

Policy paper



International
Growth Centre

Uganda

Improving export
performance



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November 2016

When citing this paper, please
use the title and the following
reference number:
F-38213-UGA-1

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Introduction

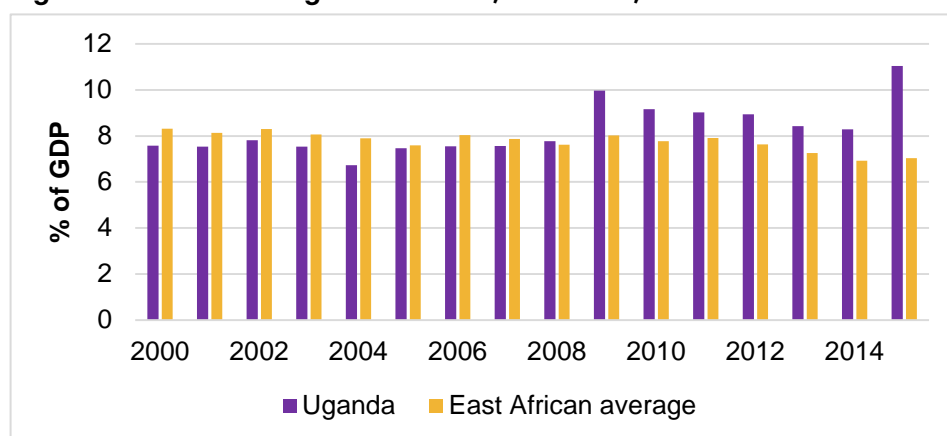
Uganda, like most developing countries, is keen to leverage its external sector to support economic growth and employment creation through structural transformation. This has become increasingly urgent as commodity prices have leveled off and volumes have stagnated with the global slowdown. Policymakers need to establish a supportive environment within which the private sector can invest in exports. The overall objective of this report is to identify key measures donors can support to help bring that vision to fruition.

Industrial sector development is a key priority of the Ugandan government, and it occupies a central position in the government's Vision 2040, which is the country's social and economic development plan outlining the government's aims to build a modern, competitive, and dynamic industrial sector that is fully integrated into domestic, regional, and global economies. Key strategic priorities in Uganda's 5-year National Industrial Sector Strategic Plan are to exploit and develop natural resource-based industries; promote agro-processing for value addition in niche markets; and support engineering for capital goods, agricultural implements, construction materials, and fabrication operations. However, to date there has been little systematic effort to develop vertical supply chains in areas where this would be possible, e.g. coffee, maize, tourism, and selected manufactures, in order to promote stronger linkages between MNEs and domestic suppliers. Developing competitive value chains will be one crucial area for development over the medium term.

By way of background, Uganda's manufacturing sector is small and is dominated by small and medium enterprises (SMEs), which make up some 93.5% of firms operating in the sector. The sector primarily engages in end-product assembly and raw materials processing, producing mainly low value added goods such as food and beverages, wood and wood products, textiles, leather, and metallic and non-metallic fabrication.¹ Agro-processing is one of the most important activities in Uganda's manufacturing sector.² Large investments by foreign companies in Uganda tend to be mainly in textiles, steel mills, tanneries, bottling and brewing, and cement production.³

Figure 1 shows that Uganda's manufacturing sector has accounted for around 8% of GDP for most of the past 15 years, which is higher than the East African average. It is not clear if the spike to over 10% of GDP in 2015 represents a sustainable change. Nonetheless, the sector is still small by the standards of countries in other regions that have leveraged light manufacturing and external engagement to support structural transformation and medium-term growth, such as China or even a lower income country, like Vietnam, which has a manufacturing share of close to 15% of GDP. There is scope to grow manufacturing activity in Uganda, within the constraints of the country's comparative advantage.

Figure 1: Manufacturing value added, % of GDP, 2000-2015



Source: *World Development Indicators*.

¹ African Development Bank, "East Africa's Manufacturing Sector: Uganda Country Report."

² Obwona et al, "The evolution of industry in Uganda."

³ African Development Bank, "East Africa's Manufacturing Sector: Uganda Country Report."

The most recent business establishment census, conducted by the Uganda Bureau of Statistics in 2010/11, reveals notable features of Uganda's manufacturing sector:

- Businesses in the manufacturing sector employed an average of four people; 86% of businesses had less than five employees, and only 3% had at least 20 employees;⁴
- Of the slightly more than 30,000 businesses in the manufacturing sector, 19% were in food processing and 81% in non-food processing (43% textiles, 17% furniture making, 13% metal products and 8% in grain milling);⁵
- Only 11% of businesses in manufacturing had an annual turnover of more than UGX 10 million, compared to almost 64% with annual turnovers of less than UGX 5 million;⁶
- 93% of businesses in manufacturing were sole proprietorships, 3% partnerships, and 3% private limited companies;⁷ and
- Across the manufacturing sector, 95% of businesses did not own a computer, and only 3% used the internet for their business activities.⁸

As these statistics suggest, Ugandan firms typically find it difficult to achieve production at scale. Developing mechanisms that allow firms to reap scale economies is one important policy objective for the government and donors. Small firms need to grow and become more productivity before they can absorb the additional costs involved in exporting, so the problem of facilitating exports is linked to this issue of scale. As will be seen throughout the text, many factors come together to make firm-level growth challenging, from the difficulty of contracting for reliable, high quality input supplies, to problems accessing finance at reasonable rates, to trade and investment policies. Access to electricity also looms large, but it is to be hoped that with new generation capacity coming on stream, and possible progress on the East African Power Pool, firms may be able to access more reliable and cost effective electricity in the foreseeable future. Progress on a variety of fronts will be needed, and part of the objective of this report is to identify the highest priority issues, and consider feasible interventions that could support the government's objectives.

The next section considers Uganda's recent trade performance in comparative context, focusing on volume and price effects, and the growth of exports and imports. Section 3 relates developments in external markets to the structural change agenda by focusing on trends in diversification—an important policy objective due to the economy's historical reliance on a narrow range of commodities, like coffee—and export sophistication. In the 21st century economy, trade and investment are closely linked, all the more so through the lens of global value chains (GVCs). Section 4 therefore looks at the trade-investment nexus in Uganda. Based on the descriptive statistics in those three sections, Section 5 moves to consider the policy dimension, looking at issues like barriers to goods trade, regulation of services sectors, and measures affecting the business environment. Finally, section 6 concludes and provides an indication of some types of measures that could be supported by donors to help Ugandan policymakers support private sector development and trade expansion.

1. Recent trade performance

Uganda runs a substantial current account deficit, which has led to concerns about relative trends in imports and exports. Of course, the current account itself is not an appropriate target variable for policy. It is important to look at underlying factors to better understand what is driving it. In Uganda's case, it seems likely that an important driver is the government's persistent fiscal deficit (negative public sector saving). The 2015 budget deficit amounted to 7% of GDP,⁹ compared with 5.2% of GDP for the current account deficit.¹⁰

Figure 2 puts the evolution of Uganda's current account in temporal and geographical context. As the comparison with the African average shows, Uganda has a stronger tendency to be in

⁴ UBOS, "Report on Census of Business Establishments 2010/11."

⁵ Ibid.

⁶ Ibid.

⁷ Ibid.

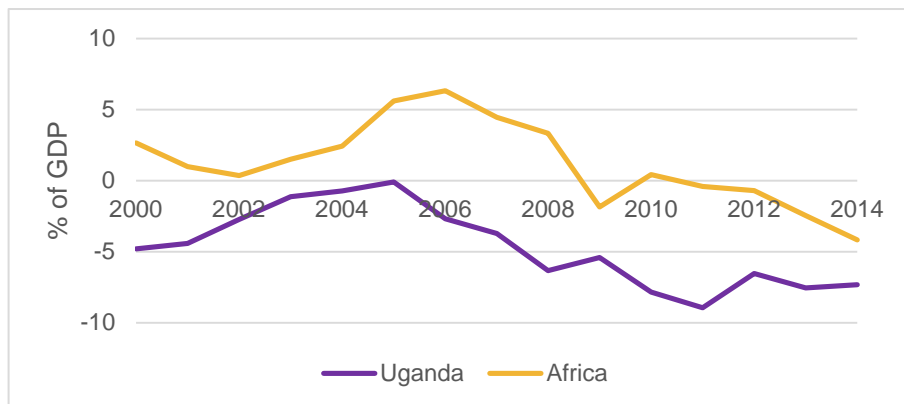
⁸ Ibid.

⁹ Reuters Africa, "Highlights: Uganda, Tanzania and Rwanda 2015/16 budgets."

¹⁰ Deloitte, "Uganda Economic Outlook 2016."

deficit than many of its regional partners. The deficit is significant in relation to the country's GDP, but has narrowed somewhat in recent years. Recent forecasts from the IMF, which show a larger deficit compared with the UNCTAD data in Figure 2 for years where both are available, also show an expected narrowing of about one percentage point of GDP forecasting to 2016 from 2014.

Figure 2: Current account deficit, % of GDP, Uganda and Africa (average), 2000-2014

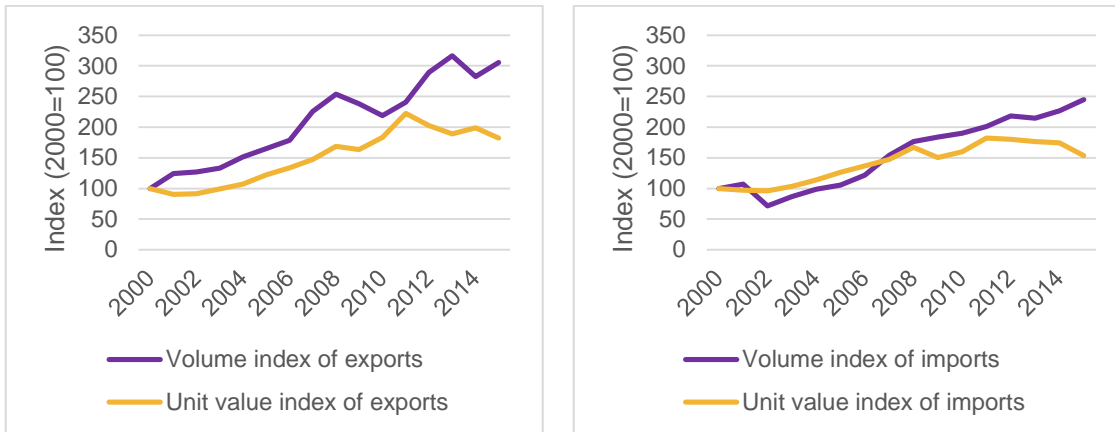


Source: UNCTAD.

If trade fundamentals are playing a role in the country's current account position, we would expect to see import and export volumes or unit prices changing in significantly different ways, consistent with faster growth of imports than exports. Figure 3 presents the relevant data. It is immediately clear that, in fact, exports are growing more quickly in volume terms than imports, and that prices for the two sides of the balance of trade are moving in relatively similar ways. This first glance at the data supports the view that it is primarily economic fundamentals, specifically public sector dissaving, that is generating persistent current account deficits in Uganda. In any event, Uganda's current account deficit is by no means at an unmanageable level, and access to concessional financing and grants means that if government borrowing is focused on securing resources for socially useful investments, the balance of benefits and costs may well be positive.

The important point to stress is that primary responsibility for the current account deficit would not appear to lie with trade policy. The point is important, because it suggests that policy responses that can help dynamise Uganda's external sector to support growth and employment generation may not be in the traditional trade policy sphere, but might instead be behind the border, related more to the business environment as it affects exporters and potential exporters. In any event, a "knee jerk" response of, for example, restricting imports would be counterproductive, for two reasons. First, in general equilibrium, the Lerner Symmetry means that a tax on imports is also effectively a tax on exports, as resources are diverted into the import-competing sector. Second, in the context of global value chains (GVCs), it is important for firms to have access to high quality imported intermediates at world market prices, so that they can themselves be competitive. Facilitating trade in both directions is an important part of the outward-oriented growth paradigm that has been so successful in other parts of the world.

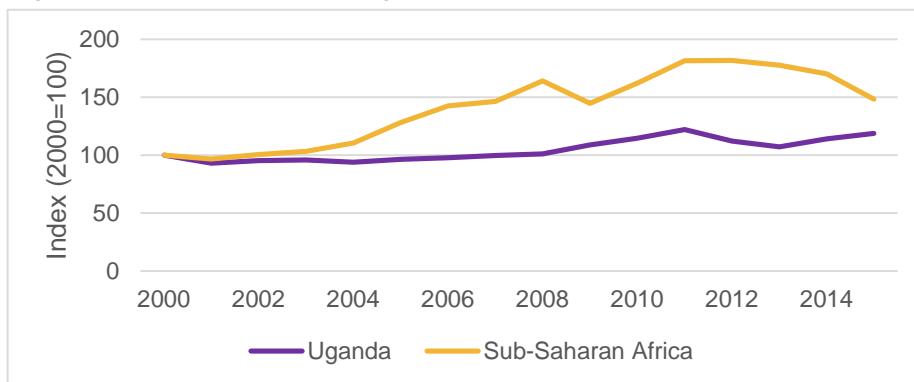
Figure 3: Volume and unit value indices for Uganda’s exports and imports, 2000-2015 (2000=100)



Source: UNCTAD.

From the point of view of Uganda’s export performance, Figure 3 suggests that there has been consistent improvement over the last decade and a half. Volumes have increased substantially, and prices have also seen some improvement. To supplement this information, Figure 4 presents an index of Uganda’s terms of trade. An increase in the index indicates that the unit price of exports has increased relative to the unit price of imports. There is thus some improvement in Uganda’s terms of trade, though at a modest rate, and considerably less than seen elsewhere in sub-Saharan Africa. Nonetheless, overall Uganda’s trade performance has been fair, which is undoubtedly one factor underpinning the country’s robust GDP growth over recent years.

Figure 4: Terms of trade in Uganda and Sub-Saharan Africa, 2000-2015 (2000=100)

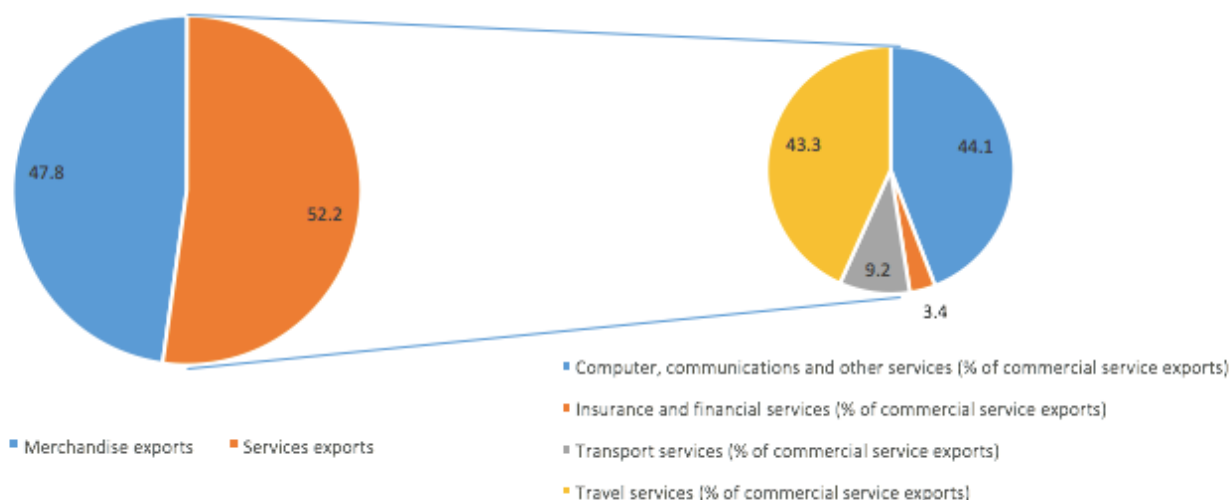


Source: UNCTAD.

It is also important to look at the sectoral composition of Uganda’s exports, in services markets as well as goods markets. In fact, in 2014 earnings from services exports accounted for 52% of total export earnings, so the sector is clearly an important source of jobs, value added, and foreign exchange earnings. Figure 5 shows the breakdown of exports by sector. It shows that services account for around half of total exports—a very significant proportion given the implications in terms of bringing in foreign exchange. Within services, travel services, which are linked to tourism, suggest that there are also substantial export earnings to be had in that sector. Another large sector is computer and communications services (which also includes other categories not listed elsewhere, such as business and professional services). The Ugandan government has been working with the International Trade Center to boost performance of the country’s call centers and outsourcing services, which make use of good access to the internet and telecommunications, and a significant English-speaking population.¹¹ The main point to take away is that goods and services markets both offer export potential to Uganda. Indeed, performance in the two areas are interlinked, as many services are used as inputs into the production of manufactured goods for exports. So developing competitiveness needs to happen in tandem in both sectors.

¹¹ International Trade Centre.

Figure 5: Sectoral breakdown of Uganda’s total exports, and services exports, 2014



Source: *World Development Indicators*.

2. Structural changes in exports

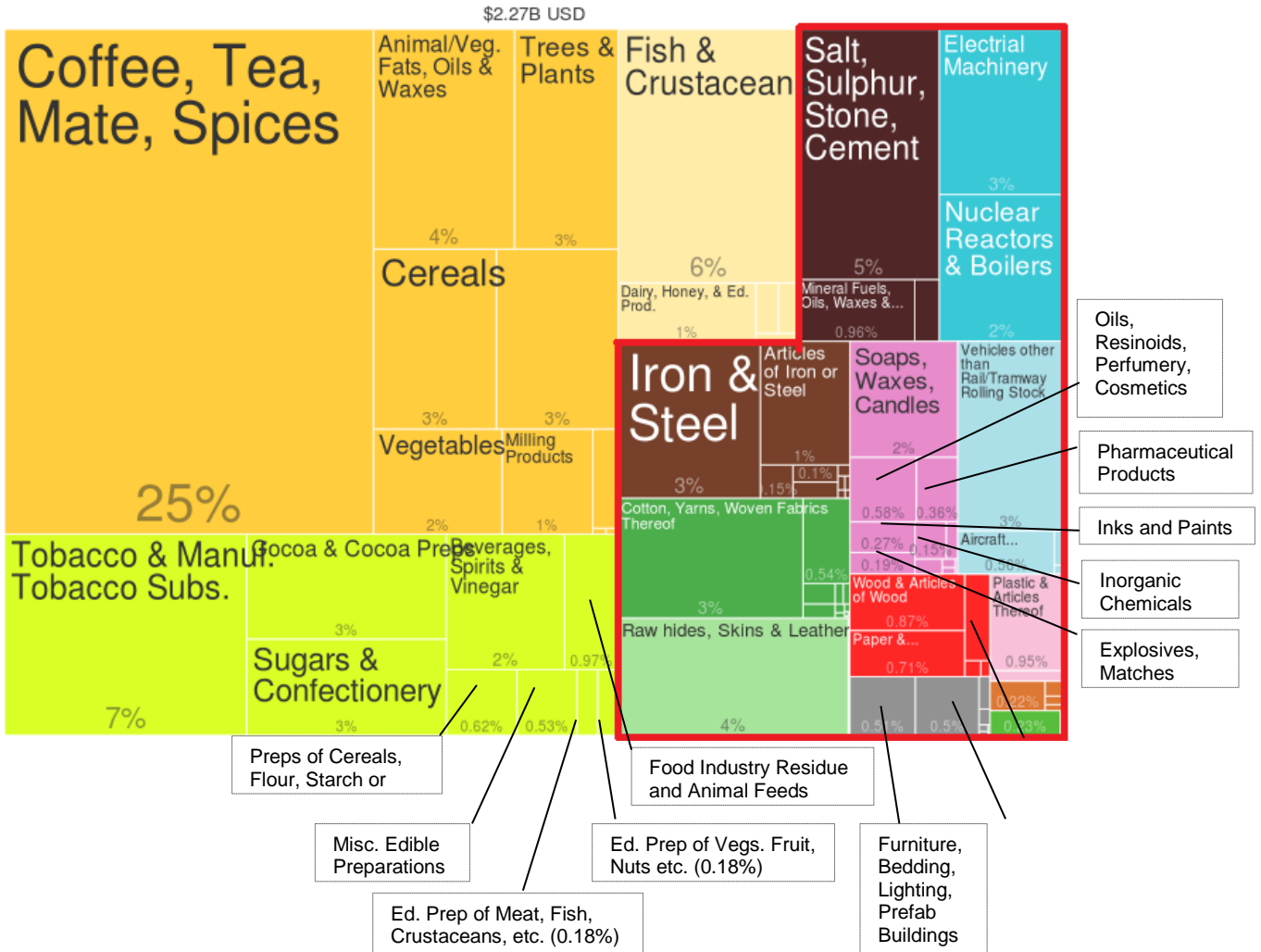
Aggregate trade data like those examined in Figures 3 and 4 do not directly speak to the extent to which the external sector is helping promote the objective of structural transformation. This section and the next look in more detail at that question, by presenting the composition of the export portfolio, its development over time, measures of export diversification and sophistication.

Uganda’s dominant export product is and has for decades been coffee, but other goods and service exports have grown in importance. Whereas in the 1990s coffee exports were higher than all non-coffee exports combined, coffee’s share of merchandise exports had shrunk to about 24% in 2013.¹² Over the last decade, Uganda has begun to export significant amounts of fish, tobacco, tea and cocoa, with shares of around 6% of merchandise exports each, depending on the year.

While food commodities still make up the majority of the export basket, the share of non-food exports has grown. Figure 6 shows the composition of Ugandan merchandise exports in 2013, with a variety of growing non-food exports produced mainly by agri-business and light manufacturing industries, here marked in the red box. This group of products includes cement, metal and steel, wood, chemicals, leather and plastic products. Overall it is much more fragmented and diversified within than the food-commodity group of exports. Figure 7 shows the growth of these product groups over the last 20 years.

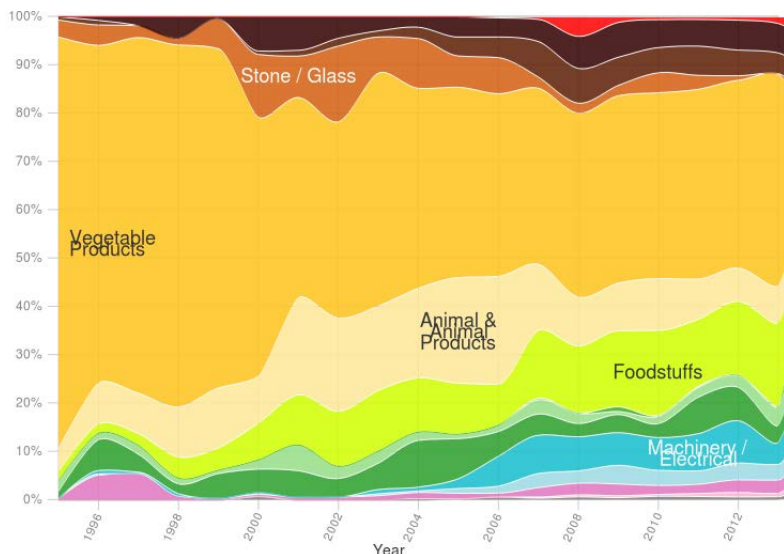
¹² Centre for International Development at Harvard University, “The Atlas of Economic Complexity.” Official export statistics from UBOS quote a substantially lower figure for coffee export of 18% of formal merchandise exports, but don’t change the ordinal ordering significantly.

Figure 6: Tree map of Uganda merchandise exports, 2013



Source: *Atlas of Economic Complexity*. Note: Official export statistics from UBOS quote a substantially lower figure for coffee export of 18% of formal merchandise exports, but do not change the ordinal ordering significantly

Figure 7: Merchandise export comparison 1995-2003

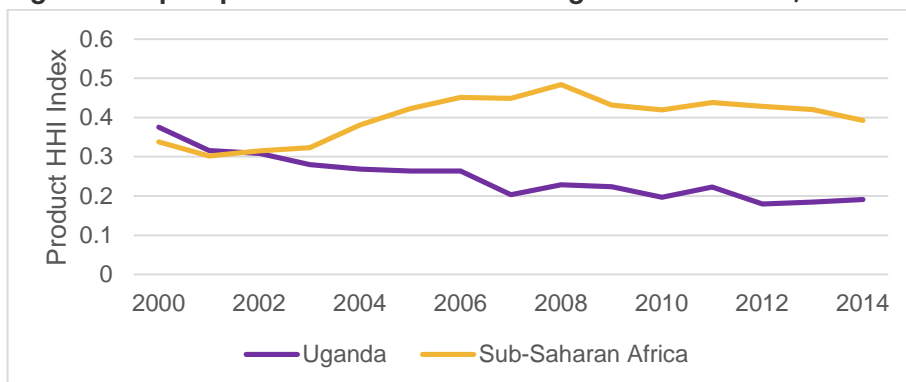


Source: *Atlas of Economic Complexity*. Note: Official export statistics from UBOS quote a substantially lower figure for coffee export of 18% of formal merchandise exports, but do not change

the ordinal ordering significantly.

Figure 8 presents data on export product concentration for Uganda. A higher index number indicates a more concentrated export bundle. Uganda has clearly performed quite well on this metric compared with its African peers: its index score in 2014 was only about one half of the score in 2000, which indicates substantial diversification, compared to a slightly higher level of concentration in Africa as a whole. This analysis suggests that Uganda's private sector is gradually expanding the range of products it exports.

Figure 8: Export product concentration in Uganda and Africa, HHI Index, 2000-2014



Source: UNCTAD. Note: The index is calculated as the square root of the sum of squared export shares in total exports by country.

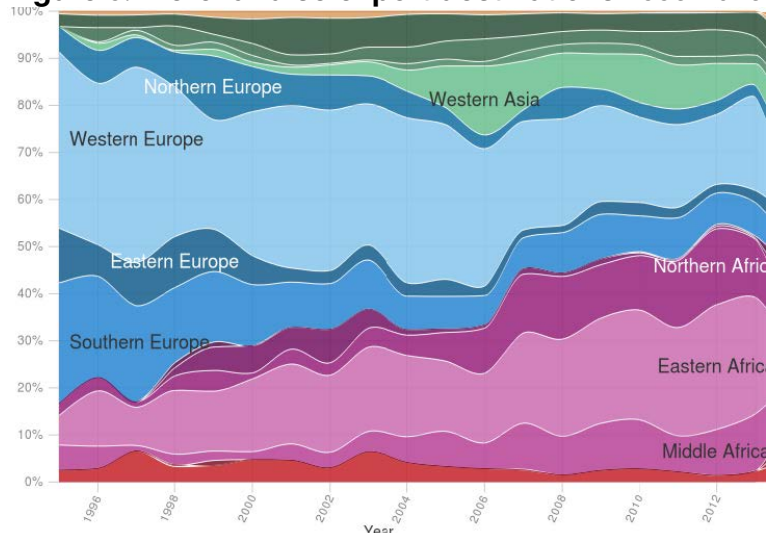
The biggest change in Uganda's export sector has come from the growth in services exports, which are not shown in Figures 6 and 7, as disaggregated data on services exports is scarce. In 1995 services made up about 15% of all exports, a value that has since risen to 42%.¹³ This growth is remarkable, especially considering that the share of services in the export portfolio in the rest of sub-Saharan Africa more or less stagnated at about 15% over the same time period. About 50% of services exports are travel and tourism services, which has become a major earner of foreign exchange. Other important service exports are transport, and construction, with 11 and 10% shares in services exports respectively; the rest is made up of business and government services.¹⁴

The Ugandan export sector has also diversified in terms of destinations served. Figure 9 shows the composition of merchandise export destinations over the last twenty years. In the 1990s, around 80% of exports, mainly coffee, went to Europe. Since then, Africa has outpaced Europe as the most important export destination for Uganda. The share of Ugandan exports that go to African nations has risen to about 50%, while the share of exports to Asia has risen to around 20%. Exports to the Americas and Australia are still almost negligibly small.

¹³ Source: World Development Indicators, BoP definition, downloaded on October 23rd

¹⁴ UNCTAD Stat, downloaded on October 23rd. Many services exports such as education services are not captured, but are known to be large in Uganda

Figure 9: Merchandise export destinations 1995-2013



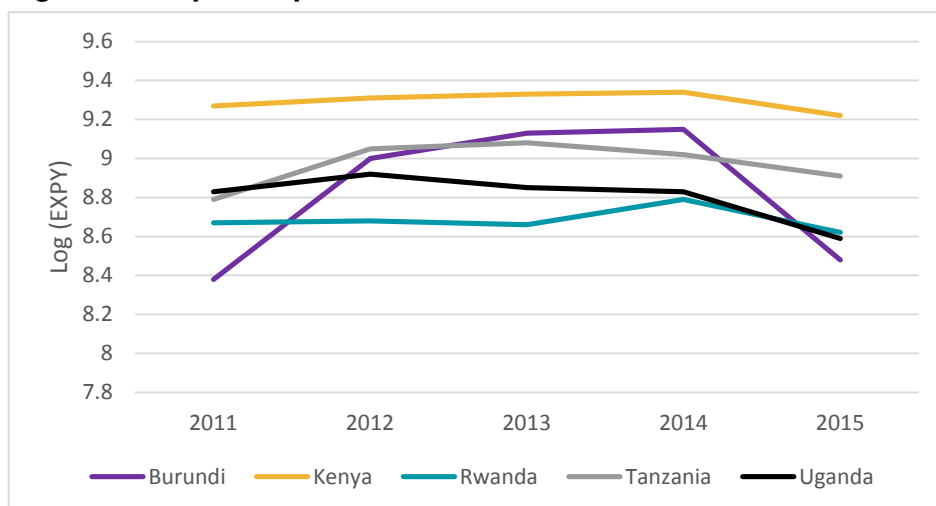
Source: *Atlas of Economic Complexity*.

Structural changes in the export portfolio have gone hand in hand with structural changes in the Ugandan economy. Services now produce 55% of value added in the economy, up from 36% in 1995. At the same time agriculture's significance has nearly halved, from 49% of value added to 25%. Meanwhile, the relative size of the manufacturing sector remains almost unchanged at 8% of value added. But the manufacturing sector has changed within: its share of merchandise exports increased from 13 to 26%, implying a strong shift of focus from the domestic towards the external market.

Diversification of a country's export bundle is one indicator of structural change. Another relates to the sophistication of its exports. A familiar framework, based on the analysis of Hausmann et al. (2007), uses the EXPY indicator. EXPY captures the productivity level associated with a country's export bundle. It is calculated as a weighted average of country income levels associated with the goods a country exports, and is based on observations across all countries in the world. Hausmann et al. (2007) show that EXPY is a robust predictor of a country's future growth rate, which makes it an important indicator of structural change. Tracking it over time, as well as in comparative perspective, is a good indicator of the extent to which structural change is taking place: it would be seen as an increase in the index relative to benchmarks.

Figure 10 presents recent results for the EAC countries. Two important conclusions are apparent. First, Uganda's level of export sophistication as captured by EXPY is relatively low, comparable to that of Burundi or Rwanda, and is noticeably lower than that of the other large EAC countries, Kenya and Tanzania. Second, the recent trend in Uganda's export sophistication is not promising: it has moved slightly lower in the last five years. That trend is not completely without commonality vis-à-vis the other EAC countries, but they generally exhibit a greater degree of stability than Uganda. It is important to keep these changes in context, however. Although there is empirical evidence in favor of the EXPY measure, its policy implications are poorly understood. There is also an argument that production processes may be more important than end products. Nonetheless, examining recent trade performance through the lens of export sophistication provides some additional details, and makes clear that although progress is being made in some dimensions of structural change, like diversification, there is much more that needs to happen for a large scale transformation of Uganda's export bundle towards one more consistent with a strong medium-term growth path.

Figure 10: Export sophistication, EAC countries, 2011-2015



Source: WITS.

2.1 The product groups and firms driving export growth

To understand what drives the changes in the export portfolio in Uganda in more detail, this sub-section focusses on the twenty (out of 100) SITC 2-digit product groups whose share in the export portfolio has risen most in the last five years. These product groups have been behind the diversification and expansion of the Ugandan export sector, have driven destination discovery, and have grown capabilities of Ugandan firms to compete internationally. Their success has been a long time in the making; 17 have been growing export shares since 1995, and 11 have also been among the top 20 product groups that grew fastest in the period 1995-2010 (see column 2 of Table 1).

Neither of the top growth product groups makes up more than 5.6% of total merchandise exports as of 2015, but while only three were bigger than 1% of exports in 1995, now only six are smaller than 1%. The highest growth product group is leather, leather manufactures and dressed furskins, which has expanded its share of total exports from 0.11% to 2.82%. Much of this growth seems to stem from a value chain upgrading process: in 1995 Uganda was exporting raw hides, skins and furskins that made up 2% of the export portfolio, in 2015 these had faded to insignificance. This story is synonymous for several of the high growth product groups. Vegetables and fruits made up 2.31% of exports in 1995, then shrunk to 1.68% of the portfolio in 2010, before recovering to 2.34% in 2010. At the same time, the product group's higher value-addition cousin, processed animal and vegetable oils, grew from close to 0.01% to reach almost the same level of unprocessed vegetables, at 2.21%.

Using the Lall-classification of SITC product groups shows that indeed value-addition has increased significantly as Uganda has been moving from more than 90% of total merchandise exports being primary products in 1995 to around 50% in 2015. This is also apparent from Table 1, which shows 14 manufacturing product groups are within the top 20 growth groups. Six of them are classified as resource-based manufactures: non-metallic mineral manufactures (which includes cement), beverages (fruit-juices, beers, liquors), fixed vegetable oils and fats, processed animal and vegetable oils and fats, paper and paper manufactures, essential oils for perfume and cleaning preparations.

Table 1: Top 20 SITC product group increases in share of merchandise exports¹⁵

<u>Growth rank</u>		<u>Lall - Classification</u>	<u>SITC Product Group Code + Name</u>	<u>Shares of merchandise export</u>			<u>Relative share growth</u>	
5y	20y			1995	2010	2015	20y	5y
1	4	Low-tech	[61] Leather, leather manufactures and dressed	0.11	1.02	2.82	2.72	1.80
2	1	Res.Base	[66] Non metallic mineral manufactures, n.e.s.	0.05	4.52	5.60	5.55	1.08
3	23	Primary	[22] Oil seeds and oleaginous fruits	1.63	1.47	2.36	0.74	0.89
4	13	Low-tech	[89] Miscellaneous manufactured articles, n.e.s.	0.15	0.65	1.44	1.29	0.79
5	52	Primary	[05] Vegetables and fruits	2.31	1.68	2.34	0.03	0.66
6	10	Res.Base	[11] Beverages	0.08	1.46	2.11	2.03	0.65
7	11	Res.Base	[42] Fixed vegetable oils and fats, crude, refined or	0.21	1.52	2.16	1.95	0.65
8	15	Primary	[08] Feedstuff for animals (excluding unmilled cereals)	0.01	0.42	1.00	0.99	0.59
9	20	Mid-tech	[79] Other transport equipment	0.04	0.33	0.83	0.78	0.50
10	8	Res.Base	[43] Processed Animal and vegetable oils and fats	0.01	1.74	2.21	2.20	0.47
11	9	Mid-tech	[78] Road vehicles	0.37	2.11	2.57	2.20	0.46
12	2	Low-tech	[67] Iron and steel	0.17	4.03	4.46	4.29	0.43
13	25	Primary	[24] Cork and wood	0.00	0.14	0.51	0.51	0.38
14	21	Res.Base	[64] Paper and paper manufactures	0.04	0.50	0.79	0.75	0.30
15	24	Low-tech	[69] Manufactures of metal, n.e.s.	0.27	0.70	1.00	0.73	0.30
16	28	High-tec	[71] Power generating machinery and equipment	0.09	0.22	0.49	0.40	0.27
17	40	Primary	[09] Miscellaneous edible products and preparations	0.24	0.21	0.44	0.20	0.23
18	34	Low-tech	[57] Plastics in primary forms	0.05	0.13	0.33	0.28	0.20
19	16	Primary	[04] Cereals and cereal preparations	3.78	4.60	4.77	0.99	0.17
20	12	Res.Base	[55] Essential oils for perfume and cleaning	0.38	1.68	1.85	1.48	0.17

Five of them are classified as low-technology manufactures: leather and leather manufactures, miscellaneous manufactured articles (which includes some soaps and candles), iron and steel, manufactures of metal (particularly aluminium), plastics in primary form. Two are classified as medium-technology manufactures: other transport equipment (fiber-glass boats, among others) and road vehicles (motorcycle assembly, among others), and one is classified as high-technology manufacture: power generating machinery and equipment, even though this group has a small share and products here could be re-exports. Only five primary commodity groups are among the top twenty growth groups.

Table 2 studies firm characteristics of exporters active in the top 20 product groups using VAT, PIT and Customs data from the Uganda Revenue Authority. It lists each product groups' percentage of exports within the EAC and to OECD countries, average monthly output (export + domestic), average number of workers and average monthly wages paid in the year 2014. For labour productivity the rank among all SITC2 product groups is reported. The number of products and product survival per firm, number of firms active in the product group and firm survival are statistics calculated using 2005-2015 as sample period.

¹⁵ UNCTAD stats, downloaded on October 24, 2016.

Table 2: Top 20 export share growth STIC product groups – firm characteristics, 2014 values¹⁶

Lall – Class.	SITC product group	# of firms	% EAC	% OECD	# of products	Product survival - years	Firm survival - years	Monthly Output in m USD	# of emp	Out/Worker Rank	Av. Wage	
1	Low-tech	Leather, leather	13	0.06	0.64	91	2.37	4.15	0.49	38	7	81
2	Res.Base	Non metallic	70	0.43	0.01	48	0.83	3.89	0.52	77	30	82
3	Primary	Oil seeds and	48	0.07	0.41	51	1.41	3.58	0.16	37	26	164
4	Low-tech	Miscellaneous man...	134	0.32	0.11	30	0.88	4.16	0.53	67	31	97
5	Primary	Vegetables and fruit...	192	0.17	0.29	39	0.72	3.19	0.35	38	21	157
6	Res.Base	Beverages	42	0.68	0.02	65	1.13	4.31	1.06	72	15	74
7	Res.Base	Fixed vegetable oils...	16	0.44	0.50	49	1.52	5.06	1.34	66	6	140
8	Primary	Feedstuff for animal...	42	0.89	0.00	59	1.82	4.88	1.14	67	4	99
9	Mid-tech	Other transport equi...	13	0.01	0.65	19	4.19	6.54	0.14	55	52	89
10	Res.Base	Processed Animal	10	0.59	0.20	83	2.20	7.10	1.59	96	5	113
11	Mid-tech	Road vehicles	51	0.36	0.07	45	0.53	3.37	0.67	48	14	109
12	Low-tech	Iron and steel	49	0.87	-	34	0.85	4.45	1.44	96	8	79
13	Primary	Cork and wood...	8	1.00	0.00	28	0.96	4.75	0.21	131	57	33
14	Res.Base	Paper and paper	42	0.83	0.03	48	0.95	3.93	0.28	71	20	84
15	Low-tech	Manuf. of meta...	91	0.54	0.02	39	0.70	4.01	0.86	70	16	97
16	High-tec	Power generating	10	0.17	0.21	72	0.98	6.50	0.16	103	56	60
17	Primary	Miscellaneous edible	26	0.20	0.00	100	1.12	5.35	0.64	44	23	108
18	Low-tech	Plastics in non-prim...	31	0.62	-	46	1.31	4.29	0.52	82	42	102
19	Primary	Cereals and cereal	159	0.52	0.00	33	0.78	3.18	0.40	52	17	134
20	Res.Base	Essential oils for p...	66	0.44	0.02	58	0.71	3.12	0.55	68	25	85
		Economy-average	44	0.46	0.16	48	1.17	4.30	0.58	70		101

Shaded in purple: High growth, high productivity agri-business product groups

Shaded in orange: High-growth resource based manufacturing product groups

Shaded in brown: High growth low-technology manufacturing product groups

Not all high export growth product groups feature high productivity firms, but correlation between productivity and recent export success is high. 16 out of 20 high-growth product groups also appear in the upper third of the labour productivity ranking. Remarkably, the four high-growth product groups with highest labour productivity as per their ranking (shaded purple in Table 1) can all be classified as ‘agri-business’ products; agricultural products with some degree of processing. They deserve to be singled out and studied in more detail.

High growth, high productivity agri-business product groups (shaded purple): The number of exporters active in these product groups is low, between 10 and 16, with the exception of the feedstuff for animals group which has 42 active exporting firms. The leather and leather manufacturing products are almost exclusively exported to non-EAC countries, and 64% of exports in this product group go to OECD countries, which indicates that companies in the leather industry in Uganda have acquired capabilities to meet high product standards and regulations. The four product groups can be ordered along a continuum, starting with the leather manufactures that relies on overseas markets to a high degree, moving to the vegetable oil and fat product group that sees about 50% of its product exported to the OECD, but maintains the EAC as a major market, then the processed animal and vegetable oils and fats group, with only 20% of its products sold overseas, to the feedstuff product group, which sells almost exclusively to the local EAC market. Interestingly, virtually none of the products among the four product groups is shipped by airfreight, even when supplying overseas markets.

In terms of products, the leather and processed animal and vegetable oil groups stick out with large numbers of 91 and 83 different HS4-level products that have been sold over the sample period 2005-2015, while at the same time having long product-survival rates of 2.37 and 2.2 years (calculated as the average time an exporter exports an HS4-level product). In general, there is a correlation between the number of products sold, and the degree of processing inherent in the product group, since processing steps can make a number different products out of the same raw material. But paired with long product survival rates, a high number of products

¹⁶ The data is described in full-length in Spray & Wolf, “Industries without smokestacks in Uganda and Rwanda”, 2016, UNU Wider Working Paper.

indicates that the industries behind these products are maturing and proving themselves in the markets they serve.

In terms of firm size, the processed animal and vegetable product group is largest among the four agri-business groups considered, both in terms of mean monthly output (1.5mUSD) and number of employees (96). The feedstuff and vegetable oil and fat product groups have firms of about equal size (1.1-1.3mUSD output, 66 employees), whereas the leather industry has firms of below-average size (0.49m USD and 96 employees). While the leather industry has the smallest firms among the four, its firms are most strongly oriented towards the external sector. The product group had a share of 2.8% in total exports in 2014, highest among the four. Summing up, the agri-business product group looks very promising for Uganda, as its firms are slowly maturing and even proving themselves competitive in overseas markets. Policy-makers should study these product groups closely and attempt to widen their success to other agri-business industries as well as a larger number of firms.

High-growth resource based manufacturing product groups (shaded orange): Next to the high-productivity agri-business groups, there is another set of high-growth product groups that relies heavily on natural resources; natural resource based manufactures. Exporters in these product groups rank slightly lower in terms of labour productivity, but are still part of the upper third of the productivity ranking. What sets these natural resource-based manufactures apart from the agri-business group considered before is that virtually none of its output is exported to OECD markets. The non-metallic mineral manufactures product group and the essential oil for perfume and cleaning preparation product group export about half of their products outside of Africa, whereas the paper and paper manufactures as well as the beverages product groups export almost exclusively to the EAC and the East African region.

The number of products exported by the resource-based manufactures set is slightly above average compared to the whole set of SITC2 product groups, but product and firm survival rates are low. The average exporter struggles to keep a product in export for more than a year in all product group except for beverages. The average wages paid by exporters in these product groups are also low, roughly 20% below average. Again with the exception of the beverage product group, the firm size in terms of average monthly output is average or below. In sum, the resource-based manufacturing sector appears to be more fragile, with smaller and more vulnerable companies, relying heavily on the regional market. Nonetheless, this set of product group deserves close policy-maker attention given its importance for the export portfolio; combined its exports are already 10% of total merchandise exports, compared to 8% of the agribusiness set of product groups.

High growth low-technology manufacturing product groups (shaded brown): A third group that deserves closer study is the low-technology manufacturing group. Products in this set of groups are diverse, and range from plastic household ware, to roofing materials, to soap and candles, to aluminum and steel. Despite the fairly different range of products produced, the low-technology manufacturing firms are actually strikingly similar to the resource-based manufacturing firms in terms of product destinations, product survival rates and firm size. Firms in this product group have slightly longer export survival rates than resource-based manufacturing firms, pay slightly higher wages and export fewer products.

The most noteworthy two product group among the four are iron and steel, and metal manufactures, which relies strongly on iron and steel inputs. The product groups have high labour productivity (rank 8 and 16) and have made up over 4.7% of total merchandise exports since 2010. Their most rapid growth period was before 2010. Firms in this industry are thus more mature: the product groups have higher firm survival rates, more employees and higher output than the average.

The product groups are a good example for the kind of manufactures that benefit from natural protection due to high transport cost. They are one of the few product groups in Uganda that feature products that are shipped by water transport on Lake Victoria. Firms in this industry seem to be able to exploit this comparative advantage and compete against stiff international competition in their industry, at least when serving its (double!) landlocked neighbors, which account for 87% (iron and steel) and 54% (metal manufactures) of their exports. An issue with

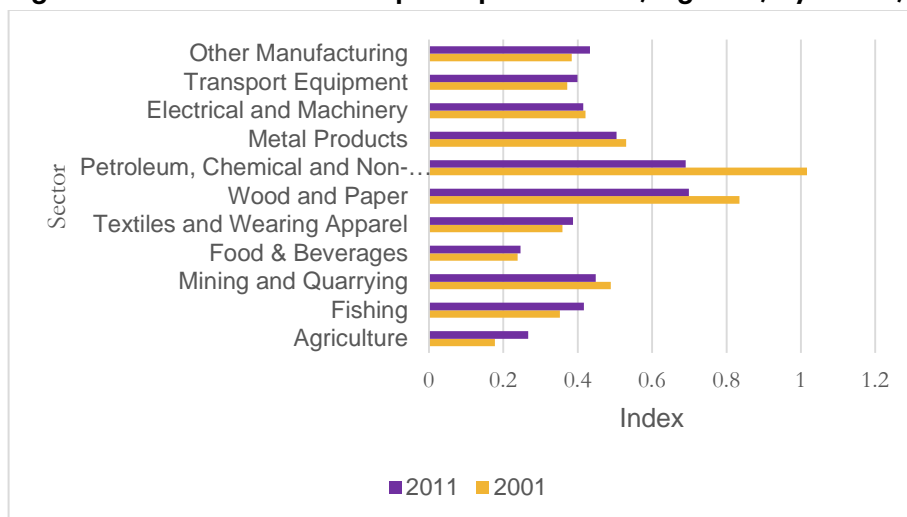
the two product groups is their low rate of product survival, which points to an obvious entry point for policy makers seeking to strengthen low-tech manufacturing. The product groups present an interesting case for further studies of import substitution opportunities and the development of regional value chains, given that many metallic manufactures are still imported.

2.2 Global value chain participation

An increasingly important aspect of policy-level discussions on trade integration and structural transformation relates to GVCs. This new form of business organisation has the potential to act as a powerful vector for technological change and upgrading, as large lead firms invest in local supplier networks. Most countries enter GVCs through a low value added activity like assembly, then seek to progressively move up to higher value added activities that have significant spillovers for the rest of the economy, like component production, or research and development. GVC development is at an early stage in Sub-Saharan Africa, but there have nonetheless been important successes in sectors like apparel, and agribusiness, particularly horticulture.

New data make it possible to identify a country's level of participation in GVC-related trade by isolating backward and forward linkages: the former refers to the use of imported intermediates in generating a country's exports, and the latter refer to a country's exports of intermediates that are themselves used in producing exports elsewhere. Indices for the two types of linkages can be summed together into an overall index of GVC participation. Figure 11 presents results for Uganda, which are quite mixed. Some sectors see a slight increase in GVC participation over the decade covered by the figure, but others see a decrease. Among the bright spots are agriculture, and to a lesser extent, textiles and clothing. There is also some movement in transport equipment. Although the sectoral classification is much more aggregate than in Tables 1 and 2, there is clearly some overlap between sectors that are internationalising through GVC linkages, and those that are experiencing rapid export growth. GVCs in light manufacturing sectors are typical entry points for lower income countries, and could be successfully developed in Uganda if linkages could be made between domestic suppliers and international lead firms, which can help structure value chains and generate efficiency gains that benefit producers and consumers alike.

Figure 11: Global value chain participation index, Uganda, by sector, 2001 and 2011



Source: Eora Database. The author is grateful to Jakob Engel for sharing data.

GVC participation is one area that remains under-developed in Uganda, and, indeed, in the EAC countries more generally. Although there is growth in the above figures, a country like South Africa—admittedly at a much higher income level—has a participation index over 0.4 in agriculture, although Uganda compares favorably in other sectors like textiles and clothing, and machinery. Large scale comparisons are fraught with these data, however, as quality issues are distinctly national, and it is difficult to be confident in cross-country comparisons.

Abdulsamad and Gereffi (2016) examine dairy value chains in the region, while Daly et al. (2016) examine the case of maize. Agriculture is an important source of economic activity in East Africa, and accounts for 83% of employment. However, a significant proportion of activity

takes place in the informal sector, which can hamper value chain development by holding back the formalisation of supply relationships and other interactions that would typically be contractual.

Uganda is a significant supplier of maize to the Kenyan market, which is the region's main consumer. Maize is often a cash crop in Uganda, whereas it is a staple in other parts of the region. Uganda has enjoyed some success in terms of value addition in the maize value chain, and has developed some larger scale actors in processing for the production of maize flour, which is both consumed domestically and exported. Foreign companies have some presence in the Ugandan maize market. The government has identified maize as a priority sector for development.

The regional dairy market, by contrast, is much less developed. Only about 1% of East African dairy production is traded, a figure that is well below the already low world figures. Product characteristics like perishability, as well as government policies, contribute to this outcome. Nonetheless, recent growth has been encouraging. Regional initiatives have contributed to a significant increase in traded volumes, although some—like the 60% CET on dairy imports—may ultimately be counterproductive in terms of producing a competitive, integrated sector. Standards harmonisation has played an important role in enabling dairy producers to reach markets beyond their local area. Unlike maize, where Uganda has been able to develop processing operations at scale, this development has proved difficult in the dairy sector. Informality of relationships has been one reason: processing operations run below capacity due to the difficulty of ensuring constant input streams.

There is evidence in the Eora data presented above that agriculture is one sector where value chain activity is deepening in the region, in contrast with some others. The evidence is strengthened by Tables 1 and 2, which show rapid export growth in a number of agribusiness sectors. As the dairy and maize examples show, however, experiences can be quite different at a sub-sectoral level. In the short term, maize remains a particular priority for Uganda, although the dairy example shows that there may be untapped potential for integration in other markets as well. Section 5 addresses policy measures that can help develop competitive value chains in the region, as part of a more general strategy of fostering structural change and promoting market integration.

The discussion of structural change in Uganda's exports has focused on goods. But services also have a role to play; in the policy discussion below, the argument is made that services policies impact manufacturing competitiveness, through an input linkage. In addition, there is potential for Uganda to export some services, or leverage service sectors to develop value chains covering a variety of activities. Tourism is one example, as analyzed by Daly and Guinn (2016). Domestic tourism is underdeveloped in East Africa, so the leisure sector relies heavily on Europe and North America as source markets. Lead firms play an important role in developing networks of service suppliers, and coordinating their offerings vis-à-vis consumers.

There is considerable scope for developing linkages with a variety of domestic firms, including small-scale tour operators, hotels, restaurants, and also manufacturers of consumables like simple textiles (e.g., towels). Of course, global competition in supplier sectors is a key constraint, and it is important not to engage in costly and possibly counterproductive attempts to shift demand artificially towards domestic input suppliers. The right approach is to develop supplier competitiveness, leverage locational advantages that can potentially reduce transaction costs, and bring suppliers and lead firms into contact.

There can be a role for policy "nudges" in facilitating the matching of supply and demand where market mechanisms are imperfect, for instance due to information asymmetry. Investment and export promotion bodies can undertake such activities at the international level, but it is important that the work continues domestically as well. For instance, a foreign hotel chain with holdings in Uganda needs to be aware of the range of products and services offered by local firms. But of course, supplier linkages cannot develop unless transaction costs are reduced, and the business environment is supportive, including in particular through the ability to enforce contracts. These issues are discussed in Section 4, below.

3. The role of investment

The FDI inflow in Uganda has been low but steadily increased in the last 20 years. Figure 12 shows the net inflow of FDI since 1990, demonstrating a net inflow in 2014 of \$1 059 million representing 3.9% of GDP. The largest inflow comes from the European Union, the Netherlands in particular contributing with \$611 million in 2012. Interestingly, the largest African source of inward FDI was Kenya (\$99 million). Extra-regionally, beyond the EU, India contributed \$39 million, compared with \$22 million from the United States.

Figure 12: FDI inflows into Uganda, BOP USD, 1990-2015



Source: UCTAD.

When we consider the number of licensed FDI projects, India was the leading source of FDI with 26% of all FDI projects in 2014/15, followed by China with 22% and the United Kingdom with 4.4% of all FDI projects in 2014/15.¹⁷ By number of licensed projects, manufacturing was the leading sector, with 43% of all licensed projects in 2014/15.¹⁸

Since 2003, about 80% of FDI to Uganda has been equity capital, and reinvested earnings comprise about 26%, with net intercompany loans being -6% (as a result of paying back loans taken out in the previous investment period).¹⁹ In 2001, manufacturing contributed about 7% of all total equity capital.²⁰ Most businesses in the manufacturing sector are sole proprietorships, but a few joint ventures have been formed between local and foreign firms, notably with South African Breweries, Coca-Cola and Pepsi.²¹

FDI has played a small but increased role in promoting industrialisation and structural transformation in Uganda. The positive performance of the Ugandan industrial sector to a large extent can be attributed to increased FDI, such that FDI inflows into the sector amounting to 45% of the FDI that came into Uganda between 1991 and 2009, a third of which (about US\$2.9 billion) was absorbed into the country's manufacturing sector. Based on extensive academic work, the positive impacts of FDI can include employment generation, technology and knowledge transfer, spillovers to other firms in the sector or through supplier relationships, and increased productivity and wages.²² The figures presented in the first paragraph of this section suggest that there is clear scope to grow inward FDI from a variety of sources if the policy settings and business opportunities are right. Countries like South Africa and China loom large as potential sources of South-South FDI that could also contain a significant knowledge sharing component. It is possible that more recent data (not currently available from UNCTAD) will show growth in these areas.

¹⁷ UIA, "Uganda Investment Abstract, FY14/15."

¹⁸ UIA, "Uganda Investment Abstract, FY14/15."

¹⁹ Obwona & Egesa, "FDI flows to sub-Saharan Africa."

²⁰ Ibid.

²¹ Ibid.

²² Javorcik (2004).

Uganda faces a variety of challenges to increase FDI. One issue is strengthening institutions and investment agencies. The authority responsible for promoting investment is the Uganda Investment Authority (UIA) - a semi-autonomous government agency with the stated aim of marketing investment opportunities, promoting packaged investment projects, ensuring local and foreign investors have access to information, and offering business support, advisory, and advocacy services. The newly developed one-stop company registration office combines processes of Uganda Revenue Authority, Uganda Registration Service Bureau, and the Kampala Capital City Authority, and the time to register a business has been reduced from 20 to 3 days (although it remains to be seen how this translates into experience on the ground).

In practice, UIA functions cover much of the generally accepted scope of investment promotion activities, including initiating and supporting efforts to improve the investment climate, promoting investment through promotional activities, granting approvals for new businesses, providing support services to new and existing investors, and making recommendations to the government on measures to promote investment in Uganda.²³ There is potentially more scope to improve UIA's after-care services.²⁴ The UIA appears not to have been burdened with regulatory tasks that tend to lower performance.²⁵

The UIA has followed a sector targeting approach, prioritising agriculture and agro-processing, tourism, mineral beneficiation, information and communication technology and infrastructure, in line with priority sectors identified in Uganda's National Development Plan II.²⁶ Apart from the latter category, these priority sectors could create employment for relatively large numbers of unskilled workers. In its investment promotion efforts, UIA should focus primarily on countries that have shown an interest in investing in Uganda, such as South Africa, Kenya, and the United Kingdom, as well as countries that could potentially play a larger role, like China and India.

In Uganda, the conversion rate of planned investments into actual investments has been relatively low for FDI, at 27%, but higher for domestic investment, at 74% (both figures for 2014/15).²⁷ While this may suggest that greater effort is needed to raise the conversion rate for FDI, the low 2014/15 rate could be at least partially explained by some investors cancelling planned investments after the signing of the Uganda Anti-Homosexuality Act in 2014.

Challenges still remain with facilitating investment, for example making it easier to register a new business, which still requires visits to a number of agencies, rather than solely the UIA. UIA is also perceived not to be active enough in selling Uganda as an investment destination. While some information on market developments and business opportunities is available, the agency does not take a proactive approach in reducing search costs for companies. Proactive engagement from the UIA for provision of information to potential investors will be critical in light of evidence that information asymmetries pose a significant constraint to FDI inflows.²⁸

4. Trade, investment, and industrial policies

The previous sections have analyzed recent data on Uganda's trade and investment performance, and have identified key issues in leveraging the external sector to support structural change. From a trade perspective, although Uganda's has enjoyed export market growth and diversification, it has not been able to translate external demand into greater export sophistication. At the same time, regional value chains in key sectors have experienced substantial difficulties, relating notably to the level of transaction costs. How can policymakers intervene to deal with these issues in a way that both supports structural transformation, and does not impose unnecessary economic costs, particularly on consumers? We now address trade measures, investment measures, and industrial policy in a holistic way, focusing in particular on the ways in which policy can support value chain development and increased linkages in key sectors.

²³ Obwona & Egesa, "FDI flows to sub-Saharan Africa."

²⁴ Ibid.

²⁵ Uganda Investment Authority website.

²⁶ UIA, "Uganda Investment Abstract, FY14/15."

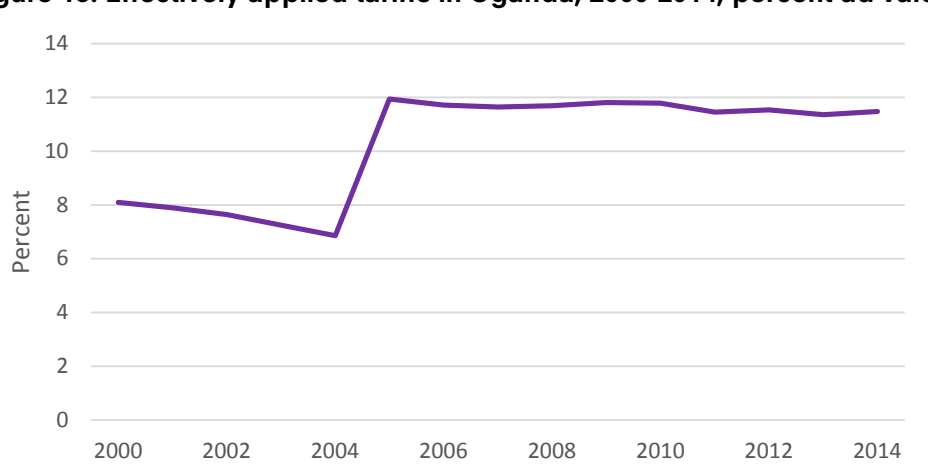
²⁷ Ibid.

²⁸ Harding and Javorcik (2013) find that the quality of services provided by investment promotion agencies (in terms of information provision and handling of investor queries) is associated with higher FDI inflows.

4.1 Tariffs and trade-related policy measures

To what extent has Uganda's trade policy actively supported structural change? A key point in the analysis is Uganda's membership of the East African Community, with its Common External Tariff (CET). As Figure 13 shows, Uganda's effectively applied tariff rate jumped substantially—almost doubled, in fact—upon entry into force of the CET—an unfortunate development from the point of view of dynamising exports through the input-output linkages typical of GVCs, as noted above. Although the country benefitted from exemptions phased out over a five-year period, the unweighted average presented in the figure suggests that for most products, the jump was immediate. Of course, sectoral distribution of tariffs matters, in particular whether their incidence is mainly on inputs or final products. In this context, the Sensitive Items list is significant, because it has the potential to allow serious distortions. Overall, the CET would seem to be a difficulty for Uganda in leveraging its external sector to support structural transformation. The fact that the CET is locked into the EAC makes it hard to change, so it will be important for Uganda to look at other policies that can reduce trade costs in other areas, particularly non-tariff measures, some of which remain under national jurisdiction, and behind the border policies.

Figure 13: Effectively applied tariffs in Uganda, 2000-2014, percent ad valorem



Source: UNCTAD.

Interestingly, the EAC has not been particularly successful in promoting intra-regional trade, undoubtedly because many national barriers remain, including non-tariff measures such as the lack of harmonised product standards and other technical measures. EAC, with the support of TMEA, has been working to harmonise standards across the region, and so contribute to the development of a regional production base where producers can realise economies of scale. The importance of harmonised standards in value chains like maize and dairy was noted above. However, implementation on the ground remains a serious issue: some member countries translate harmonised standards slowly or not at all into domestic ones, and firms—particularly SMEs—often do not take them up. There is also the issue that harmonising to a standard that is too high relative to preferences in some countries can impose unnecessary costs and producers, and hold back trade. It is important to be pragmatic in standard setting, and balance country interests.

From an external markets point of view, standards play a particularly important role in two related areas: processed agricultural products, and manufacturing GVCs. In the former case, producers need to meet high health and safety requirements of markets like the US and EU, which is costly and requires a considerable degree of technical sophistication. In the latter, producers need to make uniform, interoperable components before lead firms will include them in global or regional production processes. Even in light manufacturing value chains like ready to wear apparel, clothes need to be tested for size and color fastness, among other issues, so that lead firms can guarantee a particular level of quality to final consumers. Standards play an important role in disseminating best practices throughout the value chain, and play a significant “gatekeeper” role vis-à-vis producers.

Intra-EAC trade is essentially static over time as a percentage of members' total trade, even

though relations with the rest of Africa have been growing closer. Given that Uganda's trade has been growing over time, the implication is that intra-regional trade has been growing at a reasonably comparable rate to extra-regional trade. But that result brings into question the effectiveness of regional integration efforts, as they are typically intended to spur more rapid growth of intra-regional trade relative to other parts of the world, which has not happened. Although the EAC has enjoyed notable successes in some "deep integration" areas, the question remains as to how those policy changes have translated into firm-level realities, and in turn into trade flows in goods.

Clearly, there are important initiatives that need to be taken to facilitate trade within the EAC, most particularly in the areas of non-tariff measures and trade facilitation. The WTO Agreement on Trade Facilitation (TFA) is only a starting point for reform: Uganda should aim for a much more ambitious, and broad based, reduction in the sources of trade costs at all points through the supply chain, as one way of reducing overall transaction costs, and encouraging local and international firms to link, whether through trade, investment, or supplier relationships.

4.2 Infrastructure and trade facilitation

Infrastructure is one key input into trade performance. In this area, Uganda ranks almost at the bottom of the quality of trade and transport-related infrastructure component of the World Bank's Logistics Performance Index (LPI), far below the sub-Saharan African average and other comparably landlocked sub-Saharan African countries. The World Bank's Doing Business project tracks the time and cost associated with trade transactions, and tells a similar story: border compliance in Uganda takes 71 hours for exports, and 154 hours for imports; these figures compare with 103 hours and 143 hours for the sub-Saharan African average, but only 73 hours and 71 hours in East Asia and the Pacific. Although Uganda's performance is not dramatically worse than that of its regional peers, it clearly hampers the ability of firms to move goods across borders in a globally competitive way. Moreover, only 17% of Uganda's national roads are paved, about 25% of the country's railway network is operational, and Uganda has only one international airport in Entebbe. Clearly, connecting manufacturing firms with international markets is challenging, and a serious constraint on their ability to internationalise. Interestingly, the LPI typically measures performance at international gateways, and so overstates performance in many developing countries where connections to the hinterland are challenging. Difficulties with road transport in Uganda suggest that there may be particular problems in getting agricultural goods to market, and that levels of post-harvest loss due in part to transport problems might be high. There is real potential to improve rural livelihoods by reducing losses and lowering the transport price wedge—which passes by a comprehensive trade facilitation program that focuses on at- and behind-the-border measures.

Another area worthy of attention is behind the border barriers: Uganda ranks 2nd in East Africa, after Rwanda on the Country Policy and Institutional Assessment (CPIA) business regulatory environment index. The country's overall Doing Business ranking for 2016 is 122, up from 135 in 2015. The most significant improvement was in improving access to credit, where Uganda jumped 86 places on this indicator from 2015 to 2016, and now performs considerably better on access to credit than the sub-Saharan Africa average. Other modest improvements were seen in getting electricity access and dealing with construction permits. Uganda is now 4th in sub-Saharan Africa on Doing Business, and 3rd in East Africa after Rwanda and Kenya.

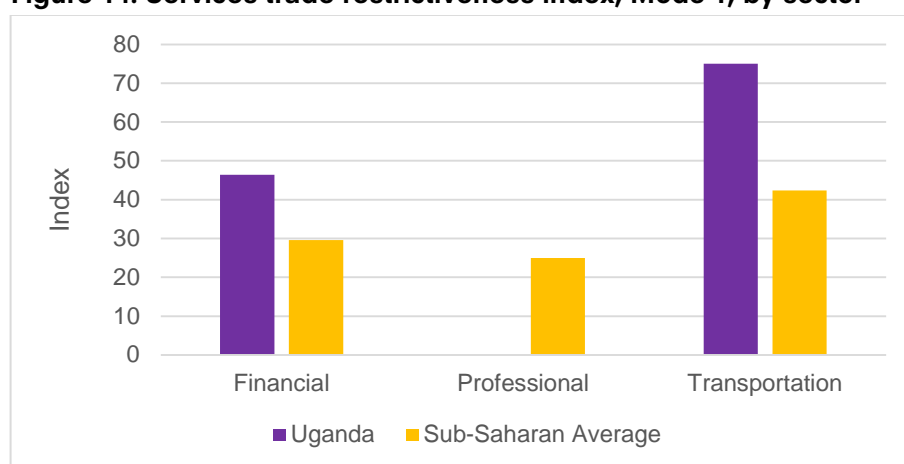
Of course, improving infrastructure is not enough on its own to support better trade facilitation. There also have to be private sector service providers who can perform cost effectively and at a high level of speed and reliability. The last LPI year for which data are available for Uganda shows the country performing slightly above the average for sub-Saharan Africa, but still evidencing considerable constraints relative to performance elsewhere in the world. Upgrading transport and logistics services is an important part of the trade facilitation agenda, and focuses on regulatory reform and private sector development rather than infrastructure financing, although the two of course need to be coordinated.

4.3 Services

Policy plays a crucial role in service sector performance, not just in transport and logistics, but in

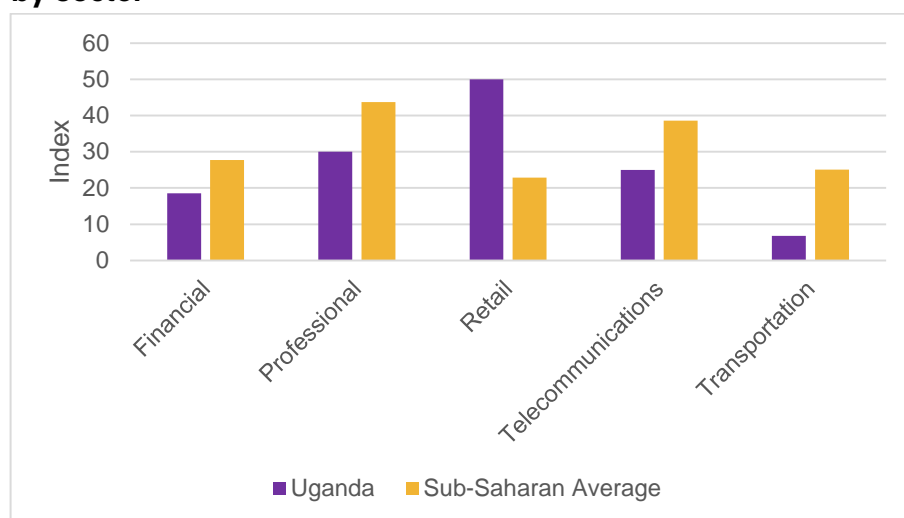
many other sectors that are crucial inputs into manufacturing. Examples include finance, business services, professional services, and retail and wholesale distribution. The World Bank Services Trade Restrictiveness Index provides an indication of the services policy environment across countries. Figure 14 compares scores for Uganda and its sub-Saharan African comparators for mode 1 trade, i.e. pure cross border services trade. It captures policy measures that may discriminate between domestic and foreign firms in the cross-border provision of services. Although Uganda has no restrictions for professional services, it is much more restricted than other regional countries in finance and transport. Transport, as already noted, is particularly important, as it is a “gateway” service, in the sense that it connects producers to markets. However, there is a contrast with Figure 15, which covers restrictions to FDI in services sectors (mode 3 services trade), and captures investment restrictions affecting services sectors: Uganda is more liberal than the sub-Saharan African average in all sectors except retail. We say more on investment in the following section, but this first pass at the policy data suggests that it may not be explicit restrictions that are preventing FDI from playing its full role, but instead other aspects of the investment climate.

Figure 14: Services trade restrictiveness index, Mode 1, by sector



Source: World Bank.

Figure 15: Services trade restrictiveness index, Mode 3 (restrictions on services FDI), by sector



Source: World Bank.

4.4 Reform priorities

A crucial question for a country like Uganda is to identify trade policies that will support structural transformation over the medium to long term, including through outcomes like a more

sophisticated export bundle and greater GVC participation. The empirical literature makes clear that insulating firms from the world market does not promote productivity improvements. Indeed, opening up can have that effect, as the resulting competitive shakeout shifts resources from low productivity firms to higher productivity ones (e.g., Pavcnik, 2002, who showed that Chilean plants' productivity in the import-competing sector grew 3% to 10% more following liberalisation than plants in the non-traded sector). Liberalisation of input markets is particularly important, as access to imported varieties can allow domestic firms to innovate, which in turn supports export diversification (e.g., Goldberg et al., 2010, who showed that lower input tariffs accounted for 31% of the new products introduced by Indian firms following liberalisation).

The EAC CET is therefore one area where, over the medium term, Ugandan policymakers could seek to introduce some beneficial reforms, in particular by ensuring input markets are completely liberalised, focusing on products that have the potential to support innovation and productivity upgrading in light manufacturing sectors like apparel, as well as processed agribusiness. The flipside of this position is that they should avoid measures like local content requirements, which shift demand away from the best inputs available on the world market, and towards local varieties. In the short term, local content requirements can provide a fillip to domestic component production, but they ultimately undermine the competitiveness of using industries, which in turn reduces demand for components, and in fact worsens the situation the measure was designed to improve. Liberalisation of input markets is a key pre-condition for effective regional and global value chain integration, and should be pursued as a priority. Using firm-level data from Rwanda and Uganda, Spray and Wolf (2016) show that all industries with high levels of labour productivity rely heavily on imported intermediates, and that correspondingly, high productivity firms are more likely to have external market linkages. Their work shows that mechanisms studied in other developing countries have relevance for Ugandan firms as well, and demonstrates the importance of international linkages for productivity upgrading and structural change.

However, the political economy of reform is not simple in light of the regional dimension, and it is important to focus on other areas where policymakers can act unilaterally and still bring substantial benefits to domestic firms and value chains. One area that stands out is services, both as a tradeable activity in its own right, and because of its function as an important input in exports of tradeable goods. A particular priority should be to liberalise transport markets, as developing competitive value chains is impossible unless inputs and final products can move freely within the region, including to international gateways.

Another services sector priority is to support access to credit on reasonable terms. The prevailing commercial bank lending rate averaged 23.54% as at June 2016, making credit prohibitively expensive and leading to loan defaults and business closures.²⁹ Farmers and businesses across Africa experience substantial difficulties in accessing credit when they need it, on terms they can afford. Reasons are manifold, ranging from the macroeconomic (e.g., inflation; now moderate in Uganda) to risk perceptions and enforcement difficulties.

Implementation of a Warehouse Receipts System is one way of loosening that constraint in an environment where financial markets are shallow, and informal relationships have traditionally played a strong role. The System requires centralised investments in infrastructure, particularly storage facilities. Policymakers can work collaboratively with the private sector to design the system in such a way as to maximise benefits to farmers and processors alike. A sector like maize is particularly well positioned to take advantage of improvements in this area.

Without access to credit, Ugandan SMEs are forced to use cheaper, but obsolete, technologies, which hinder them achieving the efficiency and productivity needed to compete internationally, and also prevent them from attaining the standards and quality marks needed to enter regional markets or leading local stores. Uganda's outdated technology makes products uncompetitive in terms of both price and quality. Sudan recently placed Uganda on warning, insisting that the Uganda National Bureau of Standards do more to ensure the quality and standard of Ugandan coffee. Given that coffee is one of the few sectors where Uganda's exports are not insignificant, and that Sudan is one of Uganda's largest coffee export destinations, Sudan putting Uganda on

²⁹ Daily Monitor, "Why Uganda's interest rates stubbornly remain high."

notice over standards in coffee is a serious matter.

Some of the difficulty in achieving standards and quality marks in agro-processing may be due to fake agricultural inputs being sold in retail markets in Uganda, and the fact that Uganda National Bureau of Standards' capacity to enforce regulations and standards governing agricultural inputs is strained. It could also be due to poor storage conditions, and the Uganda Warehouse Receipt System Authority (UWRSA) is working to construct warehouses for the collection and storage of agricultural products, to assist farmers to maintain the quality of their produce, as well as to empower them to hold on to their produce safely and to sell when prices are high. To boost Ugandan exports, it is vital that both credit be made more affordable for Ugandan firms and that the cost of modern technologies for SMEs be reduced. To the extent that policy contributes to the problem, for instance by imposing tariffs on imports of capital goods, there is a clear case to press forward with liberalisation wherever possible, within the constraints imposed by regional realities.

One option to deal with the broad-based problems—from tariffs to infrastructure—that Ugandan businesses face is to establish Free Zones, as has been done in many other parts of the developing world. The Zones can become a model for economy-wide regulatory reforms when they work well; when they work poorly, they can be the archetypal white elephant, with significant up-front costs, and few concrete benefits. It is therefore important that they be designed correctly for Uganda's individual circumstances.

The Uganda Free Zones Authority (UFZA) is a new agency, established in 2014 to oversee the establishment, management, marketing, maintenance, supervision, and control of Uganda's free zones.³⁰ Since access to industrial land is a major constraint to investment in Africa (due to titling, registration, and connective infrastructure issues), UFZA's ability to make suitable land available for investors is a significant benefit.

UFZA is hoping to have two public free zones and eight privately-run free zones operational in the next five years. Government-run SEZs have not been successful in Africa; however, privately-run ones have fared little better.³¹ Uganda's SEZ development is still in very early stages, with the first free zone being signed earlier this year with Turkish firm ASB Group, who has been given 18 square miles to establish an SEZ in Kaweweta, Nakaseka District.³² The Nakaseka SEZ is expected to focus on livestock, coffee, cotton, and other agro-processing, and UFZA hopes to get local farmers involved in the zone on a contract farming basis.³³ A second free zone has recently been awarded to Chinese firm Guangzhou DongSong Energy Group to establish an SEZ in Sukulu, Tororo District.³⁴ The Tororo SEZ is expected to produce, among other things, phosphates, steel, bricks and glass.³⁵

Choice of priority sectors for the two SEZs is a major issue. The Nakaseka SEZ includes agricultural activities (primary production), an unusual step, and one that will not necessarily help support structural change. A focus on agro-processing is appropriate, and although linkages with farmers are part of that overall approach, the nature of an SEZ typically makes it better suited to light manufacturing activity than primary production as such. The Tororo SEZ suffers from the opposite problem, in the form of an apparent focus on relatively capital intensive industries. It is far from obvious that Uganda has a comparative advantage in these sectors, and there is a real risk that firms in the SEZ will have difficulties being competitive on the world market. Although they might enjoy some success regionally if protected by the EAC CET, structural change will come most quickly from integration with world, rather than local, markets, and it is not clear that such contact in these industries would be consistent with sectoral success in Uganda.

Even using SEZs as a production platform, the issue of developing export market competitiveness remains. As part of export promotion efforts, the Uganda Export Promotion Board (UEPB) undertakes market research (for example, on consumer demand, business and

³⁰ Uganda Free Zones Authority pamphlet.

³¹ Farole, "SEZs in Africa."

³² East African Business Week, "Turkish firm gets Ugandan zone."

³³ East African Business Week, "Turks eye economic zone set for Uganda."

³⁴ East African Business Week, "China signs zone MOU with Uganda."

³⁵ Ibid.

technical requirements) on behalf of Ugandan firms and publishes information that guides exporters to more strategically enter different markets. This market research is time-consuming and expensive, and would otherwise pose notable externalities for firms.³⁶

In recent years, the UEPB has received assistance from TradeMark East Africa (under an Irish Aid-funded Market Linked programme) to build capacity on researching markets, packing their findings for exporters and sharing it with them, identifying promising exporters, and hand-holding them in moving into new markets. The services provided by the UEPB in hand-holding exporters into new markets have been found to be particularly effective, and it is hoped that after a few firms have been helped into a new market, a critical mass can be reached that draws other Ugandan firms into the new market unassisted.

The UEPB have also been assisting border traders to formalise, to bring a greater share of exports within the formal economy. Some traders had feared the tax implications of formalising and certain taxes and levies in regional markets discouraged formalisation; however, with greater EAC integration many of these fees have been removed and UEPB efforts to educate traders on these developments have made progress. Despite penalties on informal traders now making it prohibitively risky to remain informal, some formalised traders continue to informally trade certain products that do not fall under the EAC preferential trade agreement, but prevalence of informal trading has declined significantly.

Other initiatives being undertaken by the UEPB include some business incubation services and development of products that could assist exporters, such as cost-effective technologies that they are developing in conjunction with Makerere University. They have also been thinking about how they could work with the Uganda Development Corporation to create a capitalisation fund that invests in modern technologies that could be shared with SMEs to enable SMEs to improve their efficiency and competitiveness, or to assist in the development of appropriate financial products for SME exporters. The UEPB has also contributed to policy and regulatory development in cooperation with partner agencies, notably the Uganda National Bureau of Standards, to secure mutual recognition agreements under EAC standards harmonisation and to lift Kenya's ban on processed milk from Uganda.

The UEPB has been working on streamlining customs procedures with the Democratic Republic of the Congo (DRC) and South Sudan; these countries have relatively unstructured markets and their regulatory regimes lack transparency, which has limited Ugandan trade with them primarily to border towns. If constraints to trade with DRC and South Sudan could be reduced, both of these countries could be big destination markets for Ugandan manufactures.

Little work has been done on higher technology and higher value sectors by the UEPB as their efforts have been seen to be more cost-effective focused on larger, lower value sectors such as agro-processing. Where higher value products are concerned, the UEPB promotes and showcases the products at trade fairs and other events, rather than getting actively involved in trying to move these firms into new markets. Linked to this issue, a focus on SMEs is not without its own problems. Productivity-based self-selection by firms into export markets means that all around the world, trade in value terms is dominated by larger firms, even though SMEs can be numerous. Most SMEs cannot absorb the additional costs associated with exporting, and it is important to be wary of attempts to artificially suspend this important sorting mechanism. A more appropriate way of involving SMEs with the world economy is to facilitate supplier linkages with exporting firms, thereby serving the twin aims of developing the supplier ecosystem in key sectors, and providing successful exporters with high quality, reasonably priced inputs. As has been pointed out elsewhere, the key issue is sustainable competitiveness at all points in the value chain—an issue that needs to be addressed broadly.

As this discussion makes clear, it is important for Ugandan policymakers to support structural transformation and productivity upgrading. But they should avoid some highly distortionary, and ultimately counterproductive, instruments of traditional industrial policy. Policy interventions are still needed, but they should be targeted, and as light as possible, given the objectives in question. In some cases, regulatory “nudges” may be more effective than traditional policies.

³⁶ Lederman, Olarreaga & Payton, “Export Promotion Agencies: Do they work?”

Where there is a case for stronger interventions, it is important that donors in particular have regard to the risk of governance failure, to be balanced against the reality of market failure. For example, one approach to underproduction of particular goods and services in a liberalised environment relative to social objectives is to introduce time-bound subsidies for firms. Provided the time path is indeed binding, such measures can help attain important objectives, at reasonable economic cost. However, there can be a time consistency problem: lower productivity firms that receive the subsidies have little incentive to upgrade if they believe the government will not follow through on its commitment to repeal the subsidies at a particular time. Improving the government's ability to commit to a particular time path of policy, and follow through on its commitment in practice, is therefore an important precondition for effective industrial policy that does not end up imposing undue economic costs.

5. Conclusion and action points

This review of the evidence on structural change in Uganda shows that although there have been some positive developments in terms of export market growth and diversification, the major hurdle remains upgrading productivity and shifting into more sophisticated products. Reliance on resource-based exports is still high. The core element of Uganda's efforts to upgrade its productive structure should therefore be the development of additional processing activities, focusing on agribusiness and other light manufacturing activities. Promoting these activities does not involve protecting them from global competition, or engaging in costly and potentially counterproductive methods like enforcing local content requirements. Cost and locational considerations favor the development of local supplier linkages, provided that value chains can be dynamised, and transaction costs substantially reduced.

A non-exhaustive review of current donor activity suggests that donors' current focus in Uganda is centrally on agriculture, agribusiness, and transport linkages, with comparatively little attention paid to the development of the manufacturing and services sectors. To be sure, some attention is devoted to cross-cutting skills-promotion, to tourism, and implementation of the EAC market protocol with regards to services trade, but more could be done. Priority areas include lowering trade costs, improving competitiveness of services, developing domestic supply chains, attracting FDI, harmonising standards, and promoting exports. The report concludes by addressing each of these areas individually, and identifying the outline of activities donors could potentially support.

A preliminary question, though, relates to data. Evidence-based policymaking makes intensive use of data of all sorts, so investments in improving data availability and quality could translate into improved policies and outcomes. FDI data is one priority area: disaggregation by sector and source country are important so that policymakers can target resources accordingly. In trade, better data on applied services policies are crucial to identifying welfare-enhancing reform possibilities, and GVC linkages is another area where new generation data initiatives, based on multi-region input-output tables, could be improved by focusing on firm-level data collection through manufacturing censuses and other similar exercises. This area is one where investments could have a particularly high payoff.

5.1 Lowering trade costs

Through its TradeMark East Africa program, DFID has supported extensive work on regional trade facilitation, and trade costs have come down. Landlocked countries like Uganda typically perform poorly in this area; for example, De Melo and Wagner (2016) show that trade costs in landlocked LDCs are perhaps fifteen percentage points lower than those of non-landlocked LDCs. Existing efforts in this area therefore merit expansion. NTBs, standards, cabotage rules, as well as completing intra-regional multilateral open skies arrangements would all help. Beyond improving gateway facilities, developing transport linkages with the hinterland, and in particular key agricultural production sites, is a crucial part of developing competitive value chains.³⁷

Organising and consolidating value chains so as to reduce the real resource costs of moving

³⁷ Other donor activity in this space includes the Ag Cluster Development Programme of the WB, the Farm Income Enhancement and Forestry Conservation Programme. and the Market and Ag Trade Improvement Programme of the AfDB.

goods from producers to consumers, both domestically and overseas, is a priority. Background studies for this report covering the dairy and maize sectors highlight precise measures that could help develop capacity in these areas. In services, the tourism value chain has clear potential, both in terms of a Ugandan export, and also a source of demand for input producers in goods as well as services markets. Generally speaking, it is important to take a two-pronged approach to developing competitive value chains. First, barriers to engagement by large, foreign lead firms need to be reduced. The issue is not only explicit policy barriers affecting FDI, but also the business and investment climates more broadly, and in particular the level of transaction costs associated with building and operating value chains. Investment promotion is an important part of these efforts, and can be stepped up. Second, the environment needs to be supportive of the development of supplier linkages between lead firms and domestic enterprises. Part of the task at hand relates to matching supply and demand, and overcoming information asymmetries, but the more fundamental issue is competitiveness. Contact with global markets can help promote productivity upgrading among domestic firms, by shifting resources from less- to more-productive firms. This process needs to be intensified, to the extent possible given regional constraints (see Box 1). Development of an internationally engaged ecosystem of firms can use initiatives like SEZs, but their current implementation suggests caution in relation to some fundamental issues of design and focus.

5.2 Improving competitiveness of services

Efficient services as inputs are key to increasing productivity in manufacturing and export industries, including in the specific context of East Africa (Hoekman and Shepherd, 2015). A large scale program of regulatory analysis should be undertaken for backbone services sectors like transport, finance, business services, logistics, and professional services. It is likely that streamlining the regulatory burden, consistent with important public policy objectives, while at the same time developing private sector capacity, could help downstream manufacturing firms become more productive and develop linkages to foreign markets, both intra- and extra-regionally.

In finance, for example, more research into the possibility of reducing policy barriers to integration within the region could yield ways to increase competition that would drive down notoriously high spreads that stifle private investment.

Services can also be a dynamic source of exports. Tourism is an obvious source of new potential earnings, and additional analytical work would be useful. A less obvious services export industry is education. Uganda has been successful in exporting education services within the EAC for a long time now, even though the industry's performance has recently weakened. Further investments in higher education institutions could not only strengthen education as a service export, but also help the country gain the necessary high-skilled labour force required to compete in GVCs. The process of moving up in a value chain is intimately linked to the availability and quality of human capital, so investments in education can have significant payoffs if manufacturing activity grows substantially.

5.3 Increasing domestic value added

Active government efforts to develop domestic supply chains for existing efficient firms would replace imports, add domestic value added, create jobs, and be a source of vertical technological transfers. The investment promotion agency could put together such "local content programs", which bear no similarity to local content requirements: the idea is to remove distortions and market failures that prevent domestic suppliers from taking advantage of their location and cost profile, not to artificially shift demand towards domestic producers at the expense of competitiveness in using sectors. Supplier development programs, supported by lead firms in global value chain sectors, could help build the productive base and support manufacturing growth (See Box 1).

As part of investment promotion efforts, potential GVC lead firms in competitive sectors should be identified. Working collaboratively with them can help develop a competitive web of local suppliers, and can potentially lay the foundations for moving up into higher value added activities. Although light manufacturing sectors are crowded internationally, there may be scope

for Uganda in sectors like processed agriculture, horticulture, and the leather industry, where there is already some evidence of increasing internationalisation among leading Ugandan firms.

Box 1: Increasing local firm participation in global value chains

Governments can help to foster an enabling environment for the development of supplier linkages between global lead firms and domestic enterprises. In the capacity of a facilitator, a government can leverage local knowledge of industrial capabilities, constraints and upgradation possibilities, and match these to the requirements of investors. Market friendly measures such as relationship building and matchmaking through investment promotion agencies (for general manufacturing), and local content units (in the case of resource-rich countries) have proven to be effective across the globe. Two cases from John Sutton's (LSE) work in Sub-Saharan Africa are presented below:

Strengthening investment promotion: The case of Ethiopia

The Ethiopian Investment Commission (EIC), that is responsible for trade and investment promotion, has established a Relationship Building Programme consistent with international best-practice. The model seeks to move away from the culture of firefighting, and instead engage with investors (that are significant employment creators) on a continuous basis. The programme has helped to develop procedures, such as a two-tier meeting structure (fortnightly meetings to discuss live issues, and quarterly meetings to conduct a comprehensive review of all firms and issues), and tracking mechanisms to ensure that all investor issues are resolved in good time. The EIC also serves in a coordination role, helping to bring together potential business partners. By providing forums for dialogue, the EIC helps prospective international lead firms and local suppliers to understand each other's constraints and requirements. This is a low resource-intensive option that can easily be emulated by other countries.

Strengthening Local content units: The case of Tanzania

Following the discovery of off-shore gas reserves in Tanzania, the Govt. set up a Local Content Unit whose responsibilities include shaping dialogue with MNCs regarding local firm integration and encouraging the development of potential domestic suppliers' capabilities. As the supply chain is built up, opportunities will emerge for partnership between foreign and local firms in construction, followed by business and general services, and subsequently in engineering. The Unit is currently working with MNCs to agree on training arrangements for local SMEs who can then qualify as 'approved vendors' for entry into the supply chain. The institution of training programmes (e.g. through an Enterprise Development Centre, secondment of experts to local firms, shadowing schemes) will however be costly, and is an area for potential co-financing from donors. Training schemes normally run for 1-2 years, and therefore it is a timely intervention from the LCU, well ahead of MNCs requiring the goods and services that these local firms are to provide. This example of timely intervention for building domestic capabilities is an important lesson for other countries.

5.4 Attracting FDI

A review of investment restrictions affecting key partners should be undertaken with a view to facilitating flows of inward FDI, particularly in manufacturing. The review should go beyond market access and national treatment issues to look at aspects of the business climate that affect the locational decisions of firms.

Investment promotion efforts should focus on a few key sources (or potential sources) of inward FDI, particularly the developed Northern markets, but also China, South Africa, and potentially India.³⁸ Supporting analytical work to better understand the reasons why inward FDI from these emerging markets is still relatively limited will be important, including firm-level interviews with incumbents and potential investors.

³⁸ The DFID-funded Supporting Indian Trade and Investment for Africa project could be used as a model to connect to further markets. Dfid should attempt to build capacity for such initiatives within the GoU.

5.5 Harmonising standards, mutual recognition, and testing facilities

Policymakers should support efforts to develop common standards, mutual recognition agreements, and quality infrastructure in the EAC region. Key issues include take up of regional and international standards, including those in force in key developed country markets, as well as support of testing and certification facilities.³⁹ There may be scope for innovative mechanisms to help support firms in getting financial support to cover the costs of adapting products and processes to foreign standards.⁴⁰

Standards are an important issue for participation in global and regional value chains. In agribusiness, issues of quality and safety are paramount, especially for dealing with the developed Northern markets. In manufacturing, lead firms need to be assured that products are fit for purpose, and compatible with output from other source countries. Experience in agribusiness value chains suggests that standards harmonisation can help promote a regionalisation of economic activity in a way that can help firms achieve scale economies. But harmonisation on its own is not enough: related processes, specifically testing—and recognition of conformity assessment—need to be addressed as part of a holistic approach to upgrading national quality infrastructure so as to support competitiveness.

5.6 Export and investment promotion

The Government is working to establish Special Economic Zones. It is not clear that they are being properly designed and managed (and there are plenty of failures in Africa). There is potential to support the Government in learning from international experience, and adopting a more coherent approach in attracting potential investors.

More detailed analysis is necessary to identify particular sectors and products where Uganda has been successful, or where it has a comparative advantage that remains underexploited. Support should be made available for detailed sectoral studies and firm-level analysis to support a better understanding of what makes these areas competitive, and how lessons can be transferred to other sectors in the interests of diversification. One option to be explored is making use of the Trade-DSM software developed in South Africa to aid in identifying firm-product-partner relations worthy of systematic investment of government and private sector time.

Given the high capital-intensity of the manufacturing sector and the poor functioning of capital markets in Uganda, there could be a case to expand current credit facilities from agriculture to the manufacturing sector, which has begun to show promising prospects to substitute imports and for regional exports. Effective interest rates for Ugandan businesses are high, so comprehensive financial sector reform—including addressing barriers to a regionalisation of activity—is a priority, as part of a broad initiative to reinvigorate the services economy.

³⁹ USAID Feed the Future and aBI trust at the national level, and TMEA on the regional level have projects/funding facilities to support the improvement of product quality and standards, both from the government and the private sector side. However, the focus is almost exclusively on ag products.

⁴⁰ DFID-funded Misingi could take a role in this activity, working with high potential firms that do not yet meet these standards.

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