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Access to Finance and Export-Oriented Investment in Uganda's Free Zones

Isaac Musinguzi

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Uganda Bankers Association
Plot 2702, Block 244 Nyangweso Road
Off Kironde Road, Tankhill Muyenga, Uganda
P.O. Box. 8002, Kampala
secretariate@ugandabakers.org
www.ugandabakers.org

1.0 INTRODUCTION

Over the past three decades, Free zones have become popular instruments of trade policy globally due to their ability to catalyze economic development1. By 1970, there were only a handful of countries which adopted the Free Zones Policy, but all this has changed. By 2019, there were 5,400 zones across 147 economies, up from about 4,000 five years earlier and more than 500 new zones are in the pipeline (UNCTAD World Investment Report, 2019). This boom is part of a new wave of industrial policies and a response to increasing competition for internationally mobile investment. In fact, Uganda has recently also adopted the Free Zones Policy.

According to Section 2 of the Free Zones Act, 2014, a Free Zone is a designated area where goods introduced into the designated area are generally regarded, so far as import duties are concerned, as being outside the customs territory and include an Export Processing Zone or Free Port Zone. They are often offered free trade conditions and a liberal regulatory environment[2] including exemptions from tax customs duties, business – friendly regulations, administrative facilitation, and infrastructural support from the government, among others[3]. These have an impact of lowering their costs of operations and attracting more export-oriented investors.

Export Processing Zones are an important development tool used by governments to largely increase the country's exports. Today's definition of Export Processing Zones extends recognition to not only firms located within an industrial estate, usually a fenced in area of 10–300 hectares that specializes in manufacturing for export, but also those firms outside such geographical constraints but exhibiting characteristics akin to those within the Export Processing Zones (World Bank, 1992). Such characteristics include a distinct regulatory framework and infrastructural support, in which case borderline firms that take up one form or another basing on a country's respective laws (UNCTAD, 2019). Therefore, there are instances where Export Processing Firms may still benefit from the incentives offered in the zones without being physically fenced in.

In addition, several other countries have liberalized domestic sales for these firms, allowing the sale of some of their output in the domestic market depending on their respective policies. Uganda is no exception to this, allowing the sale of utmost 20 percent of output from Export Processing Zones to be sold in the domestic market[4] whereas Mexico also allows 20-40 percent of its zones' output to be sold domestically.

Export Processing Zones are established with three main goals in mind. The first of these goals is to provide the country with foreign exchange earnings by promoting nontraditional exports, secondly, to create jobs and generate income and lastly, to attract foreign direct investment, engendering technology transfer, knowledge spillover, demonstration effects, and backward linkages (Madani, 2003).

[1]United Nations Conference on Trade and Development, *Handbook on Special Economic Zones in Africa: Towards Economic Diversification Across the Continent*, p.25 (2021) available at www.unctad.org accessed on 7th June 2022.

[2]Uganda Free Zones Authority, *Frequently Asked Questions* available at www.freezones.go.ug accessed on 7th June 2022.

[3]United Nations Conference on Trade and Development, *World Investment Report 2019*(United Nations Publications, United States of America, New York, 2019) p. 128, available at www.unctad.org/system/files/official-document/wir2019_en.pdf accessed on 19th May 2022.

[4]Uganda Free Zones Authority, *Frequently Asked Questions* available at www.freezones.go.ug accessed on 7th June 2022.

Export Processing Zones exhibit a number of characteristics which may include (but are not limited to).

(i) They are allowed duty-free imports of raw and intermediate inputs and capital goods for export production.

(ii) Government red tape is streamlined, allowing "one-stop shopping" for permits, investment applications, and the like.

(iii) Labor laws are often more flexible than for most firms in the domestic market.

(iv) Firms in zones are given generous, long-term tax concessions.

(v) Communications services and infrastructure are more advanced than in other parts of the country. Utility and rental subsidies are common.

(vi) Zone firms can be domestic, foreign, or joint ventures. Foreign direct investment also plays a prominent role.

Export Processing Zones must be subjects of proper Policy Planning which takes into account their ultimate costs and achievements for them to be a successful tool for Industrialization and economic growth (Warr 1989, 1993; World Bank, 1992). However, it goes without saying that there are instances where the Export Processing Zones have failed to serve the intended purpose due to the absence of such centered planning.

Export processing zones are sensitive to the national economic environment and perform better when the host country pursues sound macroeconomic and realistic exchange rate policies. If properly managed and availed a favorable policy environment, zones can generate income, create jobs, especially nontraditional employment, and new employment opportunities for women as well as build human capital (Dorsati Madani, 1999). The long-term contributions of a competitive and efficient Export Processing Zone are the provision of industrial infrastructure that many countries lack as well as the building up of human capital either directly or through their catalyst and demonstration effects on host country entrepreneurs (Dorsati Madani, 1999).

Export processing zones build human capital in two ways. Firstly, the previously unskilled workers benefit from job training and learning by doing (Rhee, Katterbach, and White 1990). These benefits are limited, however, because most production is low-skill and low-tech. Still, workers earn income and learn industrial work discipline and routine. Often, training also occurs at the supervisory and managerial levels since local employees establish foreign contacts and learn new organizational and managerial methods, negotiation and marketing skills, general business knowhow, and a spirit of entrepreneurship.

Secondly, Human Capital is built by the catalyst and demonstration effects which are common in the host economy, through backward linkages between zones and domestic firms, which unfortunately do not always occur (Rhee, Katterbach and White 1990; Rhee and Belot 1990). In general, some linkages have occurred in countries that did not already have a solid industrial base. However, these linkages have been spotty and inconsistent, with some Zone Firms complaining of the poor quality or incompatibility of local inputs.

Export Processing Zones have increased gross foreign exchange earnings although net foreign exchange earnings have not always lived up to expectations due to the total foreign exchange expenses incurred in the production of the products.

According to the Uganda Free Zones Authority Enterprise Survey for Financial Year 2020/21, there were twenty-Seventy (27) licensed Free Zones Developers and Operators registered in Uganda. Total exports of goods in Free Zones stood at **US$1,247,370,226** during the FY2020/21, an increase by 709 percent from **US$154,172,592** registered in FY2019/20. The increase was driven by export of high value processed mineral products. Total employment in Free Zones stood at 8,389 jobs, an increase by 31 percent from 6,382 jobs, generated in FY2019/20. The Capital investment increased to **US$586.28 million** in FY2020/21 from the FY2019/20 levels of **US$71.28 million**.

Uganda's strategic location coupled with the relative stability makes it a gateway for regional trade and investments into the East African sub region. The economy of Uganda has experienced a steady and positive growth as a result of policy reforms, resulting into improved macroeconomic performance and the creation of a conducive environment for business. These reforms have been characterized by reduction in inflation, fairly stable exchange rates, relatively low interest rates and economic growth.

This study aims at identifying the barriers to entry of Free Zones in Uganda by assessing current policies and practices, identifying strategies for overcoming the constraints of development on these Free Zones and finding ways to help in improving the implementation mechanism of the Free Zones scheme.

2.0 MOTIVATION FOR THE REVIEW

With the current challenges of job creation for the increasing number of youths in Uganda, the industrial sector must solution this by generating the much-needed employment. For increased industrialisation to happen in the Country, numerous resources have to be mobilized to finance infrastructure as well as factories, industries, and their operations; that add value to the raw materials in order to increase exports. These are majorly financed using private finance, given that public finance is increasingly focused on infrastructure development. Furthermore, most Zone investments are made by Private Investors[5].

The role of the financial sector is very significant for the level of industrialisation in Uganda, in terms of provision of credit to finance industrial projects and their operations. These credit facilities include both short- and long-term loans from commercial and development banks. Inadequate access to finance remains a major obstacle for many aspiring entrepreneurs and businesses especially Micro, Small and Medium-sized Enterprises (MSMEs), which are the bulk of Uganda's manufacturing sector. As recent studies[6] confirm, the global financing gap for Micro, Small and Medium-sized Enterprises remains enormous. Entrepreneurs of all types and sizes require a variety of financial services, including facilities for making deposits and payments as well as accessing credit, equity and guarantees.

[5]United Nations Conference on Trade and Development, Special Economic Zones available at www.worldinvestmentreport.unctad.org accessed on 9th June 2022.
[6]Entrepreneurship Policy Framework by the United Nations Conference on Trade and Development (UNCTAD)

3.0 OBJECTIVE OF THE REVIEW

The overall purpose of this review is to identify barriers to access to Finance and Export-oriented Investment in Uganda's Free Zones. Specifically, the review looks at the following:

(i) To examine the availability of financial services to support Export-oriented Investment in Uganda's Free Zones.

(ii) To find out the affordability and Cost of Credit on Export-oriented Investment in Uganda's Free Zones.

4.0 LITERATURE REVIEW

4.1 Access to Finance

Access to finance is the ability of individuals or enterprises to obtain financial services, including credit, deposit, payment, insurance, and other risk management services. Such financing is intended to support and stimulate economic growth by providing financing to firms where the market is failing to do so. Access to finance policies are intended to impact on firm growth, productivity, and employment. Access to finance includes access to deposits (internal financing) and credit (external financing)[7].

Credit constraints, whether from bank financing or other means of financing, negatively affect investment in fixed assets, investments and working capital as well as the firms' growth in terms of investment and employment[8]. The competitiveness and growth of the Firm is ultimately hampered.

4.2 Export-Oriented Investments

Export oriented investments including industrialization are the investments mainly concerned with increasing the volume of production of goods and services for export. Export-oriented Industrialization (EOI), sometimes called Export Substitution Industrialization (ESI), Export Led Industrialization (ELI) or Export-led Growth is a trade **and** economic policy **aiming to speed up the** industrialization **process of a country by** exporting **goods for which the nation has a** comparative advantage. Export-led growth implies opening domestic markets to foreign competition in exchange for market access in other countries.

The investment decisions of Transnational Corporations (TNCs) are today increasingly linked to international trade patterns and the growth of Global Value Chains (GVCs), which now contribute to 80 percent of global trade. Government policymakers and their Investment Promotion Agencies (IPAs) have therefore been keen to bring export-oriented investment – often related to GVCs – to their shores. Such investment can help countries to broaden their participation in GVCs and to capture higher-value activities and upgrade their exports.

4.3 Mixed International Experience with Special Economic Zones (SEZs)

While SEZ programmes have been implemented in a number of developing countries, evidence of the effectiveness of SEZ policy is mixed. While in some countries, SEZs have proved to be catalytic to growth, in others, they have become expensive 'white elephant' projects with limited contribution to economic development[9].

[7]Paulo Jose Regis, *Access to Credit and Investment Decisions of Small and Medium-Sized Enterprises in China*, p.4 available at www.eprints.soton.ac.uk accessed on 7th June 2022

[8]Miguel Garcia-Posada Gomez, *Credit Constrains, Firm Investment and Growth: Evidence from Survey Data* (European Central Bank 2018) p.6 available at www.ecb.europa.eu accessed on 7th June 2022.

[9]M. Priya and T Matheiu, *Special Economic Zones: Policy Considerations for Uganda* (International Growth Center January 2020) p. 2 available at www.theigc.org accessed on 7th May 2022.

The clearest success story of using special economic zones to drive growth can be found in China. In 1979, four SEZs were established as an experimental policy with the aim of spurring growth in the country (Manwaring and Teachout, 2022). By addressing significant distortions in the economy regarding firm ownership, trade and taxation, these zones soon accounted for over 60% of Foreign Direct Investment (FDI) into the country. By 2010, there were over 2000 zones in the country, accounting for 30 million jobs, 60% of exports, and 46% of FDI.

Similar successes have been observed in other countries such as Korea, Malaysia, Mauritius, Dubai, and Poland. However, there have also been notable failures in the implementation of industrial parks and SEZs, in particular in India, some countries in Latin America and sub-Saharan Africa (Manwaring and Teachout, 2022). Four (4) SEZs in Kenya and Ghana have generated 10-15 percent less employment per capita than those in Honduras and the Dominican Republic (Manwaring and Teachout, 2022).

5.0 FINDINGS FROM THE REVIEW

5.1 Availability of financial services to support Export-oriented Investment in Uganda's Free Zones

According to Elinorah Tumushabe (2018), availability of credit is of great importance in encouraging Foreign Direct Investment which in turn greatly influences Export- oriented investment.

In Uganda, the Ministry of Finance, Planning and Economic Development reports that most firms are internally financed or obtain credit from domestic savings and commercial credit providers like Banks[10]. Limited access to finance is a key constraint to Small and Medium Enterprise (SME) **growth** and it is the second most cited obstacle faced by SMEs in growing their businesses in emerging markets and developing countries. SMEs are less likely to be able to obtain bank loans than large firms; instead, they rely on internal funds, or cash from friends and family to launch and initially run their enterprises.

This is because commercial bank loans are hard to pay back and have laborious requirements to fulfil before the loan application is approved.

For SMEs to grow and contribute to economic development, access to adequate credit finance is critical (Hasnah et al., 2013). This is because SMEs cannot raise adequate equity finance through informal savings and retained earnings to sustain their operations and growth. Several studies have established that credit finance obtained at affordable interest rates and well utilized have a positive significant effect on growth of SMEs.

Further, the high costs of credit, bank charges and fees hamper growth of SMEs.

Banks perceive the SME segment to be profitable, but macroeconomic instability in developing economies and competition in the SME segment in developed economies were identified as the main obstacles to them providing financing to SMEs. Banks are less exposed to SMEs than to large firms, provide a lower share of investment loans to SMEs and charge them higher fees and interest rates, especially in developing economies.

Access to reliable and long-term financing to support export-oriented investments is important in the development of the export market and allows for sustainable growth of the investments[11]. Long term and patient capital in Uganda can be remedied by the Uganda Development Bank and East African Development Bank but the two Banks are under-capitalized[12] and Uganda's Capital market which, however, still remains underdeveloped (Sejjaaka, 2009). Currently, there are no SMEs listed on the Uganda Securities Exchange and yet the bulk of companies in Uganda are SMEs.

[10] Ministry of Finance, Planning and Economic Development, *Draft National Investment Policy (2018)*, p.8-9 available at www.finance.go.ug accessed on 7th June 2022.

[11] ibid

[12] Ibid, p.9.

5.2 Affordability and Cost of Credit on Export-oriented Investment in Uganda's Free Zones.

Uganda is faced with rather costly credit which negatively impacts not only export-oriented investments but investments in the economy at large. Unlike its neighbouring countries, Uganda has a rather high bank interest rate for loans (on average, 24.7% and 10% for credit obtained in foreign currency as of 2016, which is not sustainable where loan is re-paid in local currency) and when coupled with the loan processing costs and need for collateral, it hinders export companies from accessing credit[13]. Worse yet, the decreasing Income Per Capita further makes financial services largely unaffordable to businesses which eventually liquidate due to inability to pay back the loan and its accompanying interests[14]. Moreover, credit is granted for a shorter loan period than is required for sustainable investment[15].

In effect, though micro companies, in particular export-oriented companies have greater access to financial services, the services are so costly and not granted on terms that favor sustainable investment, eventually necessitating liquidating due to inability to pay back the loan and interests[16]. Limited access to financing that favors sustainable investment has become a major constraint to companies in Uganda, hindering research, growth and development of new products and better standards[17].

[13]Ibid, p.13-14

[14]Raymond Mutungi, Daily Monitor: *The Real Timber for Coffins in Uganda is Loan Interest Rates* available at www.monitor.co.ug accessed on 7th June 2022.

[15]Ministry of Finance, Planning and Economic Development, *Draft National Investment Policy (2018)*, p.9 available at www.finance.go.ug accessed on 7th June 2022.

[16]Supra (n 14)

[17]Bob Twinomugisha, *The Path to Industrialisation in Uganda: The Analysis of Uganda's Industrial Development Journey in relation to Malaysia, South Korea, Singapore and Kenya*, p.19-20 available at www.udbl.co.ug accessed on 7th June 2022.

6.0 RECOMMENDATIONS

The review recommends the following;

(i) The Commercial banks should design specific credit packages for the different industries such as agro-processing, light manufacturing, and mineral processing. This should also involve the charges for different interest rates.

(ii) The Commercial banks should reduce the time taken to acquire credit through digitisation of processes involved in access to credit.

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Brief Biography of the Writer

Isaac Musinguzi is a Research Officer at Uganda Free Zones Authority, and he is so passionate about Research. Isaac holds a Postgraduate Diploma in Monitoring and Evaluation, Master of Science in Development Economics and a Bachelor of Economics and Management (Hons). He also holds a Diploma in Legal Instruments of International Economic Relations and Regional Integration as well as a Certificate in Computerized Applications for Data Analysis (SPSS, STATA & EXCEL).

He has more than Eleven (11) years of research and teaching experience at Insurance Training College of Uganda, Uganda Christian University and Ndejje University, in which he has worked on several projects and published in the field of Trade and Investment, Development economics, Macroeconomics, Insurance, Health, Agricultural economics, Education and Labour markets. Isaac is a member of the Uganda Economics Association (UEA), African Economic Research Consortium (AERC) and African Econometric society (AES).

Plot 2702 Block 244 Nyangweso Road off Kironde Road Tankhill Muyenga P.O. Box 8002, Kampala
Tel:+256 312 343 400, Email: secretariat@ugandabankers.org, www.ugandabankers.org