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TOWARDS ATTAINING **INCLUSIVE GROWTH**

THE CASE OF UGANDA

Policy Suggestions by **LéO Africa Institute**

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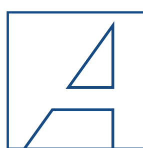

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Introduction

Uganda's economy has sustained growth at an average of 6% over the past two decades according to the International Monetary Fund (IMF). Recently though, growth has fallen to 4.5%. Despite this growth however, there are claims that income inequality has been increasing—the gini coefficient (a measure of income inequality, where 0 stands for a perfectly equal distribution of income, and 1 is maximal inequality) has increased from 0.365 in 1992 to 0.395 in 2012[1]. Although this impressive growth story has previously had dramatic impact on poverty reduction from 56% in 1992 to 19.7% in 2012, recent evidence suggests that the poverty reduction momentum has run out of steam, as many Ugandans who have recently escaped poverty feel increasingly vulnerable to falling back into poverty. For example, a 2014 Poverty Status Report by the Ministry of Finance revealed that nearly 43% of Ugandans who are able to spend US$2 a day felt vulnerable to falling back to poverty, suggesting that sources of income growth remain weak and highly unstable. The preceding growth facts thus beg the question, why is Uganda's growth story not inclusive? Stated differently, why have the benefits of growth accrued to only a few and not spread?

Inclusive growth ensures that growth creates jobs and raises income for all people, especially the poor. In order to find an answer to this question, the LéO Africa Institute organised an Economic Forum held on 22 July 2016, which attracted a group of carefully selected experts to discuss the challenges to the promotion of inclusive growth in Uganda. Building on the views that emerged from the forum and other important literature, this policy brief is intended to highlight the main constraints to Uganda's inclusive growth and then later, use this as the basis for proposing specific policy measures for unlocking Uganda's inclusive growth potential.

Conclusions from the forum and other important literature seem to suggest that growth in Uganda over the past two decades has been realised thanks to the macroeconomic and stabilisation reforms that were implemented in the 1990s. These contributed to resumption of the economic activity following almost two decades of political instability and asset-destruction. Although the commodity boom in the mid-1990s and early 2000s further boosted growth in Uganda, the failure to address the underlying structural constraints has eventually brought this growth trajectory to halt.

Specifically, the expansion of the infrastructure deficit mainly in energy and transport, limited investment in growth of the manufacturing and agriculture sectors have all combined to result into low level of firm growth and by extension, low levels of job growth. Uganda's exports remain predominantly primary commodities making them susceptible to fluctuations in global commodity prices and thus fluctuations in export foreign exchange earnings. This largely explains why Uganda has maintained a pervasive current account deficit estimated at -10.84 percent of GDP that is compensated by foreign aid inflows and remittances. As a result, labour demand within the economy remains low, fuelling high level of unemployment and underemployment. This state of affairs has been further exacerbated by a rapidly rising labour supply driven by high population growth resulting from delayed demographic transition.

1 See, the 2014 Ministry of Finance Poverty Status Report

Therefore to redress this situation and promote inclusive growth, Uganda will have to scale up investment within the economy with the view to build and promote growth of industries, specifically export-based manufacturing. This is the only sure way that promises a path towards sustainable and inclusive job creation that will drive income per capita, generate aggregate demand within the economy and thus create a virtuous circle of job creation, incomes growth, greater aggregate demand, greater profits and ultimately greater investment.

The rest of the brief is structured as follows: section two provides a detailed discussion of Uganda's growth challenges and highlights areas for policy intervention whereas the last section concludes with a set of policy recommendations for promoting inclusive growth in Uganda.

1. Challenges to Uganda's Growth

Uganda has had two phases of growth trajectories with remarkably varying differences and outcomes. Between the 1990 and early 2000s, 'growth reflected a rebound in economic activity and the resumption of trade following two decades of extreme political instability and an asset destroying civil war'.[2] During this period, the Government of Uganda with the support of International Financial Institutions (IFIs) implemented a comprehensive stabilisation, rehabilitation and reform program. Rehabilitation allowed rural people to profitably work their land and open new land for cultivation and it allowed businesses to reopen their operations. Market liberalisation allowed farmers and firms to make better choices on how much of what to produce and with which inputs while privatisation removed inefficient state provision of products and services.[3]

However, within eight years this growth spurt started to ebb as it begun to run up against some new binding constraints.[4] More recently, growth has decelerated owing to various internal and external factors like the recent global recession and election-spending volatility that has destabilised underlying macroeconomic fundamentals. So what are the specific binding constraints that account for the slowdown in Uganda's growth? Hausmann et al.,(2014) and a number of Uganda's Ministry of Finance publications including the National Development Plans highlighted Uganda's key growth constraints as follows:

High but declining dependency ratio.

Uganda has one of the highest dependency ratios in the world, though more recently it has started to decline, inducing a phenomenon known to demographers as the 'demographic window of opportunity or bonus'. As a result, this proportion of the working population is increasing rapidly, allowing for more education of the young and increased savings. The labour force growth rate is estimated at 4.7 percent per annum in 2009/10 which is even higher than the country's population growth rate. In fact the growth in youth labour force is even higher, estimated at 5.7 percent annually. According to experts, the economy will need to generate many jobs for the rapidly expanding labour force in order to exploit the potential of the window of opportunity.[5]

2 Hausmann et al.,(2014).
3 World Bank (2007).
4 Hausmann et al., (2005).
5 Klasen (2004) cited in Hausmann et al.,(2014).

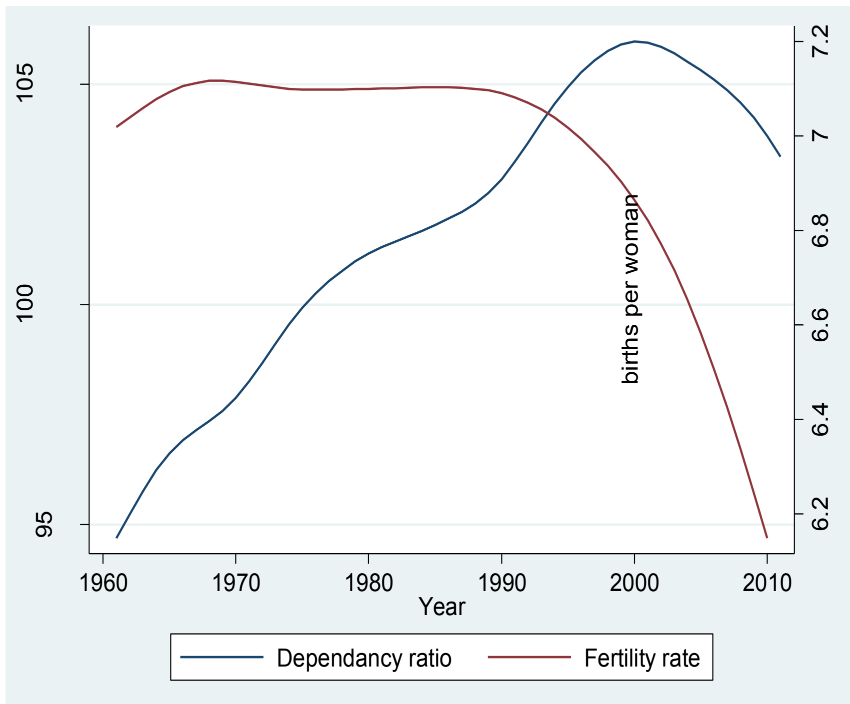


Figure 1:
Uganda's Dependency ratio

Source: WDI (World Bank 2010a) in Hausmann et al. (2014)

The underlying explanation for the high dependency ratio is high fertility rate. As indicated in the Figure 1 above, while many other developing countries (particularly in East Asia and Latin America) have undergone rapid fertility transitions, Uganda's fertility has remained obstinately high, though it has recently started to decline (see Figure 2). An important observation for policymakers is that fertility is markedly lower in cities than in rural areas. Hausmann et al., (2014) observe that significant overcrowding in rural areas with over four people per hectare of arable land has contributed to doubling of Uganda's density (see Figure 3). High population growth in rural areas has partly resulted into the persistence of subsistence farming and low agricultural productivity.

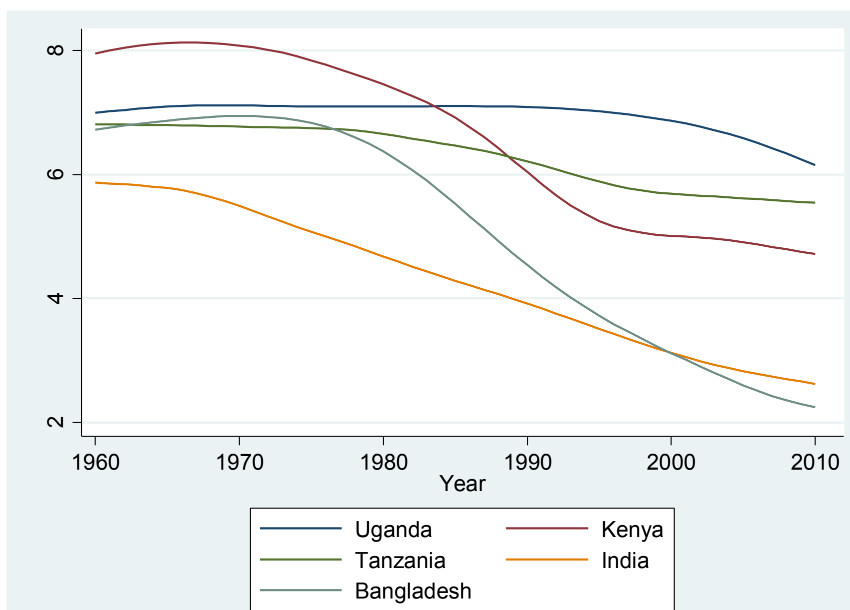


Figure 2:
Fertility Transitions

Source: WDI (World Bank 2010a) in Hausmann et al. (2014)

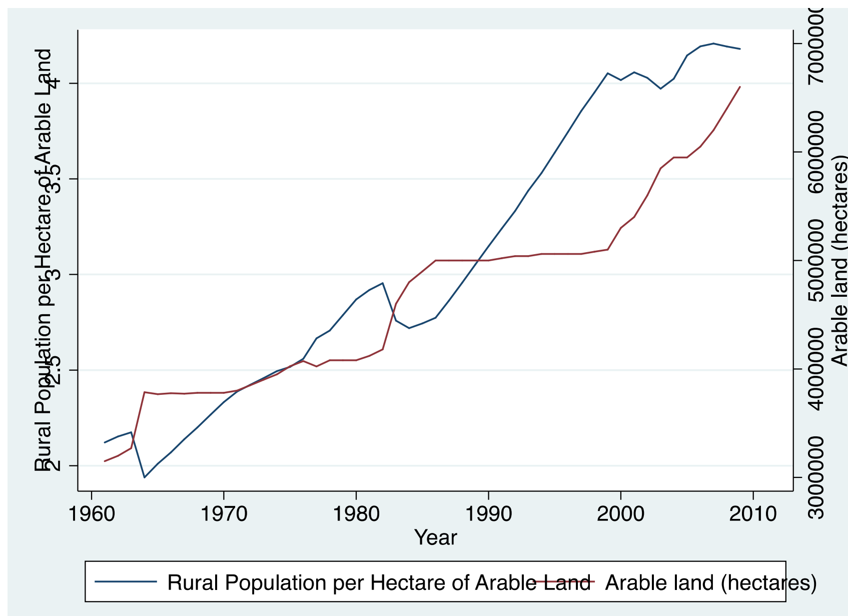


Figure 3:
Rural Population Density

Source: WDI (World Bank 2010a) in Hausmann et al. (2014)

Low contribution of manufacturing and export.

Uganda's growth has been largely concentrated in non-tradable activities, with limited capacity to expand job creation. The industrial sector which includes mining, construction and manufacturing, has witnessed only a modest increase in GDP from about 10 to 20 percent. Within the sector, construction has increased significantly from 4 percent in 1989 to 12 percent in 2010. Growth in manufacturing has been characterised by low capacity utilisation which is estimated at 50%.[6] The factors that contribute to low capacity utilisation have been well articulated in the National Development Plan (NDP) and these include: limited skills, inadequate infrastructure and credit rationing, further contributing to increased cost of doing business in Uganda. As a result, growth has led to a large external imbalance with a current account deficit of -10.84% of GDP (see Figure 4). This gap in foreign currency earnings has, to a large extent, been financed by aid inflows, further exposing the economy to greater volatility and vulnerability resulting from aid dependence. Indeed, exports per capita are among the lowest in the world (see Figure 5).

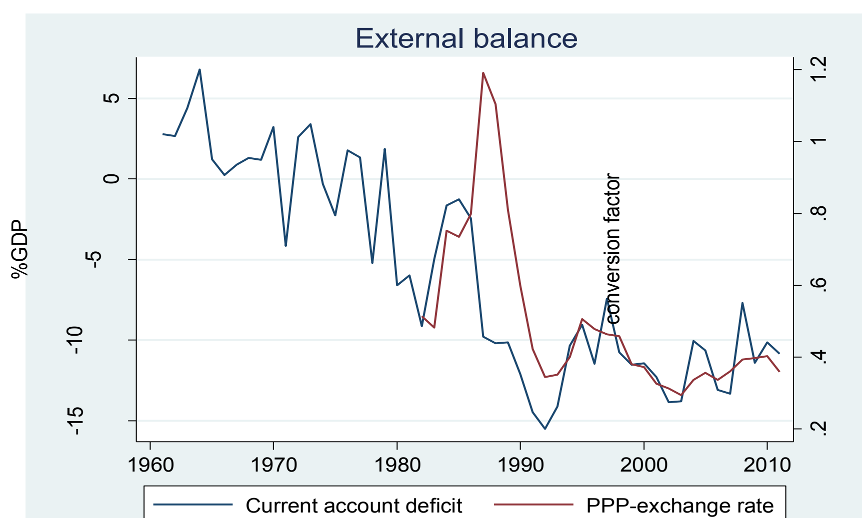


Figure 4:
External Balance

6 See, Republic of Uganda (2006).

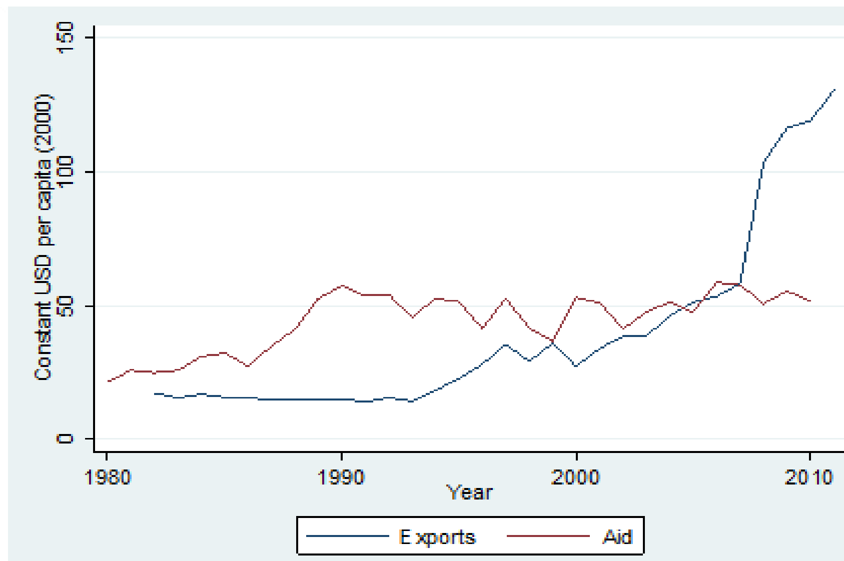


Figure 5:
Exports and Aid

Source: WDI (World Bank 2010a) in Hausmann et al. (2014)

In order to promote inclusive growth, Uganda needs to expand its exports so as to create employment, reduce the current account deficit and sustain the growth it has enjoyed thus far. Good news is that exports per capita have been growing recently and are now greater than other sources of foreign exchange such as aid flows and remittances. Recent export growth has been stimulated by demand in neigbouring countries such as Rwanda, South Sudan and Kenya. Specifically, prior to the current political instability, South Sudan had emerged to be (and still remains) an important trading partner for Uganda, demanding food and other manufactured materials to help with construction.

Primary products still dominate Uganda's exports.

The lack of dynamism in manufacturing has resulted in Uganda's export basket being dominated by primary products (around 85%) including coffee, fish, tobacco, gold and flowers. Reliance on these products has made the export sector vulnerable to volatility in world market prices and the vagaries of weather. Indeed, Uganda has faced a significant long run decline in its terms of trade (see Figure 6).

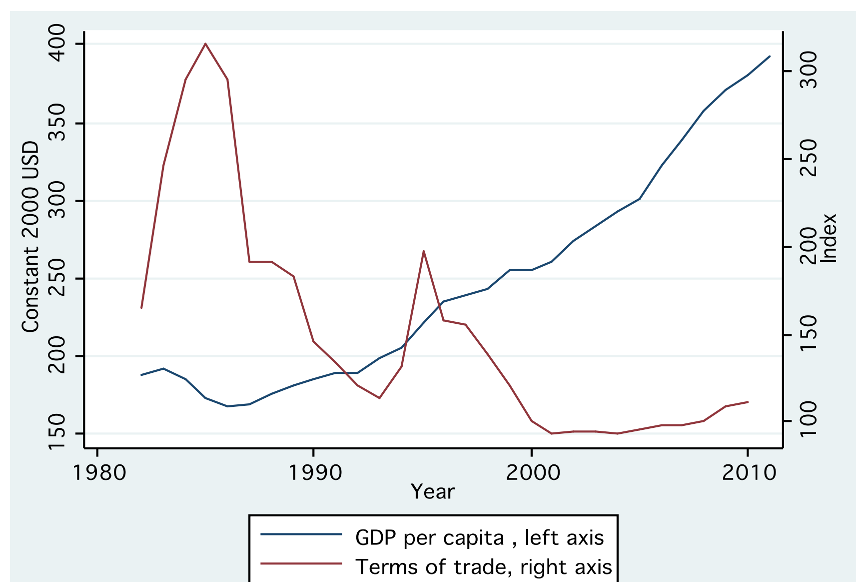


Figure 6:
Terms of Trade and GDP

Source: WDI (World Bank 2010a) in Hausmann et al. (2014)

The agriculture sector alone cannot address Uganda's demographic transition.

There were strong arguments during the Forum that the 'magic bullet' to Uganda's mediocre growth and unemployment crisis is greater investment in the agriculture sector. However, evidence from the literature and indeed different country experiences suggests contrary to this view. Uganda exhibits one of the lowest agricultural productivity levels in the world, not largely because of historically low levels of investment within the sector but partly because of high agricultural employment per hectare of arable land (see Figure 7). In subsistence agriculture, land plots are small and most tasks are performed by hand and with few inputs. This prevents economies of scale, particularly in the application of fertilizers or the use of machinery. Thus productivity per worker remains low. While there are technologies available to improve agricultural productivity and these should be pursued, as can be seen in Figure 8, improving productivity per worker generally leads to less employment per hectare. In fact with a constant supply of arable land, this means less agricultural employment overall. The case of Korea illustrates the path followed by many countries as they develop.

In the 1980s agricultural productivity in Korea was relatively low, and arable land was crowded with agricultural workers. As Korea increased use of machinery and the application of fertilisers, agrochemicals and special seed varieties, productivity per worker increased. But this occurred as farmers realised they could produce similar or higher yields with less labour. As the rural population declines, plot sizes increased enabling the remaining farmers to work on more land per worker. In sum, the expansion of agricultural production and productivity in Korea, as in many other countries, released labour to the non-agricultural sector. And this is typical: as income per capita increases, the share of employment in agriculture declines.

Overall, it is certainly true that there is great potential in agriculture in Uganda. However, this will lower the demand for labour, not raise it. Moreover, this will occur in an environment of rapid population growth, further emphasising the need for non-agricultural employment. The challenge for Uganda therefore, is to create productive jobs in other sectors to absorb the labour released from agriculture and that generated by population growth.

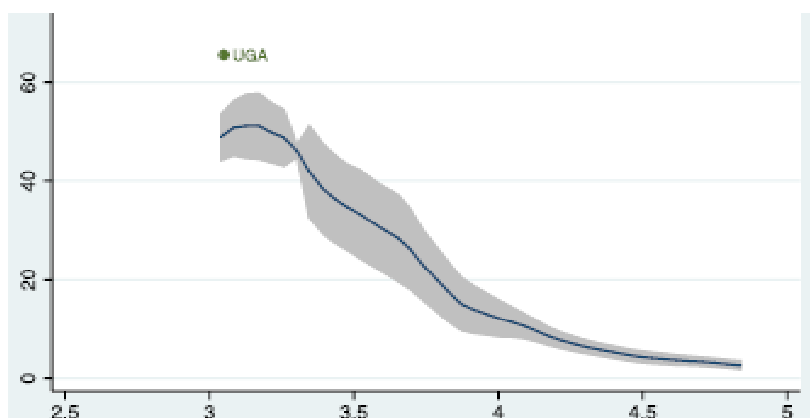


Figure 7:
Percentage of employment in Uganda vs. GDP per capita (in logs).

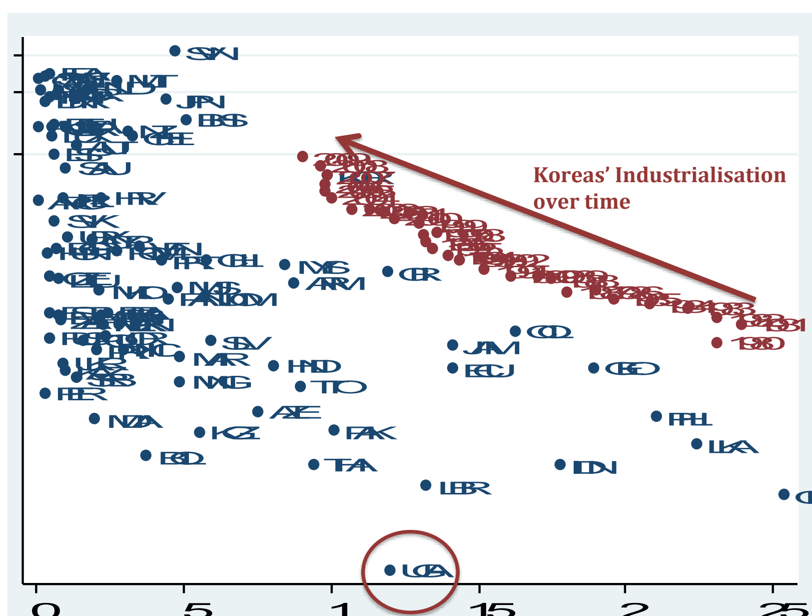


Figure 8: Agricultural employment per ha and value added per worker (in log scale)

Source: WDI (World Bank 2010a) in Hausmann et al. (2014)

High youth unemployment and underemployment.

Recent evidence from the Ministry of Finance's study on Uganda's employment challenge suggests that despite Uganda's remarkable macroeconomic performance over the last 20 years, there has been limited impact on the structure of the labour market. Although generally headline unemployment remains low at 9.4 percent, underemployment and youth unemployment remain high. Employment has expanded in lower productivity activities such as subsistence agriculture and petty trade, but contracted in some high value sectors like manufacturing and services. Over 80 percent of those engaged in subsistence agriculture work fewer than 40 hours per week.

The most pressing employment challenge is insufficient labour demand underpinned by inadequate firm creation and growth. Most jobs are created in industries such as retail trade, hospitality and recreational and personal services, which are characterised by very high firm entry but also high exit rates and therefore limited sustained employment growth. Intense competition among small and microenterprises more often than not leads to destructive imitation than innovation and positive market selection. Employment growth amongst almost all formal firms is stagnant. Evidence suggests that a 35 year old firm in Uganda is only twice the size it was at its establishment. By contrast, the same firm in Ghana is five times larger the size it was at its establishment. The main constraints to firm growth include:

1. Inadequate physical infrastructure—as much as 58 percent of the productivity handicap faced by Ugandan firms can be attributed to infrastructure constraints.
2. An inadequate supply of practical skills among the labour force. Skills intensive sectors have grown slower in Uganda than in similar countries. The current scope of vocational training remains limited to traditional courses such as carpentry, civil work, masons, and electrical foremen. If the economy is to diversify into new and more complex products, specialised new skills will be required.

3. Poor management practices. The limited supply of specialised management skills; for instance in human resource management, quality control, branding and managing supplier relationships and distribution channels, reduces consistency in business operations and increases the risk of expansion, even among established firms.

4. Regulatory framework. Regulatory requirements, corruption and Government support for individual firms disproportionately hinder SMEs. Larger and more established firms often have an unfair advantage. This limits positive market selection and discourages inter-firm linkages and development of strong value chains.

5. Credit for Small and Medium Enterprises (SMEs). Access to credit is particularly difficult for many start-ups and small firms perceived by lenders to be high risk; this adds an additional barrier to entry for SMEs and reduces competition among large incumbent firms. Average lending rates have been in the range of 20-30% in Uganda. Most lending is largely short-term and therefore not suitable for long term investments needed to produce new products. Figure 9 shows Uganda's interest rates are high in comparison to other SSA countries after accounting for inflation.

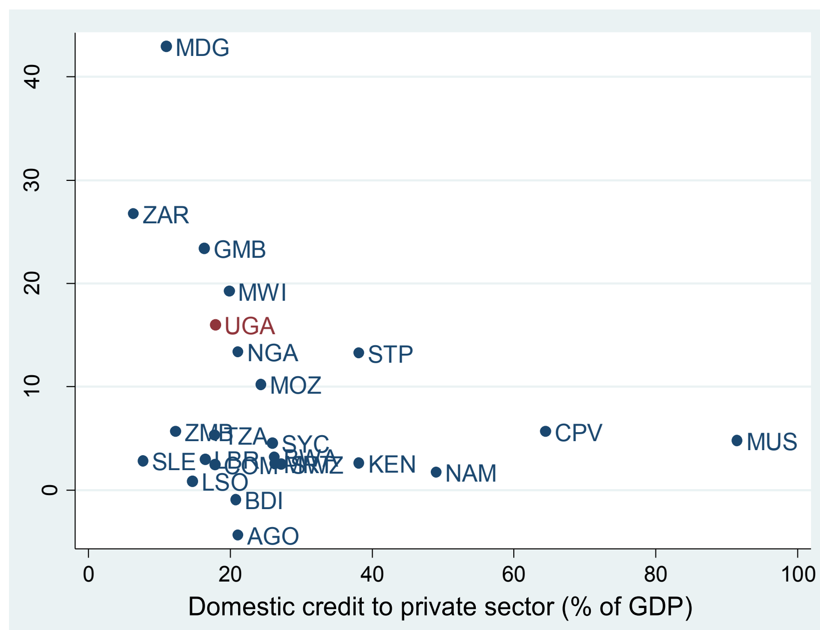


Figure 9:
Interest Rates and Credit, SSA

Source: WDI (World Bank 2010a) in Hausmann et al. (2014)

A number of reports however have suggested that even though all these constraints were removed, job creation in the formal sector cannot transform the economy fast enough to respond to the pressures presented by the rapidly growing labour force. There are currently 12 working adults living below the poverty line for every individual without work seeking a job. A large section of the labour force still depends on subsistence agriculture and informal non-agricultural enterprises. And as earlier observed, contrary to popular view, raising agricultural productivity, although important tends to shed off more jobs rather than raise them. So what then promises to sustain job creation? The answer lies in a combination of policies looking at expanding export-based industries in new and existing sectors as well as improving productivity in all other sectors.

3. Policy Recommendations

The policy recommendations provided here are by no means exhaustive. This is because, it is difficult to identify and exhaust all binding constraints to the growth of the sector which is why it is important to focus mainly on improving the institutional structures for firms investing in productive sectors to identify and find solutions to problems they face. This argument is validated by illustration by Hausmann et al. (2014) who demonstrates the complexity of correctly and exhaustively identifying binding constraints to a thriving manufacturing sector. They state, for example, that a thriving manufacturing sector requires the following inputs: power, water and water treatment, roads, ports, airports, security, medical services, day care centres, labour training, banks, other suppliers, customers, work safety, environmental law, consumer protection, corporate law, property rights, social security, labour standards and certification standards etc, which are very difficult for the government to accurately identify and appropriately address. Therefore in keeping with Hausmann et al's cautionary remark, the recommendations we propose here focus on the general binding constraints to economic growth. However, the specific strategy for implementing these recommendations will require improving the institutional structures for firms to work with the government to identify problems and find solutions. This is because, as earlier pointed out, firms that are investing in productive activities are best placed to identify the specific constraints they face and address them.

3.1 Strategies for scaling investment in physical infrastructure.

The need to close the current infrastructure deficit and reverse the cost of doing business is urgent and should be pursued. However, it must be financed in a fiscally sustainable way without adversely affecting macroeconomic stability. Given the prospect of oil revenue, it is particularly important to strengthen the linkages between the annual budget and Uganda's long term strategic goals. This approach should involve the following:

- The budget preparation process must shift from simple revenue projections to more comprehensive analysis of Government's inter-temporal trade-offs and the linkages between expenditure, economic growth, job creation and future Government revenues.

- Tax policy reforms should be pursued to reduce reliance on non-concessional borrowing. VAT exemptions should be streamlined and initial capital allowance and special income tax regimes for agro-processors and exporters should be urgently reviewed.

- A more credible long term financing strategy to guide sector planning and the annual budget is required.

- The selection of infrastructure projects should be based on the expected economy-wide returns, rather than the short term benefits or the number of jobs created directly.

3.2 Strategies for promoting firm growth.

Over the past 25 years, Government has withdrawn state intervention and enabled the private sector to take advantage of significant investment opportunities, with less attention paid to the constraints faced by SMEs. This has contributed to the 'missing middle', restricting competition and positive market selection among large firms, who can often maintain their market share without developing supply chains with smaller firms or adopting more efficient technologies and management practices. For instance, SMEs report corruption and regulatory requirements as major constraints, but larger firms do not; the weak regulatory environment means the benefits of entering the formal sector are low for most informal enterprises. This contributes to intense competition in the informal sector characterised by destructive imitation rather than learning and innovation; Government projects to support SMEs have remained small scale and require better coordination both within the public sector and among SMEs; and subsidised loans have benefitted large firms more often than credit constrained SMEs.

These issues are at the heart of relatively low employment growth among Uganda's formal firm compared to those in other African countries. Therefore to realise the potential of SMEs as an engine of job creation, Government needs to revise its engagement with the private sector, particularly to strengthen the regulatory environment and formal systems of coordination and structured dialogue among the private and public stakeholders on the formulation and implementation of policy. The following are some policy consideration for realising this goal:

- The regulatory and legal environment needs to be relaxed to enable less established firms to compete with larger incumbents on the level playing field. To achieve this, Government needs to roll out small claims courts nationally, adapt arbitration procedures to the needs of SMEs, and train a specialised team of judges to handle commercial enforcement cases. Support could also be provided to business associations to facilitate negotiation and conciliation.

- The institutional structures for firms to work with Government need to be strengthened. Existing forums such as the Presidential Investors Roundtable, the National Competitiveness Forum, and the Private Sector Forum have tended to focus on high level strategic issues. Working at a high level of aggregation encourages firms to lobby for broad Government aid—such as tax holidays—rather than focusing on industry specific public inputs. The forums have had only limited and indirect input from SMEs and on their own are unable to execute reforms or supply public inputs. Responding to these identified constraints requires public resources and institutions with the sole purpose of coordinating Government action in identifying and acting on firm constraints. Self-organised business groups should be encouraged and supported to identify common public inputs required and propose regulatory and institutional change. An annual process should be established to review these suggestions, decide which ones qualify action and coordinate Government's response. These should involve:

1. Permanent self-organised working groups at the industry level, with representatives from firms of all sizes.
2. A technical secretariat within Government to assess the public interest of proposals made by the working groups. The proposals and the secretariat's assessment should be public knowledge.
3. An annual competitiveness bill to include regulatory and institutional changes identified by working groups.
4. Co-financing with the private sector to reduce pressure on Government resources. Firm willingness to pay can also be used as a screening device for potential investments.
5. A coordinating council involving a consortium of MDAs and other stakeholders to ensure the implementation of required investment projects through the Public Investment Plan.
6. A process to monitor implementation of the resulting reforms and projects and provide systematic feedback. This should be governed independently and properly resourced.

- Government should consider expanding development banking and credit allocation policies especially to sectors such as agriculture and SMEs. Government could consider recapitalising Uganda Development Bank (UDB) to expand the amount of subsidised credit for social priority activities which might include commercially oriented smallholder farmers, SMEs, farmer collectives and business associations.

3.3 Strategies for skills development.

Skills development has a central role to play in expanding productive employment opportunities in Uganda. Skills enable individuals to increase productivity and raise incomes and allow enterprises to increase productivity and profits, making expansion more attractive. There is overwhelming evidence to suggest that Uganda's economy currently faces a number of skill deficiencies that threaten to limit the growth of key sectors and productive employment opportunities, including a lack of quality technical-vocational skills, professional management skills and financial literacy. In order to raise the level and depth of skills within the economy, Government needs to:

- Prioritise expanding vocational training through the BTVET (Business, Technical, Vocational Education and Training) enrolment, including providing incentives for private providers. Despite a number of service delivery challenges, BTVET is having a positive impact on productivity, earnings and to some extent job creation especially in the construction sector. However, enrolment is only at around 10 percent of NDP targets and there is a large unmet demand for BTVET courses among more disadvantaged sections of the population. Therefore public funds should be used more efficiently and equitably to benefit a larger section of the population.

- An independent National Training Authority giving employers a major stake in the skills development system would help to match training to employment needs. An autonomous National Training Authority—as envisaged in the Skilling Uganda Plan—would enable greater involvement in all aspects of the design, management

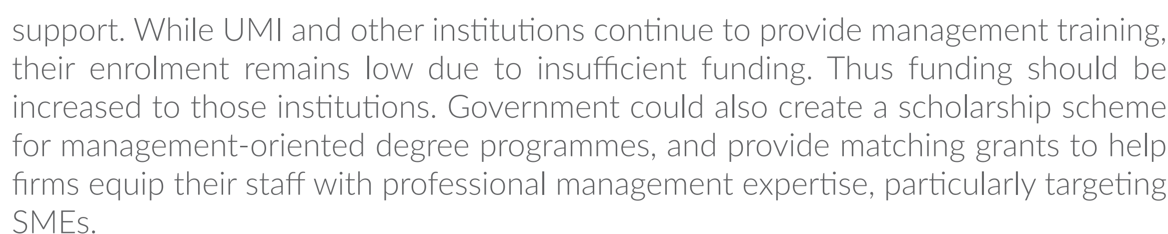
and delivery of training, allowing greater flexibility and responsiveness as labour market needs inevitably change. The private sector will only take skills development seriously if they have a major stake in the system and sufficient decision-making power. Employers should have equal representation in designing the new authority, which should be governed by a board comprised predominantly of private sector representatives.

- BTVET institutions should be incentivised to increase industrial placements. The Skilling Uganda Plan emphasises employable skills and competencies relevant to the Uganda labour market, but key initiatives to realise this—such as mandatory industrial training—have not been implemented. To address this, a proportion of funding for BTVET institutions could be made conditional on the number of students that participate in industrial training placements. This will incentivise BTVET institutions to build relationships with employers and in the end ensure provision of high quality relevant training.

- The externalisation of Ugandan labour and skilled immigration must be further encouraged and coordinated. Technical training is only one component of skills development. The skills most demanded by employers are socio-emotional skills (social skills and personality traits) and higher-order cognitive skills (logical and abstract thinking). These skills are typically learnt or refined by doing (on the job) or in secondary and tertiary education. With many young Ugandans unable to gain work experience in Uganda, temporary migration to other countries can play a significant role in developing the labour force. In addition, as the Ugandan economy diversifies, industries will demand a wide range of productive capabilities but training the workforce to master new skills is impossible without an existing cadre of experts. Thus facilitating the inflow of skilled workers including Ugandans currently working abroad, will therefore remain an important strategy to overcoming the skills constraint.

- Specialised training for potential professional entrepreneurs should be expanded. Entrepreneurship training targeting university and school leavers has proven effective in improving financial literacy, opportunity identification, firm formation and business professionalism. Such schemes should be scaled up to have a large impact on employment growth and could particularly target A-level graduates waiting to enrol in tertiary education—who have a 10-month gap between completing their exams and the start of their first university semester. A number of agencies – such as the Private Sector Foundation Uganda and Enterprise Uganda—could be facilitated to manage these programmes, which should include internship schemes to link potential entrepreneurs with established firms. Entrepreneurship training should also be better integrated into the BTVET curriculum to increase the number of graduates from formal training institutions that go on to create jobs for themselves and others, which is currently very low.

- Management practices are a more significant constraint to job creation than inadequate technical or scientific knowledge and demand at least as much policy attention as Science, Technology and Innovation. Managerial skills and business professionalism are critical drivers of firm productivity and growth. Effective human resource management, quality control, branding and well-maintained distribution channels are critical for businesses to operate successfully on a large scale. Most firms have been able to pick up sufficient technical knowledge through learning by doing, but the required management capabilities are unlikely to accumulate without Government



support. While UMI and other institutions continue to provide management training, their enrolment remains low due to insufficient funding. Thus funding should be increased to those institutions. Government could also create a scholarship scheme for management-oriented degree programmes, and provide matching grants to help firms equip their staff with professional management expertise, particularly targeting SMEs.

3.4 Strategies for prioritising manufacturing growth and industrial development.

Promoting export-led manufacturing growth guarantees a more sustainable and inclusive path to job creation, closure of the current account deficit and expansion and improvement of Uganda's export basket from today's export of a narrow range of primary commodities to high value products. To achieve this, in addition to other measures, Government needs to:

- Expedite the establishment of Special Economic Zones and Industrial and Business Parks to facilitate clustering of activities in areas where all the essential public inputs are available.
- Support organised industrial bodies and firm associations in order to facilitate learning, coordination, trust and efficient division of production processes across firms; as well as more effective dialogue with Government.

3.5 Strategies for increased agriculture production and productivity.

Agriculture currently employs 73 percent of the labour force and there is potential for significant productive improvements. Mechanisation and greater capital investment will increase productivity and release labour to find employment in high-value sectors. A shift from subsistence to market-oriented agriculture and food production for export will help raise earnings for those employed within the sector. This will increase the demand for non-agricultural products and supply of inputs for the agro-processing industry, and lower the relative price of food, increasing the competitiveness of Uganda's tradable sectors. Thus to enhance agricultural productivity, Government should:

- Address the design and implementation weaknesses in the provision of advisory services and agricultural inputs. Establishing an electronic voucher system could improve efficiency and help to develop input markets.
- Allocate efficiency savings from NAADS to areas with large effects on production and productivity in the sector such as pest and disease control.
- Support farmer and producer associations, particularly those that have emerged organically and assigned clear rights and responsibilities to a loyal membership. Strengthening the warehouse receipt system or establishing a loan scheme to support farmer associations would enable them to purchase large volumes of members' produce for bulk sale on a cash payment basis, helping to lower operational costs and increase the prices paid to members.
- Develop new mechanisms to facilitate loans to commercially oriented farmers.

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