveys fail to detect these institutional realities. In this respect, Ayogu (2000:5) conducted a survey that covered listed companies in Botswana, Egypt, Ghana, Kenya, Mauritius, Namibia, Nigeria, South Africa, Swaziland, Zambia and Zimbabwe. He argued (p.5) by stating that “the underlying thesis is that a crisis of governance is basically a crisis of board of directors”. Even within the realms of mainstream finance theory, Ayogu (op cit) did not examine the association between corporate governance, board composition, political connections, ownership structure and myopic price formations in SSA’s tiny financial markets.

In a similar theme, Nganga, Jain and Artivor (2003:4) defined corporate governance as “the set of mechanisms through which outside investors are protected from expropriation by insiders.” Nganga et al’s (op cit) survey covered Botswana, Egypt, Ghana, Mauritius, Morocco, Nigeria, Tunisia and Zimbabwe. The focus of both studies was the legal system’s effectiveness in protecting shareholders. Critical theory (Llewellyn, 2003; Tinker & Gray 2003) however not only question novice research but attempts to develop new perspectives to understand real institutions in the context in which they are operating. Real institutions in Africa must be seen in the context in which the post colony and dysfunctional States of Africa (Mbembe, 2001; Clapam, Herbst, and Mills, 2006, Muchie, Gammeltoft and Lundvall, 2003, Vestal, 2011, Zewde, 2003) are operating. In short, critical social theory shows that models, including corporate governance models, cannot be replicated and juxtaposed without examining real institutions.

Accounting and finance are branches of economics that have the comparative advantage of understanding the operating, investing and financing decisions of real institutions (organizations). Finance theory provides new and direct avenue for the study of corporate governance in institutional settings where separation of power is not practiced. Furthermore, the policy implications of the research results are less controversial. Unlike the radical humanist and radical structuralist Marxian paradigm, which often see nationalization as a solution to ownership concentration and inequality problems, finance theory, though criticized for its reliance on its orthodoxy, offers opportunities for corrections through the use of market forces. In other words, the capital structure and ownership concentration avenues to the study of corporate governance provide better insight into the understanding of the economic outcomes under dictatorships, crony capitalism, and complex ethno-religious-political alliance (conflict) that keeps the unity/disunity of the

[5] For more on country governance standards see World Bank’s World Wide Governance Indicators (Kaufmann, Kraay and Mastruzzi, 2010), Transparency International’s Corruption Perception Index, Foreign Policy Magazine’s Failed States Index, the Institute for Economics and Peace’s Global Peace Index, The Mo Ibrahim’s Foundation’s Index, and the questionnaire used by the toothless African Peer Review Mechanism (APRM).

fragile post colony states of Africa.

In a recently completed PhD thesis entitled "Capital and debt maturity structures: Evidence from selected African countries", Lemma (2012) examined 986 African firms listed on nine African stock exchanges. Except for Egypt, Morocco and South Africa, most of the firms were listed in tiny, inactive, inefficient and volatile stock markets. The period covered by the study was ten years (1999-2008). Lemma (2012) used dynamic models in a system GMM environment and reached several important conclusions. One observation that Lemma (2012:27) makes is the influence of institutional (law, organization), macroeconomic and industry variables on cross country differences on the dynamics surrounding capital and debt maturity structures.[6] In essence, Lemma (2012) extends De Silanes et al's (1999) thesis of the link between finance and law into the African institutional settings, and updates Gwaditzo and Ojah's (2009) work on cross country differences in the level of leverage.

Cross country differences in capital and ownership structures are important variables in explaining corporate governance practices. At the firm level most of the target adjustment and pecking order theories were very much conditioned by the size of the firm and the short term nature of the debt. In cross markets studies the situation is not straightforward. Bas (2012:83) for example, using a mix of data sources (World Bank enterprise survey data, world development indicators and Kaufmann et al's 2009 world governance indicators, etc.) from 24 developing countries, indicated that leverage level is different between those that have stock markets and those that do not (Bas, 2012:158). Countries with stock markets generally have higher level of leverage than those without stock markets, and this increase in the level of debt is observed across small, medium and large firms. Furthermore, institutional variables that relate to political governance were also found to be statistically significant in explaining cross country differences in the level of the use of debt (Bas 2012:186). If Bas's (op cit) results are correct, since Ethiopia has no organized stock market one expects lower level of leverage in Ethiopian firms.

Another interesting governance variable that is identified in Bas's (op cit) work is corruption. This is supported by a more recent work. Lemma and Ambe (2012) directly tested whether corruption indeed explains capital structure. Using 556 listed non financial firms' data from ten African countries across a time period of 15 years and system GMM regressions, they found interesting set of results regarding the association between key political governance variable (corruption) and how firms are financed. The countries in their sample were Botswana, Egypt, Ghana, Kenya, Mauritius, Morocco, Nigeria, South Africa, Tunisia, and Zambia. Using World Bank's corruption index, they reported that high corruption countries used more debt than equity in the capital structures, and much of the debt was of short term nature. The level of ownership concentration (measured by major block holders) was also an important variable.

The implications of the above empirical evidences is that they take De Silanes, et al's (1999) findings a step further and suggest that there might be an optimal level of ownership concentration in the equity structure of share companies.[7]That is, there is a trade off one has to make between diffused ownership structure which supports the Berle Means (op cit) image of corporations, and concentration levels that create an

[6] Notwithstanding the exclusion of countries that do not have stock exchanges from the study, the continental ratios (indicators of liquidity, short term and long term leverage, firm size, dividend payouts, inflation, rule of law, tax shield, asset tangibility, profitability, etc.) that were computed by Lemma (op cit) are useful pointers for comparing the unlisted corporate sector, and firms in decoupled markets such as Ethiopia's large enterprises.

[7] Optimal ownership structure suggests optimal ownership dispersion and relates to the theory of property rights, governance, negotiation, bargaining power of managers, board structure and diversity, and the type of debt obtained by the firm. Analysis of these issues is beyond the scope of this paper.

effective monitoring of the management of the organization.[8] Furthermore, for countries where the governance system is on the high end of corruption (absence of accountability and separation of powers), the dominance of debt finance brings two possible scenarios. First, wealth transfer from debt security holders to shareholders, and second how controlling shareholders are associated with the group that is controlling the levers of political power. When one deciphers the literature, he/she quickly observes that the study of corporate governance in institutional settings of dictatorships and cronyism require a methodological innovation.

3. A Focus on Ethiopia

3.1 Introduction

To link the international literature to Ethiopia's institutions (laws, organizations), one needs to have a brief account of the post World War II (WW II) history of large companies in Ethiopia.[9] Writing on the history of accounting and modern business in Ethiopia, Johannes Kinfu (1990:197), citing Geiger, states that "small scale Greek, Armenian and Ethiopians, stall keepers and itinerant peddlers, were in the course of time replaced by Indians, Italians and Levant wholesalers, distributors and retailers handling a large variety and volume of goods in the towns; and enterprising merchants and shopkeepers who formed the basis of the Ethiopian business sector after 1954". Kinfu (op cit) further notes that modern business enterprises were established as branches of foreign enterprises. This was accelerated during the post war period of the restoration of the Imperial Government of Haile Selassie I. Companies with substantial capital were created through a mix of government, public and private partnership. The State primarily owned the commanding heights, either in whole or in part, and had significant influence on key economic institutions. Both the Commercial Code and the Civil Code of 1960 promulgated the sacrosanct nature of private property, and provided key sections for contracts and expectations from directors of share companies (Gebremeskel, 2010).

This growth trend in both institutions (law, organizations) and the economy was however halted after the Arab Israeli war and the oil shock of the early 1970s, when the military, in a slow motion coup, removed the age old Imperial Regime by murdering and imprisoning almost all of the members of the cabinet, senior State functionaries, religious leaders and members and affiliates of the Royal establishment. All rural and urban lands together with major business enterprises and "extra houses" were nationalized. The net assets of over 72 companies were confiscated, and in 29 firms the government became the majority holder of equity (Kinfu, op cit). Most of the nationalized companies were given to the then Ministry of Industry. The ministry in turn reorganized the nationalized companies into 12 corporations, and appointed senior ranking military officers and civilians who were closer to the military regime as managers. The elite, which ended up in disarray, did compete against the military for political power on the basis of a more "refined" Marxian ideology, but did neither object the removal of the Imperial Regime nor the nationalization of private property. As most State Owned Enterprises (SOEs) in the world, Ethiopia's public enterprises and the nationalized companies showed dismal financial performance for nearly two decades (Negash, 1986, 1991). In other words, between 1974 and 1993 Ethiopia did not have a corporation that fits the definitions often found in the conventional literature of corporate governance.

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[8] Note that board composition (inside-outside, gender, diversity) studies do not directly address issues of ownership structure and ownership concentration.

[9] WW II and the manner in which it ended had important historical bearings for modern Ethiopia. The five year Italian occupation of Ethiopia was an interruption in the continuity of the independent traditional polity. At the end of WW II the Imperial regime was restored with the help of the Allied Forces, and Eritrea was federated with Ethiopia by the resolution of the General Assembly of the United Nations.

In May 1991, after the breakup of the Soviet Union and Russia's disengagement from the Horn of Africa, the military government of Colonel Mengistu Haile Mariam collapsed with a dramatic speed. The institutions of the State were captured by the guerrilla forces of the Tigrai People Liberation Front (TPLF) and the Eritrean People Liberation Front (EPLF). The winners of the civil wars inherited a post conflict economy and complex political problems in their respective territories. The main cities (Addis Ababa and Asmara) were captured without much death and destruction. The TPLF elected to demobilize an estimated 189 000 national army and voluntarily ceded the two ports to Eritrea. This decision continues to cause tension within Ethiopia as it has both economic and security ramifications. Faye, McArthur, Sacks and Snow (2004) empirically show the particular economic challenges that are faced by landlocked developing countries.

In addition to the 1991 event, two important events have affected the development of policy in Ethiopia. The first event is the 1998-2000 border conflict between Ethiopia and Eritrea. The second is the 2005 election. The first relates to peace, security, landlocked-ness and the split within the Marxist Leninist League of Tigrai (MLLT), the group that controlled the TPLF/EPRDF and the Government of Ethiopia. The second relates to governance and economic policy. After the failure of the 2005 political liberalization effort, the country became a de facto one party State that is controlled by the winning faction of the MLLT and developed new allies.

The winning faction of MLLT and its new allies, accelerated the implementation of a privatization program that is similar to the East European privatization, the result of which was gains from economic rents, massive transfer of wealth and new entrants in the market. Getahun Seifu (2010) states that since 1995 some 308 tenders of SOE's and their branches were offered to the private sector, and about 276 (89.6%) of the firms were sold. The firms were in the manufacturing, agro-industry, mining, hotels and tourism and trading sectors. It was in the middle of these changes and tensions that Meles Zenawi, the person who ruled Ethiopia for the past 21 years died of undisclosed illness in August 2012 in Brussels. At the time of writing this paper, there are no indications of either political or economic liberalizations in the country. In fact key reform questions of accountability are being attacked for being "neo-liberal"

Returning to the corporate governance related issues, during the 21 years of TPLF/EPRDF rule, there was no major corporate law development. The Commercial Code of 1960 remains unchanged and Proclamation Number 686/2010 deals with Commercial Registration and Business Licensing. Hussein Ahmed Tura (2012), writing on the overview of corporate governance standards states that Ethiopia's "company law does not have adequate legislative provisions on governance issues related to the separation of supervision and management responsibilities, and on the composition, independence and remuneration of board of directors in share companies". In other words, the GoE has not been keen in reforming the corporate law in line with international best practices.

3.2 Capital structure and ownership concentration in Ethiopian Companies

The capital structure and ownership pattern of large Ethiopian enterprises are by and large unknown. Research on the capital structure of Ethiopian firms is also difficult because of absence of data. The depth, rigor and completeness of the few Master's thesis projects that are available on line are disappointing. Major global data streams do not include information about Ethiopian companies. There is no national data center other than the one owned by the Ethiopian Economics Association.[10] Furthermore, many of the large firms are incorporated as private limited companies and hence they are not legally required to publish their financial statements. In addition to this level of information opaqueness, most of the microeconomic statistics that is issued by government departments and the World Bank are results of surveys. Any

[10] Access to this data requires passing bureaucracy hurdles.

empirical work on Ethiopia's corporations faces the problems of data integrity. Therefore the absence of reliable information continues to be a point of distress for many researchers.

Notwithstanding the above, we review the available work so that we have some pointers. In this respect, Bas (2012:133, 137), using World Bank data of 733 Ethiopian firms (of which measured by sales and assets 76% are small, 18% medium and 6% large) indicates that the ratio of short term debt to total asset was about 10%. The ratio of long term debt to total assets was about 5%. Similarly, Bas (2012) estimated that the profitability ratio of some 1076 firms was in the range of 20%. Inflation was on the average at about 4%. If one takes Bas's (op cit) ratios seriously, one might be tempted to conclude that debt is not an important element in the capital formation of Ethiopian firms, and a rate of return of 16% net of inflation, is a comfortable level of profitability. As we shall see later, this statistics is misleading.

Kinde (2011), using nine companies' and seven years (2004-2010) financial statement data, estimated that at least half of the total capital of the insurance industry is owned by the State owned Ethiopian Insurance Corporation, and the ratio of total debt to total assets for the industry was in the region of 64% while ratios of debt to equity and profitability (operating income to total assets) were respectively 28% and 4.8%. The ratio of short term debt to total debt was about 70% and the liquidity ratio (current assets over current liabilities) of the industry was about 1.99. For the manufacturing sector, Mekonnen (2011) using 12 manufacturing share companies' data, across a time period of 2004-2010, from the city of Addis Ababa, estimated that the ratio of total debt to total assets was about 47% while the ratio of current liabilities to total assets and ratio of long term liabilities to total assets were respectively 31.4% and 16.59%. The profitability ratio was 3.1%. In a related study, Lelissa (2007), in his work on bank liberalization in Ethiopia indicated that by the end of 2006 there were ten banks in the market. The two state owned banks (CBE and CBB) dominated the sector. About 70% of the assets of the sector, 45% of the loans and 67% of the deposits were controlled by the two State owned banks. Kapur and Gualu (2012) provide evidence which shows that the performance of the newly established private banks is better than the performance of State owned banks**.**

A number of points can be raised with the financial indicators mentioned above. First, most of the parameters indicated above were taken from student works done at Addis Ababa University. Second, since the financial statements do not comply with IFRS (International Financial Reporting Standards) the ratios cannot be easily compared to the statistics from the rest of Africa. Third, the historical cost information becomes irrelevant for decision making purposes as the country has been undergoing through a period of hyperinflation.[11] Fourth, related to point number three, above, the cost of debt finance and profitability ratios require special attention. The interest rates do not reflect the real cost of capital and furthermore credit channeling is common. Fifth, we are not aware of prior research that examined the emerging ownership concentration patterns in the Ethiopian economy. We are not aware of previous work that examined the share ownership concentration pattern in Ethiopia. It is in the light of these voids that we attempt to examine the corporate governance system in the country. The remaining section of the paper focuses on the two major actors of the Ethiopian economy whose ownership structure and concentration are fairly clear. They are the EFFORT group of companies and the MIDROC group of enterprises.

3.2.1 Political Party Owned/Controlled/Linked Companies

Political party affiliated companies are often discussed in connection with the financing of political organizations and whether there is any link between these firms and election outcomes. In democracies (where there is separation of powers and accountability), party funding rules often put caps on donations,

[11] IAS #29 requires the preparation of inflation adjusted financial statements once the three year cumulative inflation rate passes the threshold of 100%. An average profitability ratio of 4.8% suggests that the firms have not been able to either control costs or adjust their premium incomes accordingly.

and require audit and disclosure. Regulations attempt to curb donations/briberies from companies that do business with the government. In other words, any actual or perceived conflict of interest between the party, its members and the state must be avoided and controlled. See for example http://www.idea.int/publications/funding_parties/ summary.cf. These issues are equally important in emerging democracies. In this respect, in June 2012, the African National Congress's Mathews Phosa, though correctly alerted his audience that unregulated political party funding is dangerous to democracy, he did not elaborate whether his own party owns and controls companies.[12] In short separation of powers, contestable entry and exit from power, and systems and process that curb conflict of interest are important elements of sound public and corporate governance. In post-conflict economies the situation is worse in that the institutions of the State are captured through violence. Furthermore, all indications throughout Africa is that the former "liberation movements" that captured power have not been able to convert themselves to peace time political parties.

In its rather dated website, http://www.effortgroup.org/ companies.htm, EFFORT, the main political party controlled conglomerate in Ethiopia, lists the names of 13 companies that are under its control and management. The website does not contain financial information. Analysts and opposition forces however state that the list of TPLF linked companies is more than what is stated in EFFORT's website.[13] Most of EFFORT's companies were established between 1993 and 1995. They are incorporated under the 1960 Commercial Code as private limited companies.[14] EFFORT claims to be "committed to contribute to the sustainable development efforts in the region [Tigrai]" and uses terms like "shareholders" and "corporation" without qualifiers. In substance, the companies are controlled by the TPLF leadership and often managed and staffed by party loyalists rather than meritorious employees. In terms of ownership, no one owns the shares of the company, and it is evident that the people of Tigrai do not own these companies. [15] In the section that deals with vision, EFFORT defines its aspirations as follows:-

"*The vision of EFFORT Corporation is to be* a *corporation that can consistently and successfully be a competitor in a global market, a corporation that has entered a progressive development path, and a corporation that can be an exemplary corporate citizen."*

As noted above there is no theoretical support for party owned and operated businesses in democracies. The exception is observed in those who advance "development/transformation patrimonialism" paradigm

[12] http://www.iol.co.za/news/politics/party-funding-reform-urgent-phosa-1.1314203

[13] For instance, http:abaymedia.com/news/?p/=2683 provides a list that contains the names of 66 companies that it claims to be affiliated to the ruling party. The total initial paid in capital, according to this website is some 2.3 billion birr (1995 value, 1 US about Birr 5.88). The same website lists the names of additional 32 affiliated companies whose startup capitals are not disclosed. If this website is correct, ruling party owned/affiliated companies are about 98.

[14] According to the Ethiopian law, a private limited company can be created by a minimum of two individuals and a maximum of 50. The law gives its shareholders the same right as shareholders of a corporation in that risk is limited to the assets of the enterprise. In many countries private limited companies are also referred to as close corporations. Compared to normal corporations the risk profile of close corporation is high. Private limited companies have advantages and disadvantages. The main advantage is that it gives their owners control and ownership with limited liability, saves them from complying with intricate rules of share companies. Whether public interest companies such as EFFORT should be allowed to be incorporated as private limited companies is an interesting debate. For more on this see coming sections.

[15] By the end of 2012 EFFORT's Chief Executive Officer is the spouse of the late Prime Minister. She is a member of the Executive Committee of TPLF/EPRDF and the Parliament. Its key board members are the members of the central committee of the TPLF.

which breaks down when it faces the scrutiny of academia. In this respect, Booth and Golooba-Mutebi (2011) and Vaughan and Gebremichael (2011) respectively attempted to explain the merits of political party owned businesses in post conflict economies. The reports on Ethiopia and Rwanda were funded by Britain's Department for International Development (DFID). The report on EFFORT appeared to be self-serving, lacked independence, intellectual depth and rigor. It was reviewed by Ambassador Abadi Zemo:- a member of the TPLF's Executive Committee, and until recently EFFORT's Deputy CEO. In a report entitled *Rethinking Business and Politics in Ethiopia: The Role of EFFORT, the Endowment Fund for the Rehabilitation of Tigray*, Vaughan and Gebremichael (2011)claimed that the one billion US dollars strong company which accumulated its funds during the civil war in the 1980s, is "conducive to transformational economic growth" (page 12). Notwithstanding this unfounded claim, evidence unambiguously shows that not only unregulated political finance is both a danger to democracy (separation of powers and elections), but also distorts the economy. The distortion is in both the allocation and the distribution of resources. Contrary to the claim, political party controlled companies are indeed one of the results of state capture by organized groups.

3.2.2 The MIDROC (Ethiopia) Group of Enterprises

Claessens, Djankove, Fan and Lang (2002) examined control and entrenchment through share ownership and its association with firm value in eight East Asian countries, and concluded that concentrated ownership has impact on corporate governance. Heugens and van Essen (2008) used meta-analysis and found that concentrated ownership can be "an efficient" form of corporate governance. Lins (2002) extended the work to emerging markets using financial statement and stock market data of 1433 firms from 18 countries. He examined "whether management ownership structure and large non management block holders are related to firm value, and finds that management ownership is associated with value, and these associations are stronger in countries where shareholder protection is weak. Letsoenya and Negash (2013) reported that ownership concentration in South Africa's listed non mining and non finance sector is high as measured by the equity ratio that the top five shareholders have. On the other hand, widely held ownership has been found to have a significant positive relationship with leverage levels. Ownership by insiders such as directors, however, was found not to be significantly related to debt level that the firms are having. Letsoenya and Negash (op cit) did not examine the association between ownership concentration and corporate governance.

Related to the ownership concentration and corporate governance literature is family ownership. International evidence on family controlled firms shows mixed results. In sum, when families control less than 50% of the shares, firm performance is higher (Yin-hua Yeh, Lee and Woidtke, 2001). The organization literature on family controlled businesses suggests that these firms enjoy competitive advantage over non-family owned businesses. Carney (2005) argues that fair control over the assets of the firm produces three dominant propensities (parsimony, personalism, and particularism); these in turn provide comparative advantage to the firm. These studies were examined using data from stock markets and assume a separation of powers institutional setting. Whether these findings can be extended to unlisted companies, or firms operating in countries where there are no stock markets, and/or in institutional settings where there is no separation of powers, remains unclear.

Examination of MIDROC Ethiopia, a family owned and controlled private limited company provides a useful insight into the state of corporate governance in small economies like Ethiopia. MIDROC is owned by Sheik Mohammed Hussein Al Amoudi. According to Forbes Magazine, in October 2011, the Ethiopian born Saudi Arabian Sheik's net assets were estimated at 12.3 billion US dollars, making him the 63rd richest person in the world. In a recent interview with the State owned television (ETV), the Sheik announced that his investment in Ethiopia is estimated to be between four and five billion US dollars. If one takes this statement at face value and relates it to Forbes's estimation, it suggests that between 35 and 40 percent of his wealth appears to have been invested in Ethiopia.[16]

Anecdotal evidence (Wikipedia) suggests that MIDROC's profit in October 2011 stood at about 1.3 billion birr or a mere 76.5 million US dollars. If one takes Wikipedia's figure as a pointer, the conglomerate's reported profit becomes just about 2% of the Sheik's declared investment in Ethiopia. This figure does not make sense. First, the country is in hyperinflation cycle (cumulative three year inflation totaling more than 100% per IAS #29). Second, the rate of return does not mirror the GDP growth rate (real growth rate of 11% per annum) that is claimed by the Government of Ethiopia. Third, when benchmarked by African standards (see Lemma 2012), the rate of return is low.[17] Fourth the market structure is monopolistic, and at best an oligopoly of two contestants (EFFORT and MIDROC).

In its website http://www.midroc-ethiopia.com.et/index.html MIDROC lists 18 companies that are under its full ownership, 4 affiliate companies, 16 companies under its technology group and states that the company is in the process of starting 5 new projects (companies). The initial capitals of these companies were published in a rather dated flyer. Most of the MIDROC companies, which according to the website total about 43, are private limited companies. This legal and market structures when added to its affiliations with the ruling group, provide the dominant owner the benefits of control, with no personal liability in the event of bankruptcy.

Under its corporate citizenship title, the website lists the awards, donations, fames, philanthropy works and recognitions given to the Sheik. Interestingly, with regard to corporate governance the website states the following:-

"The MIDROC Ethiopia Investment Group is organized with various modalities of management. One set of companies are organized under MIDROC Ethiopia Technology Group, Chief Executive Officer. The other set of companies are organized as totally independent entities, some having Boards of Directors, where as a group have a Consultative Body represented by the Top Management of each of these companies. The Head Office of the MIDROC Ethiopia Investment Group serves also as the secretariat of this Consultative Body…. In line with the motto of the Investment Group **"***Committed to Development," MIDROC Ethiopia allocates huge amount of local and foreign resources and exerts extensive efforts to ensure Good Governance in the investment group, promoting transparency and ethics in its public and private partnership affairs..."*

Two important points can be raised from MIDROC's corporate governance statement. First the statement does not comply with the standards that are set by the Global Reporting Initiative (GRI). The information does not meet Social and Environmental Reporting (SER/ESG) reporting norms. Second, the organizational structure does not provide indication how the Sheik is managing and exercising control over the resources of the companies. Third, though the conglomerate claims to promote transparency and ethics in its public dealings, it has not disclosed even its summary financial indicators. Hence, consistent with DiMaggio and

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[16] However, it is important to examine the capital structure (debt-equity ratio) of MIDROC and how much of the debt is financed from local sources. Finance theory generally suggests that in environments of high economic, political and financial risk, investors tend to use various forms of hedging strategies, including sourcing their financial requirements from domestic sources. Unfortunately, the information environment and the legal framework in which MIDROC operates are not conducive for reliably estimating the Sheik's net investment (assets less liabilities) in Ethiopia.

[17] Lemma (2012, see Table 4.2) estimates that between 1999 and 2008, the 986 firms listed in nine African stock exchanges had an average profitability ratio of 11.2%, a dividend payout ratio of 61% and total leverage ratio of 49.3%.

Powel's (1983), legitimization theory it is difficult to separate the information from corporate propaganda. Consequently, the challenge for researchers and policy makers is how to improve the corporate governance standards of important public interest economic institutions that are operating in post conflict and opaque governance settings. Neither critical social theory nor radical humanist nor radical structuralist theories nor main stream corporate governance literature provide cues for addressing these challenges.

4. The Reform Issues

In section 3, the paper has shown that EFFORT is one of the major actors in the economy, and according to some estimates the number of linked firms total to 98. Many of the SOEs are headed by senior ranking members of the ruling party and the military. MIDROC in turn is owned and controlled by the Sheik and his family. In other words, there is an oligopolistic competition between the two horizontal conglomerates. The interesting question is how to reform these institutions. In this respect Glaeser et al (op cit) show that reforms to such institutional settings might be achieved through the "inevitability" of a revolution. Another interesting question is whether changes sparked by revolutions and instability will necessarily lead to the decoupling of State institutions from its capturers. Hence, which way Ethiopia's corporate governance reforms will come is hard to predict. The paper outlines the feasible policy options below, nonetheless.

In the event that the system is changed through popular revolution, the threat of nationalization cannot be removed especially if the power falls in the hands of populists (such as in Argentina, Bolivia, Egypt, Spain and Venezuela). Nationalization however has a number of problems. First, capital will be shy and Ethiopia's economy will be forced to contract again. Second, the half hearted respect for property rights can easily be reversed through a political process. Third, there is no evidence which shows that nationalization leads to better performance of assets. Fourth, the companies might already have been heavily geared towards debt, and the source of debt finance is often the State owned banks.[18] Furthermore, disfavored majority groups are unlikely to remain quiet as the stakes have already been high. Hence, the important reform debate should be how political party owned and controlled companies and family owned private limited companies can be restructured with minimum shock(s). One approach is viewing these companies as public interest entities (IFAC, EU). A public interest perspective together with insights from finance and governance theories, provide opportunities for considering policy options.

(i) First and foremost, Ethiopia needs a careful institutional development/reform that puts separation of powers and accountability at the corner stone of the governance system.[19] The link between finance and politics must be clearly identified and conflict of interest must be regulated. This institutional development/reform, if supported by functioning monitoring devices, opens the road for stability and reforms will not continue to be driven by political exigencies.

(ii) The political decision of whether the net assets of EFFORT and similar institutions are owned by one ethnic group or not needs to be resolved. Furthermore, even if the ethnic enclaves are allowed to break away as per Article 39 of the present Constitution, political party controlled companies are untenable when such institutional arrangement is examined from the perspectives of allocation and distribution efficiency,

[18] The state of Ethiopia's state owned banks is not clear. The Development Bank which lends to government sanctioned projects has gone through recapitalization. The association between corporate debt level, aggregate debt in the economy, liquidity and currency crisis is complex. What triggers capital flight from smaller economies to bigger economies is not known. Evidence however shows that corporate capital structure is associated with the vulnerability of countries to currency crisis, and the rehabilitation programs are often interconnected with corporate debt. For more on this see NBER papers and Beim and Calomiris (2001).

[19] Whether this reform is likely to occur without political liberalization remains a moot point. It is beyond the scope of this paper.

control, democracy and public interest. The citizens of the new small states will still be worse off because resources will continue to be controlled by one close knit network through a political process. Furthermore, the market structure will continue to be distorted.

(iii) Converting EFFORT into an SOE, to be administered by either the regional government or the national government, does not resolve the dismal financial performance observed over many years in many public enterprises that are managed by governments. China's conversion of its key SOEs into share companies through limited privatization programs provides some lesson. The poor financial performance of Ethiopian SOEs is generally associated with political intervention, absence of competition, multiplicity of objectives and management incompetence. Reform programs that aimed at providing autonomy for SOEs have largely failed, and privatization through specific ways was taken as the preferred option. In some cases the government was selling assets that were nationalized. Hence, the conversion of EFFORT's groups of companies into national SOEs might reduce regional tension, but does not resolve the allocation and governance problems. Therefore, the important point then becomes finding the ways and means of converting EFFORT from a politically sensitive, poorly managed and region focused organization into a vibrant public interest company.

(iv) Privatizing the political party owned and controlled conglomerate and its associates through tender process transfers the assets of the party into the balance sheet of few individuals, and hence worsens the degree of ownership concentration in the economy. It is more than likely to exacerbate corruption. Privatization through the sale of shares also brings an additional issue. The proceeds from the sale cannot go back to a political party which is determined to continue to capture the institutions of the State. The risk that buyers will be selected in a particular way or the shares will be transferred to linked companies and fronts, and the proceeds of the sale will be used for political purposes, puts additional problems to the privatization process.

(v) Political party owned and controlled companies can be converted into public share companies by initially distributing shares to the general public freely, in a fair and equitable manner, and with an extended vesting period for ownership right transfers. Except for price formation purpose, the process would be similar to an initial public offering. The manner in which SOE's in Russia were converted into share companies and how the Russian financial oligarchs were created might provide important lessons. Ethiopia must be able to control the adverse effects of privatizations. The social and humanitarian wings of EFFORT can be merged with regional government departments or allowed to operate as welfare organizations.

(vi) With regard to MIDROC group of enterprises, there are two avenues for reform. The reforms can be both internally initiated and externally imposed. Within the firm itself, it must be realized that, under conditions of separation of powers and the rule of law, much of the firm's association with the ruling regime cannot be business as usual. Secondly, the unhealthy association between business and government is an obstacle to free and fair election, and hence the firm is more than likely to face political risk. Hence, a major image correction, and reposition/rebranding of the institution with Berle Means (op cit) thesis of diffused ownership, converting it into a public share company without necessarily surrendering control, and keeping an arm's-length distance, might be a better option for the future of MIDROC. The experience of Chilean, Indonesian and South African companies might provide lesson.

(vii) The externally imposed changes can come both from changes in government policy and market forces.

5. Concluding Remarks

This paper has traversed through the literature in an attempt to examine the problems of corporate governance in one of the SSA economies. Capital structure and ownership concentration studies provided particular insights into the governance problem in institutional setting where separations of powers is absent, constitutions and transplanted European laws are not enforced, information is opaque and financial markets are undeveloped. We learn that bad governance as represented by corruption, and institutional settings that are devoid of checks and balances, is associated with increased use of debt. In other words the risk for debt security is high. Ownership concentration studies also show how few families that control the business sector are in close knit association with ruling regimes in many emerging economies. Furthermore, the situation becomes more complex in post conflict-ridden economies in that the winners of the conflict will also capture the coercive institutions of the State and the economy. As a result, the reform issues bring additional challenges.

Using the capital structure, ownership concentration and governance theories, the paper finds that (i) consistent with Glaeser et al's (op cit) observation, macroeconomic growth is possible under dictatorship; (ii) we also find that Ethiopia's large businesses can be easily classified into three groups of enterprises. They are State owned enterprises (SOEs), political party owned and controlled companies and family owned and controlled private limited companies (Plcs); (iii) when the IAS # 27 definition of *control* is invoked and cash flow rights are considered, we find that the ruling party exercises control over the resources of both the State owned enterprises and the political party owned enterprises; (iv) when IAS # 24 is considered it emerges that Ethiopia's large enterprises are in close knit association with the ruling party; (v) unlike what is premised in most corporate governance studies, we observe that separation of powers is the corner stone of sound corporate governance practices in emerging economies.

The reform programs can be either evolutionary or revolutionary. In the emerging structure, the decoupling of the State and the party (military) is main challenge. Regardless, the reform needs to aim at making the principles of separation of powers the cornerstones of the improved constitution. This in turn paves the way for corporate law development, and the buildup of institutions of accountability and accounting. The paper recommends that political party owned and controlled companies be abolished and restructured, and the net assets of these public interest entities be privatized through the issuance of free shares to the general public. This action does change the ownership structure without having cash flow effects, and de-politicizes the firms. An extended vesting period will minimize the speculation in the unofficial share market. As regards family owned and controlled private limited companies, though the international empirical evidence could not be directly confirmed, the conjuncture is that they are associated with relatively high leverage and do business with the government.

There are several directions for future research. The analysis of the state of SOEs, the effects of the privatization and management contract programs, a proper empirical study on the ownership pattern and capital structure of Ethiopian firms are some of them.

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