

The Effects of Investment Climate on Manufacturing Firms' Growth in Uganda

By

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EXECUTIVE SUMMARY

This study investigated the effects of investment climate on manufacturing firms' growth in Uganda using pseudo panel data. The low and stagnant level of manufacturing in the Gross Domestic Product within most African countries has been widely recognized to be an important policy problem. This study adopted *Gibrats Law of Proportionate Effect (LPE)* and *Learning model*, due to Jovanovic, with some

modifications to analyze investment climate factors that determine firm growth in Uganda. Results show that firm size, age, and average education are the main determinants of growth in a sample of Ugandan manufacturing firms. These results have important policy prescriptions to increase firm growth.

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INTRODUCTION

This policy brief highlights findings on the effects of investment climate factors on manufacturing firms' growth in Uganda. The low and stagnant level of manufacturing sector share in Gross Domestic Product within most African countries has been widely recognized to be an important policy problem. It is important for manufacturing firms in Sub-Saharan African countries to be able to grow over time if they are ever to play an increasing and predominant role in economic growth, facilitating poverty reduction through fiscal transfers and income from employment and firm ownership. However, there is controversy on why the share of manufacturing in Gross Domestic Product is so low and stagnant and what would be the appropriate policies to raise manufacturing firms' growth in Sub-Saharan African countries.

Politicians, policy makers, researchers and international development agencies have devoted substantial resources to creating and implementing policies that assist firms' growth, and thus create employment and reduce poverty. One of the major objectives of the reforms towards the manufacturing sector in Africa is to improve the investment climate. The potential benefits of such reforms to firms are that they may induce firm growth. Evidence on the key factors that determine firm growth in Sub-Saharan African countries (firm size and access to credit) are mixed, thus providing no clear guidance to policy makers. In order to ensure effectiveness of these policies, it is important to understand what factors contribute to manufacturing firms' growth.

METHODOLOGY

The study was based on descriptive and explanatory analysis using econometric modeling and analysis. We attempt to identify the most important investment climate factors from a wide range of perspectives. This study adopted *Gibrats Law of Proportionate Effect* (LPE) and *Learning model*, due to Jovanovic, with some modifications to analyze investment climate factors that determine firm growth in Uganda. A new survey data on manufacturing firms,

conducted by World Bank (2003) in conjunction with Uganda Manufacturing Association Consultancy (UMACIS), provides us with rich information. It gives us an opportunity to investigate investment climate factors that determine manufacturing firms' growth in Uganda.

RESULTS AND CONCLUSIONS

The descriptive results show that the average growth rate of firms for the present sample of firms does not show much variation among most groups. For example, there are no significant differences between the average growth rates of exporting and non-exporting firms, firms owned by foreigners and non-foreigners, firms with managers whose education is above secondary and managers whose education is below secondary education level. However, firms owned by females compared to those owned by males, non-unionized firms compared to unionized firms, young firms compared to old firms, small firms compared to large firms, and firms located in the main city compared to those located outside the city, were more likely, on average, to grow faster.

The government should increase funding to education, more especially vocational training institutions, which produce educated workers with relevant skills required in manufacturing firms.

The regression results showed that firm size, age, and average education were the main drivers of firm growth in a sample of Ugandan manufacturing firms. Access to credit, value added capital ratio, and unionization were shown to be negatively associated with firm growth, but the association was weak. Most of the variables that were analyzed, such as gender, sector effects, export participation, inadequate provision of infrastructure, inadequate demand for produced products, location in the city, foreign ownership, education of the manager and loss of output due to power outages, had the expected signs but the coefficients are not significantly different from zero. In general, the results are consistent with comparable studies.

POLICY RECOMMENDATIONS

If the private sector is to be the “engine of growth” in the economy, then the factors that drive the growth of firms need to be given serious attention. Empirical evidence from this study on the growth pattern of firms across the size distribution should guide government policy makers to target firms that make the best use of such assistance programmes. It is important for Ugandan policy makers to design policies that promote growth of small firms. For example, this would include extending incentives like tax holidays that are currently being enjoyed only by medium and large firms. There is also need to extend the same preferential treatment to new startups and young firms irrespective of

their size because their potential to grow are high compared to old firms. The policy makers should simplify regulations and reduce costs for more informal and new firms to register and help these firms to expand. Empirical evidence from this research can guide firm managers to focus efforts on the most important factors determining firm growth. For example, this includes human capital, by increasing their human capital base in their firms. The government should increase funding to education, more especially vocational training institutions, which produce educated workers with relevant skills required in manufacturing firms.

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