

## Contract Enforcement in Ugandan Business Transactions: The Case of Small and Medium Enterprises

By

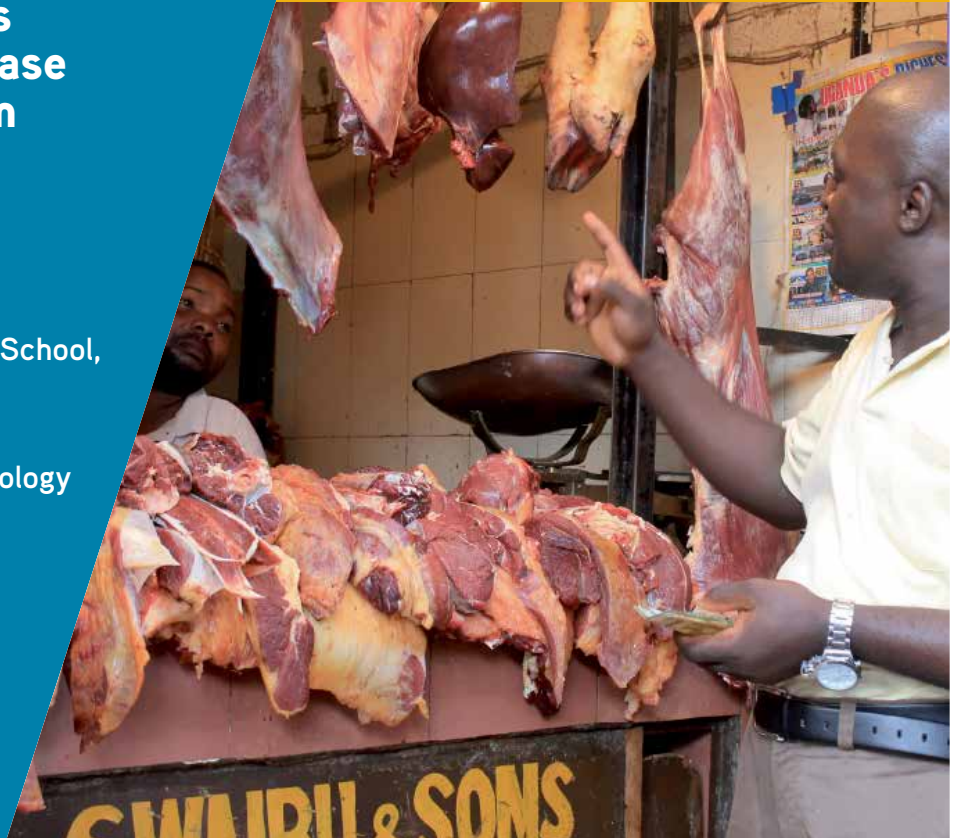
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## ICBE POLICY BRIEF



### EXECUTIVE SUMMARY

This study examines the extent to which small and medium sized business in Uganda use formal agreements when purchasing supplies. It also looks at the dispute resolution mechanisms the SMEs use when suppliers do not honour their contractual obligations to deliver supplies on time. The paper is based on a survey with a sample of 422 Ugandan Small Scale Businesses and 417 medium enterprises. The businesses surveyed were drawn from

manufacturing, construction, hotels and restaurants, education, wholesale and retail trade sectors. Respondents were managers who deal with the purchasing function within their businesses.

Data were collected using a questionnaire which was made up of both closed and open-ended questions to corroborate responses from respondents.

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## CONTEXT AND IMPORTANCE OF THE PROBLEM

The study examined contract enforcement among Ugandan business transactions. Despite being a major engine for business development, studies on contract enforcement by policy makers and academicians in developing countries remain sparse.

This observation is supported by Ntayi (2010) and Bannock et al. (2002) who argue that commitment to developing the SME sector through systematic and coherent institutional policies is often lacking. This state of affairs weakens SMEs, which could otherwise be used as an engine of growth and development given their potential to create employment in large numbers.

Government policy has been focusing on an enabling environment for large firms in a bid to grow tax revenue. According to Albaladejo (2001), the top heavy and uncoordinated institutional policies encourage rent-seeking by bureaucrats, thereby promoting large firms that are able to exploit this weakness. Such an institutional setup frustrates the use of formal contracts by SMEs. This business practice has resulted in continued adversarial relationships among SME business partners in Uganda, which are counterproductive to growth and survival.

## RESEARCH FINDINGS

### Key findings of the study were:

i) A majority of the SMEs use oral and informal contracts in their dealings with suppliers. Seeking redress in the case of oral and informal contracts is not easy since there is no accurate evidence of the contract terms that are made between business partners. Employing the services of a lawyer is expensive for SMEs.

ii) A majority of the respondents were not familiar with arbitration as an Alternative Dispute Resolution method (ADR). Those who were not familiar with ADR thought that it was cheap and time saving. This was however at variance with the views of those who had used it and believed that, arbitration is expensive and time consuming. SMEs which are familiar with ADR are hesitant to use it again,

because it is perceived to be costly, and takes a long time to resolve conflicts.

iii) There is a high level of unethical behaviour amongst firms that supply to SMEs, of which the majority are also SMEs. These include exaggeration of supplies contrary to the terms of the contract, exaggeration of offers in order to get the firm to make a purchase, lying about products and delivery time, alteration of facts relating to a contract and failure to execute their promises. Despite these unethical actions, SMEs still do not make formal contracts and largely rely on informal agreements.

iv) Contracts between SME buyers and suppliers do not articulate aspects of pricing, terms of payment, quality, quantity and delivery. This has become a breeding ground for conflict between SMEs and contracting firms. When the roles and responsibilities of each contracting party are not clearly specified, it is difficult to argue out a case in court when one party fails to deliver their end of the bargain.

v) SMEs often experience problems with their suppliers on a number of aspects. The problems experienced in order of their severity include quality, late deliveries, price, quantity and scarcity. Problems relating to the quality of products were the most frequent in a majority of the firms that responded to the survey.

vi) Finally, the majority of SMEs seeking solutions to problems with their suppliers reported to Police (36.6%) and Local Councils (36.6%) while very few (12.2%) reported to the commercial court. Few resorted to commercial court because a majority of the SMEs are not very familiar with the commercial court as an avenue for resolving the problems that they face with their suppliers.

## CRITIQUE OF POLICY OPTIONS

In just under five years left to implement some of the provisions of the United Nations Millennium Development Goals (MDGs), Uganda seem to be far from achieving her set targets. The country continues to increasingly rely on aid and has in the past joined other indebted countries, requesting developed countries to write-off large amounts of official debt and increase aid as a growth and development agenda.

This move has attracted the attention of some international agencies that believe in aid. The International Monetary Fund 2005 (p. 147) revealed that financial assistance aid as envisioned by the UN Millennium Report financed about 60 percent of government expenditures in low-income African countries.

However, available research on aid and growth is mixed. African countries where aid represents the highest percentage of gross domestic product have had the slowest rates of per capita growth (Shirley, 2008). One would be right to conclude that aid neither promotes sustainable development nor improves institutions. In fact, large amounts of aid damage the existing weak institutional environments of developing countries. Burnside and Dollar (2004, p. 4) contend that “there is broad

agreement that giving a large amount of financial aid to a country with poor economic institutions and policies is not likely to stimulate reform, and may in fact retard it.” This is mainly true because aid givers do not necessarily work within the host countries institutional structures, they instead try to bypass the existing institutions by creating special structures to implement projects (Shirley, 2008) which diminish with the project life cycle and discourage the establishment of small and medium-sized enterprises (SMEs).

Available evidence from the Ugandan SMEs reveals that the donors’ practice of bypassing institutions in their effort to implement donor-funded projects has left harmful institutions unattended to. This has, for instance, caused serious negative impact on the functioning and sustainability of aid projects which were intended to stimulate SME start-ups and growth. This is exacerbated by the fact that Uganda scores poorly in terms of failing to have an institutional framework that governs starting and successfully running SME businesses (Kiryabwire, 2010; Ntayi, 2010). Consequently, such an environment has made Uganda a favourable ground for the rapidly growing informal sector which has become the “sponge” that provides job avenues to all categories of labour, including skilled workers. As a consequence, the existence of harmful institutions limits SME growth and development (Ntayi, 2010).

## POLICY RECOMMENDATIONS

### Key policy recommendations include:

- 1) A need to create awareness of arbitration and other forms of Alternative Dispute Resolution (ADR) using social learning framework.
- 2) Creating a special desk for SMEs at the commercial court.
- 3) Teaching SMEs and suppliers the importance of formal contracts and providing skills of writing.
- 4) Providing legal help to SMEs.
- 5) Training SMEs and suppliers in ethical business behaviour.
- 6) Building the capacity of the police and local councils in handling and resolving business disputes.

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