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## Donor Aid Cuts, Kenya Elections Affect Uganda Business Climate

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### Executive Summary

In the October – December quarter of 2012, the business climate index declined to 4.5 points having recorded a score of 8 points in the previous (July – September) quarter. The deterioration of business environment perceptions emanated from elevated risks arising from the budget support withdrawals by some development partners and anxiety over potential business interruptions emanating from the presidential elections in neighbouring Kenya. Expectations for the next quarter are such that the business climate will start to improve but at a slower pace compared to the previous quarter. The drivers of the expected business climate improvement are anchored on the expected continuity in macroeconomic stability, recovery in domestic demand, and an upturn in the global economic outlook that is expected to boost export demand. On the overall, the business environment remains largely unchanged, having improved only modestly, and is expected to remain weak in the short term.



Major road works across the country are expected to reduce the cost of doing business

### Background

The Economic Policy Research Centre (EPRC) initiated the quarterly Business Climate Index (BCI) for Uganda, starting with the April – June 2012 issue. The BCI reflects the perceptions of Ugandan business executives of the current and expected business economic conditions. The BCI is a perceptions indicator of economic activity, to supplement official statistics.

The major advantage of the BCI over other measures is that it is compiled more frequently and therefore contains recent and up to date information. More importantly the BCI can be used to forecast turning points in economic activity, with a view of informing policy makers both in Government and business.

The BCI is a composite perception index based on the following indicators: level of business activity, turnover, profitability, incoming new business, capacity utilization, average costs for inputs, prices of produced goods, new orders for goods, business optimism, and number of employees. The Index can take scores in the range -100 to +100 and is interpreted as follows: a negative score indicates deterioration and a positive score indicates improvement in the general business conditions.

### Data

The data used in computing the business climate index was collected from 150 business establishments sampled from the 450,000 businesses in the 2011 Uganda Bureau of Statistics business register. The probability proportional to size sampling technique was used to select businesses into the sample. The different business sub-sectors were treated as sampling strata. The largest two firms in each stratum were automatically selected, while the rest of the businesses were selected using simple random sampling within each stratum. Sample weights were used in the computation of the results. The respondents are the business executives. We keep tracking the same businesses over time. Businesses that opt not to respond to the survey are replaced by their substitutes which were also determined through the sampling process explained above. The distribution of the sampled businesses is presented in Table 1.

Table 1: Distribution of the sampled business, %

Business					
Size <sup>a</sup>	%	Type	%	Location	%
Micro	10	Agriculture and agro processing	14	Kampala	52
Small	29	Hotels, recreation and tourism	23	Central	18
Medium	29	Manufacturing and industry	13	East	10
Large	32	Mechanical services	13	North	7
		Retail and wholesale trade	17	West	13
		Social services	5		
		Professional and other services	15		
Total	100		100		100

Notes: a The classification of businesses by size was guided by the World Bank Enterprise Surveys that classify a business as Micro if it employs no greater than 4 people; Small if it employs 5-19; Medium if it employs 20-99; and large if it employs more than 100 people.

### Evaluation Methods

The business climate index is computed based on the following business evaluation indicators: level of business activity, turnover, profitability, incoming new business, capacity utilization, average costs for inputs, price of produced goods, new orders for goods, business optimism, number of employees, average monthly salary. For each of the evaluation indicators, respondents are asked to express their perceptions on a Likert scale as follows: “improved”, “did not change”, “declined”. These responses were coded as -1, 0, and 1 respectively. For example, if a respondent’s perception of the business environment is that it deteriorated, such a response would be coded -1, it would be coded 0 if business climate did not change and 1 if business climate improved.

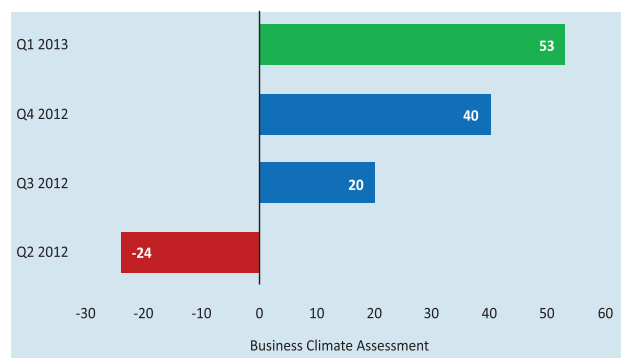
The balance score of a business evaluation indicator is the difference in percentage shares of the responses “improved” and “declined”. The business climate index is computed as the weighted arithmetic and seasonally adjusted mean of the balances based on the business indicators described above. The interpretation of the Index is such that any positive scores point to an improving business climate, while negative scores would imply that general business conditions are getting worse.

### Results

#### The Business Environment Assessment

The business executives were asked to assess the general economic environment for the fourth quarter of 2012 (October – December) (Q4 2012) relative to the third quarter (July - September) (Q3 2012); and their expectations for the next quarter (January – March 2013) (Q1 2013). The findings show that the overall perception of the business environment in Uganda continued to improve for the October – December 2012 quarter. For example, 64 percent of all business executives cited improvement, decline was cited by 24 percent and only 12 percent cited no change. Thus the balances score for the October – December quarter business environment stood at 40 percentage points as illustrated in Figure 1. This result implies that the perceived business conditions have significantly improved compared to the July – September 2012 quarter when the balances score stood at 20 percentage points.

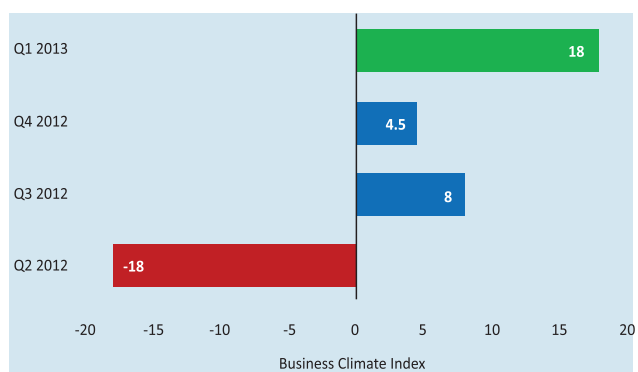
Figure 1: The Business Environment Assessment



#### The Business Climate Index

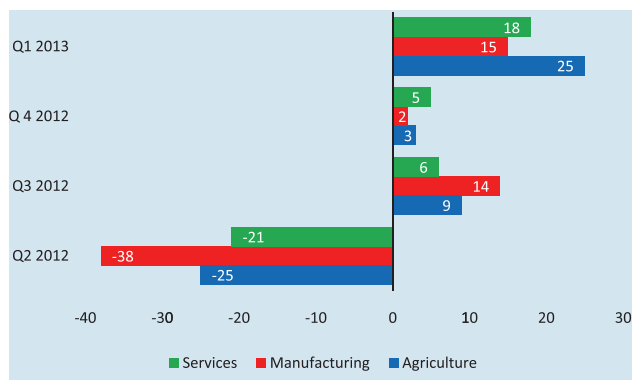
Our results show that while the business environment improved, business performance remained weak. The results in Figure 2 indicate that business climate, based on the business performance evaluation indicators remained positive for the fourth quarter (October – November) of 2012. The business climate index, computed at 4.5, is still weak and depicts a less optimistic perception about the business conditions in Uganda, compared to the third quarter (July – September) of 2012 when business executives expressed a more positive assessment of the business climate. Our results are consistent with data available from the Uganda Bureau of Statistics, which indicated a slowdown in real GDP growth from 3.3 percent in the previous quarter (Jul – Sept 2012) to 0.8 percent in the current quarter (October – December) 2012.

Figure 2: The Business Climate Index



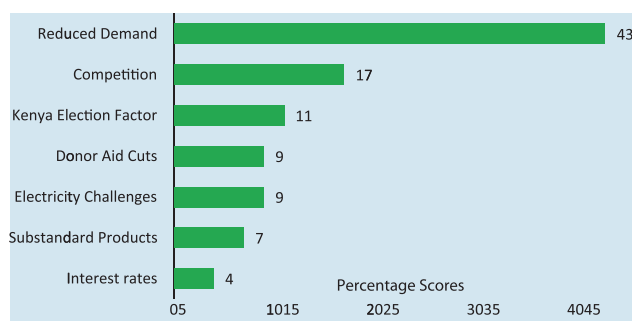
#### Sectoral Analysis

At disaggregated level, the business climate has slowed across all sectors as depicted in Figure 3. The services sector recorded the highest index score of 5 down from 6 in the previous quarter. The agricultural and agro processing sector recorded an index score of 3 down from 9 as compared to the previous quarter, while manufacturing recorded the lowest index score at 2 down from 14 in the previous quarter.

**Figure 3: Business Climate Index by Sector**

### **What explains the observed deterioration in the business climate in the current quarter?**

In the previous issue of the business climate index, it was expected that the business climate would continue to improve greatly with an expected index of 66 for the October - December quarter. However, the realised index for the October - December quarter was only 4.5. Although this still signifies an improvement in business conditions, it is lower than the index for the previous quarter (July – September) which stood at 8. The slowdown in the business climate index could be due to a number of factors that include: unstable demand for goods and services, increased competition, challenges with the cost and reliability of electricity supply, the proliferation of substandard products on the market and the persistently high interest rates.

**Figure 4: Reasons for the declining business climate**

Moreover, there are two unique and emerging risks that could have greatly influenced the lower business climate and they include: the presidential election situation in neighbouring Kenya; and the decision by donors to suspend aid to Uganda following financial scandals in some Government departments.

### **i) Expected effects of the Kenya election on Ugandan business activity**

The electorate in Kenya was expected to cast their vote for a president in March 2013. Following the election violence that rocked Kenya in the aftermath of the 2007 election that destabilised regional trade among other things, the

Ugandan business community opted to adopt a more cautious approach to business whenever Kenya goes to the polls. Thus, with the Kenyan election expected in March 2013, Ugandan traders started reducing business activity between Uganda and Kenya as early as November 2012 so as to reduce any risks of loss of goods in transit while in Kenyan territory. It should be remembered that Kenya is Uganda's most important trade partner that handles in excess of 80 percent of Uganda's import trade volumes. Kenya also provides Uganda's most important export route to the sea. Therefore any disruptions in Kenya, actual or expected, have grave consequences for doing business in Uganda.

### **ii) Reduced donor financial support to Uganda**

Numerous development partners have agreed to freeze all budgetary support to Uganda. This follows strong allegations of misappropriation of donor funded public funds particularly in the Office of the Prime Minister and the Ministry Of Public Service. The abused money in the office of the prime minister had been earmarked for rehabilitation of Northern Uganda following close to three decades of insurgency. In addition, the donors expect Uganda to pay back the said misappropriated funds in full. It should be remembered that development partners fund up to 25 percent of Uganda's annual budget. The suspended donor funds coupled with the fact that Uganda is expected to refund all misappropriated funds have had the effect of reduced fiscal expenditure by Government. This is expected to result into slowed project implementation by the Government and thus result in reduced economic activity, and thus affecting doing business in Uganda.

### **Future outlook – January – March 2013 quarter (Q1 2013)**

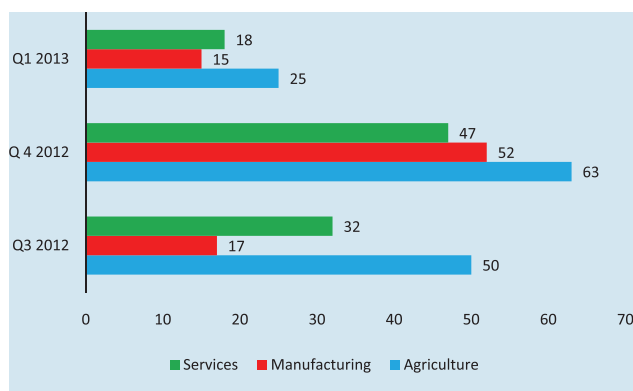
The business climate is expected to improve, but at a slower pace compared to what it was expected to improve by in the current quarter (see figure 6). Most business executives are not as optimistic about the future business developments as they were last quarter. For example the expected business climate index is 18 compared to last quarter's expected business climate index of 50. This is due to the downside risks to the business climate discussed earlier. These downside risks are expected to linger well into the next quarter.

However, despite the risks to the business climate in Uganda, the index is expected only to slow down (remain positive) and not to fall into negative values. This implies that the business climate is expected to improve but at a slower rate. The main drivers of improvement in the business climate index during the quarter are agriculture (25), followed by services (18) and manufacturing (15). This is expected to result in improved incoming new business, turnover, profitability, capacity utilisation, and employment Business executives do not expect significant further reductions in the inflation as the current and expected balances scores for the product and input prices are not significantly different. Overall, they expect the

business environment to continue improving in the next quarter, but at a slower pace.

On a positive note, the business community expect to benefit from sustained macroeconomic stability characterised by reducing inflation, a more stable exchange rate and expected reductions in the commercial bank interest rates. However, on the overall, the subdued optimism implies that national economic recovery could falter in the short term, albeit temporarily.

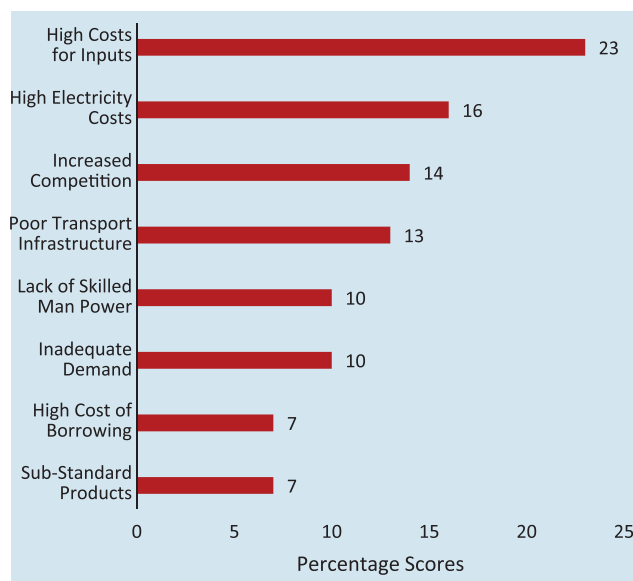
**Figure 5: Expected Business Climate**



### Constraints in Doing Business

Despite efforts by Government to improve the business environment in Uganda by focusing on policy actions that would reduce the cost of doing business and spur economic growth, the business executives still believe that binding constraints to business competitiveness still exist. For example, successes in reducing inflation notwithstanding, business executives perceived the increased cost of inputs as the most burdensome challenge (23 percent) they faced in the current quarter. However, this was a reduction from the 33 percent that reported cost of inputs as the most important challenge they face, signifying that inflation rates have been abating over the last quarter. Business executives continue to report challenges with the cost and reliability of electricity supply (16 percent) as a persistent constraint that requires urgent Government intervention. Figure 5 also depicts other challenges that include: increased market competition (14 percent), poor transport infrastructure (13 percent), lack of skilled manpower (10 percent), high cost of borrowing (7 percent) and competition from sub-standard products (7 percent).

**Figure 6: Challenges to doing business, %**



### Conclusions

Using perceptions data collected from 150 firms, we set out to assess the current and expected business economic conditions. We achieved this by constructing a business climate index, computed as the weighted arithmetic and seasonally adjusted mean of the balances scores based on the business indicators. We show that compared to the previous quarter (July - September 2012), conditions for doing in Uganda have continued to improve, albeit at a slower rate, in the current quarter (September - December) of 2012. The business climate index declined from 8 points to 4.5 points signifying continued recovery in the business activity, but at a much slower rate. The perceived decline was due to some downside risks that ensured that both the current and expected business conditions are below potential. In particular the anxiety over the Kenya presidential elections and reduced donor budget support have negatively impacted on the Uganda business environment.

Despite falling inflation, business people perceived the cost of inputs as one the most challenging constraint for business. Interestingly, businesses still rank the cost and reliability of electricity supply of electricity as a persistent constraint in doing business followed by the high cost of inputs.

### About EPRC

The Economic Policy Research Centre (EPRC) is an autonomous not-for-profit organization established in 1993 with a mission to foster sustainable growth and development in Uganda through advancement of research –based knowledge and policy analysis.

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### Acknowledgement

The Business Climate Survey was conducted by a team of EPRC Researchers led by Joseph Mawejje (Research Analyst). The team appreciates the support received from all participating Business Establishments across the country and all persons who reviewed and edited this publication. Special thanks goes to Deogratius Katongole for the data management.

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