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Issue 13, January – March 2016

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## Political election cycle and subdued domestic demand affect business environment

### Executive Summary

*The Uganda business climate index declined by 6.2 points to 93.5 during the January – March 2016 quarter from 99.7 during the October – December 2015 quarter. This indicates a slight slowdown in the conditions for doing business and is consistent with expectations from the previous quarter. The negative sentiment in the business environment was largely driven by some persistent challenges in doing business and some new emerging ones. In particular, the domestic political election cycle and concerns over waning domestic demand have elevated the perceived risks for doing business in the current quarter. In terms of business constraints, volatility in the macroeconomic environment, substandard products, tax policy, and concerns over the cost and reliability of electricity supply continue to constrain business competitiveness and their severity was perceived to have been elevated during the current period. Contrary to expectations, business sentiment in agriculture and industry was upbeat. However, business sentiment in the services sector was downcast. Perceptions about business sentiment in the next quarter (April – June 2016) are favourable on account of the expected recovery in domestic demand, macroeconomic environment, and improvements in domestic and regional political environment.*



Kampala road: Business sentiment in the services sector was downcast

### Data and Methods

The data used in computing the business climate index were collected from 173 business establishments sampled from the 450,000 businesses recorded in the 2011 Census of Business Establishment conducted by the Uganda Bureau of Statistics. Throughout the surveys we keep following the same businesses. This enables us to construct comparable indices through time.

The business climate index is computed based on the following business evaluation indicators: level of business activity, turnover, profitability, incoming new business, capacity utilisation, average costs of inputs, price of produced goods, business optimism, number of employees, and 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” or “above normal for quarter”, “normal for quarter”, below normal for quarter” or “more favourable”, “unchanged”, “less favourable”. These responses are coded as 0, 1, and 2 respectively. In this case, if a respondent’s perception of the business environment is that it deteriorated, such a response would be coded 0, it would be coded 1 if the business climate did not change and 2 if the business climate improved.

It is worth noting that the index does not consider the magnitude of change in the data but considers the general direction of movement in the key indicators. As such, the index is sensitive to the direction as opposed to the magnitude of the change in business conditions. During the data collection process, the business managers were asked to assess the general economic environment for the current (January – March 2016) quarter relative to a similar period a year earlier; and their expectations for the next quarter (April - June 2016). Based on the business evaluation indicators explained earlier, the business climate index is computed as the weighted arithmetic mean of indices of the individual busi-

ness evaluation indicators. The indices range from 0 – 200. The interpretation of the business climate index is such that scores above 100 point to an improving business climate. Scores below 100 imply that the general business conditions are getting worse. And, a score of 100 points to unchanged business conditions.

In addition, the index analyses the evolution of challenges facing businesses over the last quarter, by identifying which business constraints are more of a problem and less of a problem. The survey respondents were asked to indicate how each of the identified business constraints have evolved over the last full year. For each of the business constraints we asked if it was “more of a problem”, “unchanged”, or “less of a problem”. These responses were coded, 1, 0, and -1 respectively. We then computed the weighted average response for each of the constraints, the interpretation of which is such that scores above 1 point to a constraint that is more of a problem; scores below 0 imply that a constraint is less of a problem; and zero scores point to unchanged business constraint.

## Results

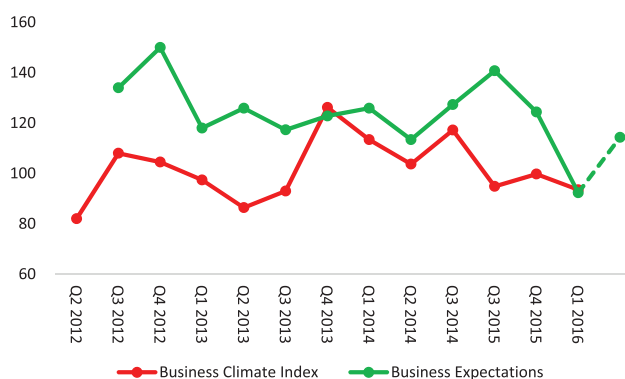
### Business Climate Perceptions Indicate Elevated Risks

Results indicate a slight slowdown in the conditions for doing business in the current quarter (January – March 2016), having declined from a generally optimistic trend over the previous five quarters (Figure 1). The business climate index is 93.5 and has declined by 6.2 index points on a quarter-on-quarter basis from 99.7 during (October – December 2015). The drop in the index is an indicator of deteriorating conditions for doing business in Uganda during the period under review. In particular, the sub-indices for capacity utilization (80.1), turnover (83.1), activity (84.4) and profit (82.9) were all below normal. This indicates that the economy is operating at less than full potential.

The negative sentiment in the business environment was largely driven by some persistent challenges in doing business and some new emerging ones. In particular, the domestic political election cycle and concerns over waning domestic demand have elevated the perceived risks for doing business in the current quarter. In addition, volatility in the macroeconomic environment, substandard products, and tax policy and concerns over the cost and reliability of electricity supply continue to be binding constraints to business competitiveness and were reported to be more of a problem in the current period than in the previous.

There are concerns that interest rates are very high posing constraints to private sector credit growth. In addition, the depreciation of the Uganda shilling against the leading world currencies has affected business especially in the services and wholesale trade where a sizeable amount of stock and other materials are imported. The nominal exchange rate continued to depreciate by 18 percent during January – March 2016 on a year-on-year basis. The depreciation of the local currency further strengthened the inflationary outlook with headline inflation averaging 6.9% compared to 3.2% during January – March 2016.

Figure 1: The Business Climate Assessment

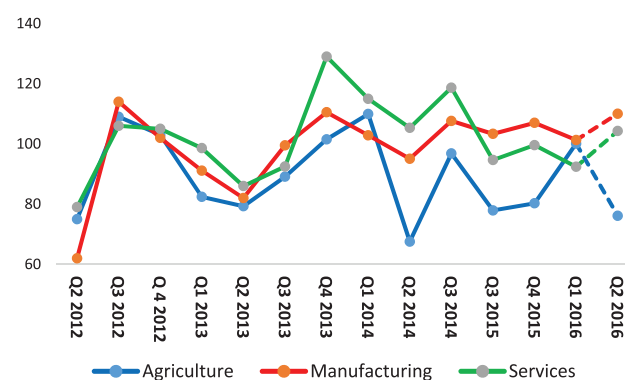


### The Business Climate Index by Sector

There were differences in the sectoral perceptions about the business environment sentiment in the current quarter. Business sentiment improved in the agricultural sector while manufacturing and services sectors experienced deteriorating conditions for doing business. (Figure 2). In the agricultural sector, the business climate index improved by 19.8 points to 100.1 from 80.3 points. However the indices for manufacturing declined by 5.7 points to 101.3 from 107 in the previous quarter. Similarly the index for services declined 7.2 points to 92.4 from 99.6 in the previous quarter and accounted for the largest drop in the perceptions about the business environment. The deteriorating confidence in the service sector was largely attributed to the less favourable input and output prices, and subdued demand that affected business profitability.

The favourable perceptions about the business climate in the agricultural sector were primarily driven by improvements in perceptions about product costs, input costs, and incoming new business. These in turn helped to lift the capacity utilization whose index improved to 109.3 in the current quarter from 39.4 in the previous quarter. Equally important, the positive sentiment in the agricultural sector was also supported by more favourable rains than would normally be expected during the quarter. In addition, the agricultural exports benefited from relatively higher prices particularly for tea, coffee and cotton.

Figure 2: Business Climate Index by Sector

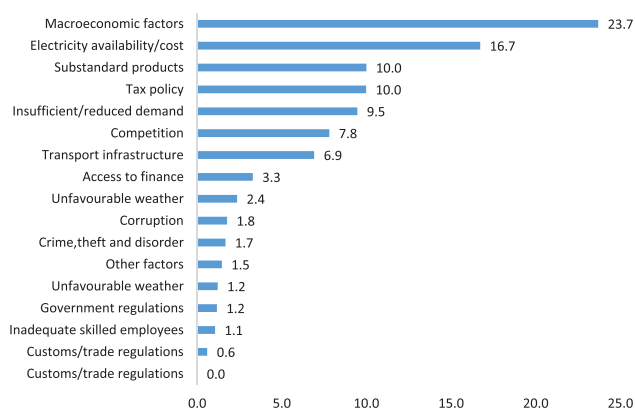


In the manufacturing sector, the business sentiment remained marginally above normal despite dropping by 5.7 points to 101.3 in the current quarter from 107.0 in previous quarter. The slight decline in business sentiment was driven by low business activity that affected profits and jobs. Similar to developments in the manufacturing sector, business sentiment in the services sector deteriorated on account of below normal business activity that affected capacity utilization and jobs. These were largely due to waning domestic demand and the business anxiety due to a political election cycle.

### Challenges in doing business

The top five most important constraints in doing business for the current quarter have not changed since last quarter. This suggests that major policy and regulatory constraints facing Ugandan businesses are rather persistent. The macroeconomic factors particularly exchange rate volatility and high interest rates (23.7%) continue to be the number one business constraint in the current quarter. Challenges with electricity availability and cost (16.7%) continue to take second place but the weighted percentage of businesses reporting electricity issues declined from 17.3% in the previous period. Substandard products and tax policy (both 10 %) take the joint third position. Insufficient demand for products and services (9.5 %) completed the list of the top five business obstacles in the current quarter.

Figure 3: Business Constraints, %

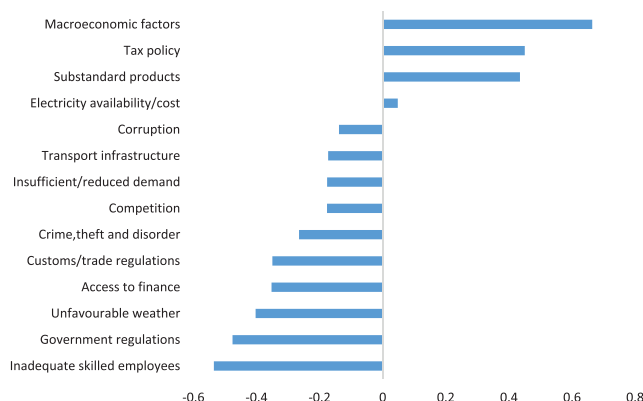


### How have the business constraints evolved over the last period?

The results (Figure 4) indicate that the four most important challenges that businesses had to deal with during the quarter are also the ones whose severity got worse over the last full year. The severity of the challenges posed by the macroeconomic environment were perceived to have been elevated during the current quarter. In particular 77.2% of all business executives in our sample indicated that the macroeconomic environment deteriorated, 12% indicated that it was unchanged, while 10.8% indicated that the macroeconomic environment was easier for businesses. Tax policy was reported to be more of a problem in the current quarter than in the previous, with even more business executives reporting that it was a challenge in the current (59.2%) than in the previous quarter. The threat of unfair competition due to the proliferation of substandard products was perceived to be greater in the current period than in the previous. Lastly electricity availability and cost continue

to be perceived as an increasing threat to business in Uganda, but, rather encouragingly there are signs that electricity is no longer perceived to be such a big challenge as it used to be in the past. This is due to a number of factors: first the country has prioritized investments in the electricity sector and episodes of load shedding have greatly reduced. Second, the introduction of prepaid meters has incentivized many businesses to better manage electricity consumption and thus leading to reduced bills.

Figure 4: The evolution of business constraints



### Future business outlook: April - June 2016

The businesses are more optimistic about the near term developments than they were in last quarter. The expected index for April – June 2016 is 114.3 (figure 1) and is 22 index points higher than the current quarter’s expectation which was 92.3 points. Generally, improvements in business conditions are expected to accelerate across all sectors, and will benefit most from expected favourable product prices and improvements in capacity utilisation.

However, there are sectoral differences in the expected business environment. Lower business confidence is expected in the agricultural sector, while manufacturing and services are expected to have rather modest improvements. The expected indices are 76.1, 110.0, and 104.3 for agriculture, manufacturing and services respectively. While the index for agriculture is higher than was expected (50.0) business perceptions continue to point to an uncertain environment for doing business. The expected below potential performance of agriculture sector could be attributed to the high cost of imported agricultural inputs (fertilizer and seeds) brought about by the depreciation of the shilling. In addition, the agricultural sector is likely to perform below potential owing to the onset of the effects of the El Nino with more volatile and unfavourable weather patterns during the coming quarter, implying that the gains experienced in the current quarter will not be sustained.

The expected favourable business environment in manufacturing and services sectors are anchored around improvements in domestic demand and incoming new business, possibly signalling business recovery after the effects of the political election cycle. This will in turn drive expected incoming new business, business

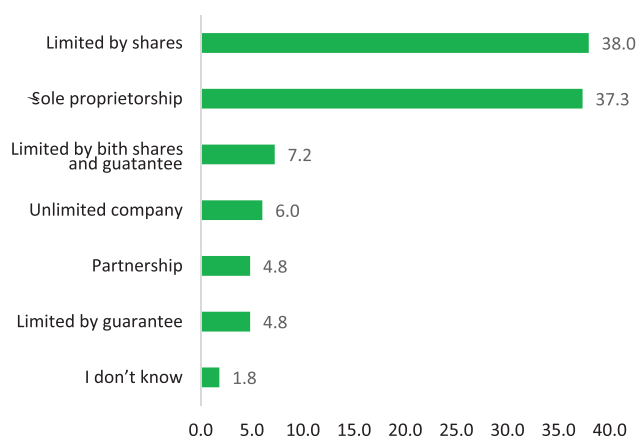
activity and profitability.

## Question of the Quarter

### Formality and Legal Status

In this quarter we sought to understand the extent to which Ugandan businesses are formally registered and their legal statuses. In particular, we asked: a) “Is this business operating as a formally registered company?” b) “If the business is formally registered what is the legal status?” Results indicate that majority of businesses in our sample (97 percent) are formally registered. In addition most businesses operated either as “Limited by shares” (38.0 percent) or as “sole proprietorship” (37.3 percent) as indicated in Figure 7. Other legal representations include: Limited by both shares and guarantee (7.2 percent), Unlimited Company (6.0 percent), partnership (4.8 percent), and limited by guarantee (4.8 percent).

**Figure 5: The legal status of Ugandan businesses, %**



Results further indicate the business legal status differs by size and sector: more micro (61%) and small (46%) businesses are likely to be sole proprietorships, while more medium (51%) and large (50%) businesses are likely to be limited by shares.

## Conclusions

Perceptions about the business environment in Uganda deteriorated slightly. The negative sentiment in the business environment was largely driven the domestic political election cycle and concerns over waning domestic demand. Volatility in the macroeconomic environment, substandard products, tax policy, and concerns over the cost and reliability of electricity supply continue to be binding constraints to business competitiveness in Uganda. Contrary to popular expectations, business sentiment in agriculture and industry was positive, while business sentiment in the services sector was downcast. The next quarter will see improved performances in the manufacturing and services sectors due to expected recovery in domestic demand, investment, macroeconomic environment, and improvements in domestic and regional political environment. However, the positive sentiment in the agricultural sector is not likely to be sustained due to expected El Nino effects.

*The Economic Policy Research Centre (EPRC) has been producing the Business Climate Index (BCI) for Uganda since June 2012. The BCI reflects the perceptions of Ugandan business managers on the current and near future (expected three months ahead) business conditions. The BCI is a perceptions indicator of economic activity and the general business environment in which businesses operate. It can be used to forecast turning points in economic activity and thus provides critical information for policy makers both in Government and the Private Sector.*

### 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 Maweje (Research Analyst). The team appreciates the support received from all participating business establishments across the country, our partners at the Uganda National Chamber of Commerce and Industry, Kampala City Traders Association and all persons who reviewed and edited this publication. Special thanks goes to Deogratius Katongole for the data management.

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