Rethinking Corporate Governance in Ethiopia

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Abstract

This paper is a follow up of a recent work on the link between failed State indicators and the four thematic areas of the African Peer Review Mechanism (APRM). The present paper disaggregates the four areas, and deals with the issue of corporate governance in Ethiopia. Sound corporate governance is grounded in the anti-thesis of the so-called “revolutionary democracy”. The paper’s contribution to the literature is twofold:-(1) It provides additional evidence that a microeconomic perspective of studying governance leads to a better understanding of key reform issues in many Sub Sahara African (SSA) economies; and (2) with regard to Ethiopia, the paper surmises that the overall standard of corporate governance is disappointing. More specifically, the legal and constitutional instruments do not provide adequate enabling environment; key international conventions and standards are not ratified; political parties own substantial number of business enterprises and operate in key sectors of the economy; ownership concentration through pyramid structure introduces particular problems of agency and creates crony capitalism; investor and creditor protection laws are inadequate; the absence of organized equity market is a serious void, and finally with regard to professional education, the increase in the number of tertiary institutions granting degrees and diplomas is not matched by sound quality standards. The reform debate in Ethiopia, sooner or later, will have to find solutions to these problems. Notwithstanding these problems, many Ethiopian politicians, including the authors of the recently released policy document of the ruling party, appear to have missed the opportunity to engage in the discourse that is brought by the APRM.

1. Background

The 6th Summit of the Heads of State and Government Implementation Committee (HSGIC) of the African Union, held on 9th March 2003 decided to adopt the African Peer Review Mechanism (APRM). The APRM is an effort to enhance the quality of governance in Africa. It has four perspectives; namely, democracy and political governance, macroeconomic policy and management, corporate governance, and social and economic development. By the end of June 2008, seven countries have already been reviewed by the APRM country review teams. Ethiopia has also availed itself for the review. The ruling party has also reportedly released its new policy. Hence, an independent and dispassionate work is timely.

Corporate governance is an interface, and thus the research can be approached from several disciplines; including political theory, legal theory, sociology, management, psychology, economics, and accounting and finance. Hence, the phase corporate
governance requires scope limitation, and it is important to note that the definitions that are commonly found in textbooks may not adequately describe the institutional realities and value systems of a given country. Notwithstanding this, the paper follows the structure of the official APRM questionnaire as a guiding instrument. The research methodology is qualitative, and examines publicly available archival material and uses secondary sources.

The paper surmises that the overall standard of corporate governance in Ethiopia is disappointing. More specifically, (i) The Commercial Code of 1960 does not provide adequate legislative response to complex governance issues of the day, and the new draft corporate law has not yet been finalized; (ii) Key international conventions, codes and standards are not ratified or adequately incorporated in the Proclamations; moreover the Decrees and Directives lack coherence and foresights, and at times suffer from poor drafting; (iii) Political parties own substantial number of economic institutions that operate in key sectors of the economy; making the funds suffer from high political and agency costs; (iv) Ownership concentration and pyramids create particular problems of agency, and increase the risk of chain bankruptcies and contagion especially when interest rates are liberalized; (v) Investor and creditor protection laws are inadequate, and as the court system is ineffective local investors substantially rely on traditional dispute resolution mechanisms; (vi) There is no organized share market. Hence, even though many share companies were created in the last decade or so, valuation and price discovery are problematic; (vii) The quality of professional education has become even more problematic in that the increase in the number of tertiary institutions offering degrees and diplomas is not matched by improved quality standards.

The rest of the paper is organized as follows. Section 2 reviews the literature on corporate governance in the context of Africa. Section 3 discusses the state of corporate governance in Ethiopia. To compare and contrast the conclusions of this paper with other works and reports, I use the standard APRM questionnaire and follow its structure. Section 4 provides key recommendations while section 5 contains some concluding remarks and indicates the direction for future research.

2.0 Relevant Literature

Most Internal Auditing textbooks define corporate governance as “a process conducted by board of directors to authorize, direct, and oversee management towards the achievement of the organization’s objectives” (see for example Reding et al 2007:4). Furthermore, most surveys of corporate governance focus on legal, institutional and firm level corporate governance practices that are designed to protect shareholders in publicly listed companies. In the context of the APRM, the term corporation is used “to broadly describe any form of entity that conducts commercial activity in an incorporated form.”

If one follows the definitions provided so far, it is evident that there are very few corporations in Africa, and more particularly in Ethiopia that fulfill the criteria. In other words, one cannot really speak about the corporate sector, in an environment where the

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1 APRM Master Questionnaire
economy is dominated by state owned enterprises (SOEs), political party controlled enterprises, and where few actors dominate the top tier of the economy.

Hence, international codes and best practices may have little relevance to the institutional realities of many top tier companies that are operating in several Sub Sahara Africa (SSA) economies. The scanty literature on African corporations mimic, replicate and juxtaposes Africa’s situation with European and American studies. It either takes the theories at face value, or follows a rejectionist paradigm. Most studies aim at the protection of investors, and the creation of sound capital markets. The recommended corporate governance instruments are largely embedded in rationalism when in fact several African institutions are often shaped by irrational leadership; in a collectivist, power distanced and male dominated cultures that exists by making complex ethno-political-economic alliance. Hence, one needs to separate between the African Corporation (where indigenous ownership is sought) from the corporation in Africa (subsidiary of multinational corporations which are largely present in resource extraction and commodity trade sectors).

Hence, curbing the dysfunctional behavior of managers (Jensen and Meckling 1976; Jensen 1984; Senbet and Otchere (2008), Uncue and Senbet, 1997; Negash, 2008) or curbing the behavior of “some wicked man” as described by the Ethiopian scholar Gabrahiwot Baykadagn’s (c1910) is a moot point. Licht, Goldschmidt and Schwartz (2003:1), using cross section samples of nations from around the world, and drawing on two models of cultural dimensions in cross cultural psychology, examined investor legal rights and national cultural profiles to show that legal approach to the issue of governance only provides a partial depiction of the “universe of corporate governance regimes.”

Claessens and Laeven (2003) provide evidence about the link between property right and growth. As regards ownership structure, La Porta, Lopez-de Silanos and Shliefer (2002), using cross country panel data examined government ownership of banks and showed that the reduction in State ownership resulted in significant growth of the sector. Recent research on capital structure also show that debt might have a useful role as a governance mechanism (Jensen, 1986; Stulz, 1990; Shleifer and Vishny, 1997) in disciplining management and improving performance on one hand, and addressing potential conflict between shareholders and lenders, and conflict within the shareholders themselves. Rajan and Zingales (1995) also show how poor governance is associated with crony capitalism, which in itself transmits shocks leading to bankruptcy and contagion.

There is dearth of studies in corporate governance in the Sub Saharan Africa (SSA) context, and the limited research is dominated by commissioned reports (Economic Commission for Africa, Guidelines for Good Economic and Corporate Governance, Addis Ababa, 2002; African Development Bank, 2001 Economic Research Papers # 66). Ayogu’s (2000) work falls into this group, and Ayogu (2000:5) argues that “the underlying thesis is that a crisis of governance is basically a crisis of board of directors”. He conducts a useful survey using international criteria, and concludes that corporate governance in Africa can be enriched by expanding the framework of analysis beyond the conventional criteria of development.” Ayogu (op cit) though seems to be critical of the
agency perspective, nonetheless follows the familiar indicators to gage governance in Africa.

Governance indicators are several and include both legal instruments (shareholder and creditor rights, efficiency of courts, contract enforceability), institutions (stock and bond markets), product market and implicit control methods for managers. Key indicators were executive compensation, succession planning, board size and composition, committee structure, accounting standards, creditor rights and bankruptcy law. In other words, the survey can be described as a replication of European studies. Ayogu’s survey covered *listed* companies in Botswana, Egypt, Ghana, Kenya, Mauritius, Namibia, Nigeria, South Africa, Swaziland, Zambia and Zimbabwe.

Nganga, Jain and Artivor (2003:4) defined corporate governance as “the set of mechanisms through which outside investors are protected from expropriation by insiders and was focused on countering what the authors refer to as the “myth of doing business in Africa”. The survey covered Botswana, Egypt, Ghana, Mauritius, Morocco, Nigeria, Tunisia and Zimbabwe. It focused on legal system effectiveness in protecting shareholders, information provision and competitiveness. The survey concluded that shareholders rights in the countries covered by the sample were comparable to rights enjoyed by investors in other emerging markets. Furthermore, it confirmed the importance of McKinsey’s 2002 survey; which stated that governance is more important than financials. McKinsey’s indicators included accounting disclosure, shareholders, capital market factors, broad country level factors (property rights, corruption, insolvency and bankruptcy, fiscal environment and banking system), independent and effective boards. Unfortunately, Ethiopia is not covered by these continental surveys, hence this paper did not benefit from prior research on Ethiopia.

**3.0 Corporate Governance in Ethiopia**

**3.1 Introduction**

Corporate governance is a new issue for Ethiopia. The history of corporations in Ethiopia requires a separate study, preferably from the perspectives of economic history. Neither the popular literature nor the reformist intellectuals of the 19th century (see Bahru Zewde, 2002) have openly argued for the creation and expansion of corporate entities. As to the origin of modern businesses in Ethiopia, Johannes Kinfu (1990:197), writing on the history of accounting and auditing in Ethiopia and 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 wholesales, distributors and retailers handling a large variety and volume of goods in the towns; and enterprising merchants and shopkeepers who became to form the basis of the Ethiopian business sector after 1954”. Johannes Kinfu (op cit) further notes that modern business enterprises were established as branches of foreign enterprises.

Notwithstanding the historical evidence of modern business, the companies with substantial capital, in one way or another, were created through a mix of public and
private partnership. In HIM Haile Selassie Government (-1974) the State either owned the major firms in whole or in part, or had significant influence. Hence, corporations that can be explained by the principal agent model, and thus needing the type of corporate law reform observed in the rest of the world, may not exist in substantial number in contemporary Ethiopia. Furthermore, unlike its neighbors, Ethiopia still neither has a stock market nor are its firms allowed to be listed in foreign stock markets. Hence, a brief review of the overall state of corporate governance and ownership structure should precede the application of the APRM instrument.

3.2 Corporate Governance during 1974-1991

Following the second Italian-Ethiopian war and the return of Emperor Haile Selassie from exile after the victory of the allied forces, British influence in Ethiopia increased. Between 1960 and 1973, the establishment of share companies (aksiyon mehaber) became routine, and stock broking firms (trading firms) started to emerge. The two key legal instruments, the Commercial Code of 1960 and the Civil Code of 1960, were major legal developments. However, the 1974 revolution brought to the Imperial Palace hard liners, which made the Commercial Code effectively non operational.

Several provisions of the Commercial Code and the Civil Code were either formally repealed, or suppressed by a series of Proclamations and Decrees. Negash (1986:31) stated that “the revolutionary transformation which started in 1974 from a once feudal-capitalist society to a socialist society brought massive (by country’s standards) private companies and share enterprises together with land into public ownership. 72 companies were nationalized and in 29 firms the government became the majority holder of equity. The nationalization process was initially sudden but later became gradual and planned.”

The nationalized companies operated under a central planning system. They were clustered under ministries, and public investment was channeled through them. The term “corporation” was used as suffix to their names. For instance, by the end of 1986 there were about 12 corporations that operated under the Ministry of Industry. The corporations were governed by government appointees and members of the military’s political network. The minorities in the 29 nationalized companies were largely foreign shareholders who were seeking compensation for expropriated assets. The result was disappointing. Ethiopia’s State Owned Enterprises (SOEs) showed dismal financial performance. In the majority of the corporations financial, activity, productivity, growth and risk indicators, showed poor performance; making privatization the most favorable option for the post military government of Ethiopia (Negash, 1991).

3.3 Corporate Governance: 1991-2008

In May 1991 rebels from Northern Ethiopia controlled the levers of political power in Ethiopia. The ideology of the victors was shaped by the now defunct Marxist Leninist League of Tigray (MLLT), whose chief ideologue use to be the present Prime Minister of Ethiopia, Ato Meles Zenawi. The ousting of the military brought new ethno-political alliance in Ethiopia, and facilitated the separation of Eritrea. By 1993 the leaders of
MLLT which formed the Government of Ethiopia, completed a “transition period”, and started to show some clarity to what they wanted to do in the rest of Ethiopia. The prevailing international order, and donor influence obliged the government, albeit at a snail pace, to liberalize the economy.

With regard to the nationalized corporations, the Privatization Agency was created and the agency’s key positions were given to the then trusted functionaries. During its brief effective life the agency allegedly worked under an opaque system, and transferred assets to (i) political party controlled regional (endowment) companies; (ii) Midrock Ethiopia, a privately held diversified conglomerate; (iii) few well connected individuals and groups. Corporations that could not be sold in the privatization programme or those believed to be the commanding heights, were kept under the control/influence of government. Jesiah, Meenakshi and Iyappan (2005:1), using data between 1994/95 to 2002/3, concluded that the net effect of Ethiopia’s privatization program towards investment (capital formation) was “robustly negative, owing to the lack of in-depth insight not only into privatization program itself, but also to overall reform and structure adjustment programs.”

It is important to note that political party controlled regional companies are uniquely Ethiopian, and bring particular issues of corporate governance. Furthermore, it is not clear how the initial capital of these endowment companies was paid up. As of late, the endowment companies are presented as if they are regional development organizations/companies. In this respect, Young (1997) explains the development and change in “post revolutionary Tigrai”, and narrates the role that was played by endowment companies in channeling resources.

Endowment companies operate factories, banks, insurance companies, and are involved in import/export, and distribution of key agricultural inputs and implements. Each federal region is supposed to have at least one endowment fund that holds various forms of companies. For the purposes of this paper, it is sufficient to show that a number of foreign based Ethiopian websites state their negativity by listing the names of the endowment groups, the shareholders and directors. For instance, one opposition website that criminalizes the ruling regime (http:www.abbaymedia.com/TPLF_companies.htm) lists 32 companies together with their share capital, and names another 42 companies that are affiliate with the ruling regime. Furthermore, another website (http://ethiogerany.de/tplfcompanies.htm) states that 33 companies, which most of them were created in 1995, control book capital to the tune of Birr 2345 million (1 US =7 Birr at the time). The same web page also lists additional 50 companies but does not state the share capital. The Oromo Liberation Front, once a junior partner in the transition and now an armed group, describes the privatization program in Ethiopia as a replacement of public enterprise with political party business. (http://www.oromoliberationfront.org/publications/osvol10 AArt1002.htm). The important point here is not the statement indicated in the various websites, but if and when such corporations are discovered, in Ethiopia or elsewhere, the tricky part is the type of reform that is needed.

In its millennium issue, Tiret Special, the official publication of MIDROC Ethiopia, lists the sectors, names of enterprises and initial capital outlays for the “Group”. By most
accounts, Midrock group of enterprises appear to be relatively better run business organizations. Management systems and processes that were tried and tested in the group’s overseas operations have been successfully introduced. The group has take up several risky projects that otherwise would not have been picked up by foreign investors. However, critics argue that the group’s close association with government might be counter productive to the survival of the firm in the long run. Others confide that there are endemic problems of governance within the group. Intercompany debts; ineffective boards; absence of consolidated accounts; cronyism and use of fronts as minority shareholders, appear to be some of the main governance issues that the group has yet to address.

Hence, the key reform challenge is how to reform Ethiopia’s four types of corporations:- endowment fund controlled corporations; state owned enterprises/corporations; Midrock Group and the other companies and corporations(see for example the membership list of the Addis Ababa Chamber of Commerce). What can the APRM bring to Ethiopia’s corporate (big business) sector is the central question. Having stated the key question/agenda for reform, the remaining section of this paper moves to the application of the APRM instrument. The result of the application of the instrument is to point out the direction of market, nonmarket and legal reforms that are necessary to enhance corporate governance in Ethiopia.

3.4 The APRM Instrument

The APRM questionnaire has four parts, and is well structured. The section on corporate governance begins by providing the definition and introduction. It aims at creating an enabling environment for effective regulatory intervention. It asks whether corporations are “good citizens”; whether good business ethics exists; and raises the issue of the fair treatment of shareholders and other stakeholders; the accountability of corporations and directors, and adherence to international codes and standards are key factors found in this continental instrument.

The questionnaire then defines three major goals, and enumerates the set of questions and sub-questions that should be answered by the country under review. The country signs a memorandum of understanding, and provides a country focal point. The review process involves four stages and follows complex processes. The integrity of the process however largely depends on the competency, effort and independence of the review team. The country review team is led by one of the three eminent persons. The term of office of the present officer bears appears to have expired, and the replacement process and the reorganization of the secretariat seem to have faced some difficulties. The key areas of corporate governance are discussed under the following subheadings.

3.4.1 Effective Regulatory Environment

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2 The questionnaire is available for inspection either from NEPAD website, the APRM secretariat or this author.
The first key issue that is raised in the questionnaire is whether or not effective regulatory environment exists to create the necessary reform. In other words, the questionnaire is asking whether the governance system follows the separation of powers (trias politika) principle. It is evident that the Government of Ethiopia is more than likely to claim that this question has been achieved in post Mengistu Ethiopia (1991-2008). Opposition groups, human rights advocacy groups, disenchanted groups and cynics are more than likely to argue otherwise. Notwithstanding the debate, no group can miss the point that Ethiopia has had a Constitution of one sort or another for many decades. The dispute however is on the degree of the separation of powers provided by the constitutions, and the effectiveness of the written rules.

In recent years the general peace and stability that is prevailing in the region is even more worrying, hence affecting the regulator environment. The independence of the legislative organ (House of Peoples Representatives) from the Executive is also a moot point as Ethiopia has undergone from one election crisis to the next. Furthermore, there is evidence which shows that the executive routinely intervenes on the operations of the election board, auditor general, and the courts. The court drama in respect of the ex-Defense Minister, the leaders of the main opposition, and the firing of the two auditor generals by the executive, were events that tarnished the image of the Ethiopian court system.

The issues that relate to property rights and the protection of investors and creditors cannot be resolved by reforming only the Civil Code and Commercial Code. The section on bill of right of the Constitution needs to be improved. There ought to be a constitutional court. Owing to capacity limitations, the powers given to the regions need to be revised. Therefore, in a seven point scale, the regulatory environment can be rated as poor.

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3.4.2 Good Corporate Citizenship (Social & Environmental Accountability)

The SOEs and endowment companies have multiple objectives that include “development” and, thus by extension are expected to address “social” issues. Whether this is best achieved under an environment of complex set of agency problems, is not debatable. Another more observable, but unclear matter is the type of corporate citizenship that comes from the series of donations and compassionate and charitable activities of the owner of Midrock Group of enterprises. The rules and procedures need to be made known to the general public so that one separates general charity from corporate social responsibility. Donations to political parties and holders of public offices must be regulated. The regulation must aim at (i) transparency (ii) set the criteria and disclosure requirements and (iii) resolve the sticky points of donation taxes.

With regard to labour, there is a law which provides for basic worker rights. The politicization of labour however has been problematic. Furthermore, indices that compare
hiring and firing difficulties internationally, often rate Ethiopia poorly. One final point that needs to be noted is that the conflict between unions and management often has a ripple effect on the demand for civil and political rights. Hence, during the last thirty five or so years, Ethiopia’s official trade union organizations have always been tamed by the government of the day. The effect of this taming is straightforward.

The link between the sustainability of corporate earnings, climate change and the environment, is not adequately understood. This is an international problem. The cyclical drought is in part linked to bad environmental degradation and the absence of emission control. It is unclear whether Ethiopian corporations have been engaged in environmental upgrading and rehabilitation programmes. It is also unclear to what extent new projects are subjected to environmental impact studies. Furthermore, the extent to which hazardous waste is imported and dumped in Ethiopia is unknown.

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### 3.4.3 Business ethics

Transparency International, Heritage Foundation’s Index of Economic Freedom, Dailamani’s Financial Openness Index, Financial Freedom Index, Doing Business Index and anecdotal evidence suggests that Ethiopia is one of the most corrupt countries in the world. In a rather passionate article, Seid Hassan (2008; see www.etiromedia.com) links the construction boom in Addis Ababa with corruption. He further argues that the much publicized Federal Ethics and Anti Corruption Commission is toothless. Seid Hassan (op cit) further notes that the government is channeling projects, overtly and covertly, to endowment companies. Another recent report also states that funds earmarked for capital project have been directed towards endowment companies. Hence, the cumulative effect of these news items and indicators do not help Ethiopia to become a destination for international finance.

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### 3.4.4. Accountability of Corporations, Directors and Officers

The literature on the problems of corporate governance focuses on the relationship between management (directors and officers) and shareholders (residual risk takers in the corporation). The foregoing discussion suggests that many of Ethiopia’s top tier business organizations are share companies, but their shareholders are unknown. Furthermore, their financial statements are not in the public domain. Structurally, the endowment companies appear to have some similarity with nominee and proxy companies that used to be found in some European institutions. Unbundling, full disclosure, and consolidated accounts were the European response (see European Union Directives). Hence, looking at Europe does not provide an answer. Ethiopia probably needs to look to the east, learn
from the reform done by China. A number of SOEs were successfully listed on the Shanghai and Hong Kong stock exchanges.

The Midrock Group is another big enterprise that dominates Ethiopia’s corporate sector. It has a group structure but it is not clear how it is treating its minority shareholders. One allegation suggests that the minority shareholders are mere fronts (for legal compliance), and therefore have no or little influence. The shares are not tradable in an open market. When disputes arise or they fall out, minority shareholders surrender their shares to “the company” at a price determined by “the company”. Hence, the type of reform required here might be like the one observed in European capital markets.

The companies that are ordinarily incorporated under the existing Commercial Code and are unconnected to SOEs, endowment and Midrock Group, are few in number. The type of reform that is required for this group of companies should attempt to resolve the normal agency problem found in the literature. The Sarbanes Oxley Act in the United States indicates the type of regulation that modern corporations are facing.

With regard to the adoption of international standards, there is some evidence which shows that aspects of international accounting and auditing standards, COSO, BASEL, are selectively applied. It is unclear whether standards on the issuance and trade in financial instruments were adopted. Furthermore, it is important to note that financial globalization does not allow selectivity. The scandals at the National Bank of Ethiopia and the firing of the Federal Auditor General are serious damages to the credibility of Ethiopia’s microeconomic and macroeconomic statistics.

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4. Concluding Remarks and Direction for Future Research

This paper has attempted to address the intricate issue of corporate governance in a developing environment, where market instruments that discipline directors are almost nonexistent. Non-market instruments are systems and process that are put in place by management to ensure both custodianship and performance. Non-market instruments include the voluntary adoption of international operational and ethical standards. When voluntary adoption of standards are not working, regulatory intervention becomes important. Unfortunately Ethiopia’s regulatory environment suffers from a major credibility problem. The reform programme must aim at enhancing the credibility of the institutions of governance and the legitimacy of the State.

The paper has identified seven key areas that need to be addressed by the APRM process. The type of reform required for each type of “corporation” is however different. Even in the absence of APRM, it is the responsibility of the Ethiopian authorities and the business community to curb the dysfunctional behavior of corporate managers, and reduce the agency problems of trust by adopting international norms and standards. One key institution that is missing in Ethiopia is a stock market. This void is a serious deficiency,
and makes corporate governance reforms more difficult than they already are. Added to this is the ruling party’s move in reverse gear. How these and related matters can be achieved is a matter that is left for future research.

References