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Government demand and domestic firm growth: Evidence from Uganda

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- Government procurement is an important mechanism for private sector development in Uganda. The 2014 *Buy Uganda Build Uganda* policy aims to expand domestic consumption of locally produced goods and services, setting a target of awarding at least 20% of the value of public procurement contracts to Ugandan firms.
- We study the impact of participation in public procurement on firm performance in Uganda. Compared to other firms, those that sell to government entities report higher sales, have larger networks of suppliers and buyers, and tend to be older.
- Compared to firms that never sell to government entities, we find that participation in procurement triggers a significant boost in sales and in sales per employee (a measure of labour productivity) by about 73% and 32%, respectively.
- We also find that firms which enter government procurement contracts report reduced sales to other buyers both within the period in which sales to the government commence and afterwards if they continue selling to government. The reduction in sales to non-government firms, estimated to be about 55%, may reflect the existence of short-term capacity constraints.
- We find suggestive evidence that this failure to expand production may be due to capacity constraints. Understanding the drivers of this pattern of reallocation away from private buyers following entry into public procurement requires further analysis.

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Introduction

Private sector development is a central pillar of Uganda's national development strategy. One policy instrument employed by the government to support the private sector is public procurement. In Uganda, public procurement represents an important share of government spending – accounting for almost 60% of the government budget. The 2014 *Buy Uganda Build Uganda* policy aimed at expanding the share of public procurement contracts that are awarded to national companies. The policy complements the Public Procurement and Disposal of Public Assets (PPDA) law, which provides for the application of preference and reservation schemes to encourage supply from local firms when procuring goods, works or services, by calling for measures to raise awareness of local products, support development and marketing of local brands, and encourage local firms to participate in procurement opportunities. In the 2020/2021 period some 42% of the value of public contracts were awarded to local contractors.[1]

Data description

In a new paper, we use administrative data on transactions in Uganda to analyse whether selling to government entities affects firm performance (Hoekman et al, 2022).[2] The data span the period from 2012 to 2019 and cover both firm-to-firm transactions and transactions between firms and government entities (either central government bodies such as Ministries or provincial or municipal public entities). Since 2012, registered Ugandan firms must report periodically detailed information on their value-added tax (VAT) declarations, including about all their buyers and suppliers. These data include sales and purchases by government bodies, permitting the identification of whether and when a firm sells goods or services to a government entity, and, if so, the value of the transaction. We match VAT transaction data at the level of reporting firms with information from the corporate income tax (CIT) and pay as you earn (PAYE) datasets,[3] which provide firm-level financial and employee information, respectively, to explore the relationship between selling products to government entities and indicators of firm performance.

[1] PPDA Annual Performance Report, July 2020 – June 2021. No information is available on the extent to which such preference policies are implemented or whether a distinction is made between firms depending on their size.
[2] Hoekman, B., Sanfilippo, M., Santi, F. and Ticku, R., Government Demand and Domestic Firms Growth: Evidence from Uganda. IGC Working Paper, forthcoming.
[3] The PAYE dataset records firm-level information on earnings and employment.

Characteristics of procurement firms: Descriptive evidence

The dataset that we use for empirical analysis includes 18,457 unique firms. Out of these firms, 6,725 firms reported selling to a government entity at least once. Compared to firms than never sell to the government, firms that sell to government entities:

- Are more likely to be concentrated in trade services (1,648 firms), construction (1,193 firms), manufacturing (432 firms), and high value-added services activities (ICT and Technical Professions, 926 firms);
- Tend to be three times larger in terms of sales (average annual turnover of **USD 3.09 million** (UGX Mil. 11,337) compared to **USD 0.99 million** (UGX Mil. 3,611) for other firms, a feature that is particularly evident for firms that sell to government entities throughout the sample period (average annual sales of **USD 4.27 million** or UGX Mil. 15,640);
- Have a larger number of partners to which they sell or source from; and,
- Are three years older (their median age is nine years compared to other firms with a median age of six years).

Methodology: Causal analysis

It is challenging to determine the direct impact of receiving a contract to supply a government entity and a firm's subsequent performance, because firms which are initially more productive are more likely to win a public procurement contract. That is, differences we observe in performance between firms that sell goods or services to the government and firms that never receive a procurement contract might simply be due to more productive firms obtaining procurement contracts in the first place.[4]

To address this challenge, we compare the evolution in the performance of firms that sell part of their output during the 2012-2019 period (and continue doing so) to the government — to firms that never sell to a government body. This allows us to compare the difference in performance between the two groups of firms before, at the time of, and after the time of government procurement.

We first establish that prior to beginning to sell to government bodies, the firms that receive a contract perform similarly to firms that never receive one. This allows us to be sure that the differences in performance between firms involved

[4] As descriptive data indicate, procuring firms tend to register higher total sales compared to those who do not sell to the government, and tend to have larger buyer/supplier networks.

in procurement and firms not involved in procurement are not due to government purchasing predominantly from more productive firms.

Findings: Impact of public procurement on firm performance

- Firms entering public procurement register a significant boost in sales and in sales per employee (a measure of labour productivity) compared to firms that never sell to government entities. This effect persists until the end of the sample period.
- Firms that start selling to the government, on average, report reduced sales to other buyers both within the period in which sales to the government commence and, if they continue to sell to government entities, throughout the remaining period covered by the data.
- These findings suggest the existence of short-term capacity constraints.
- The pattern of reallocation of sales by firms that sell to government entities away from private sector buyers is less pronounced for firms that provide services, which tend to rely more heavily on labour than capital equipment or other tangible assets. The reduction in sales to private buyers is the smallest for services firms that can be characterised as relatively low-skilled, labour-intensive, which may be able to expand output more easily (be less subject to capacity constraints).

Conclusions

The main result obtained from the empirical analysis is that government demand (participation in public procurement) is related positively to firm performance. Total turnover and labour productivity (sales per worker) of firms that sell to government entities are higher than comparator firms that do not. However, firms that sell to the government reduce their sales to other companies (the private sector).

These findings raise important questions from a private sector development perspective and call for further research to better understand both the short and longer-term effects of successful participation in public procurement by Ugandan firms. Data limitations do not allow us to identify the exact mechanism for why firms which receive government procurement contracts reduce sales to non-government buyers during the period covered by the data.

Assessing the drivers of the pattern of reallocation of sales across buyers requires additional data, including information on the extent to which firms are constrained by access to credit to expand production capacity, and the incentives perceived by managers of firms that win government contracts to continue to sell – or increase sales – to non-government clients. For example, if contracts to supply government entities are associated with higher profitability than those for private sector buyers, the incentive for managers to consider investment to boost capacity may be weak. Alternatively, if banks and/or managers of companies perceive continued success in supplying government entities to be too uncertain, this may reduce investment expansion incentives.

Understanding the drivers of the pattern of reallocation away from private sector buyers by firms that succeed in selling to the government, and thus the policy implications of our findings, calls for surveys of firms that have engaged in public procurement in Uganda as well as financial intermediaries that are (potential) sources of funds to expand capacity.