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# RESEARCH Paper

## Informal Cross-Border Trade in EAC *Implications for Regional Integration and Development*

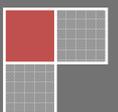
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## Executive Summary

### Informal Cross- Border Trade in EAC

A significant proportion of cross-EAC border trade is conducted informally. There is no universally accepted definition of the informal sector to start with. But in this paper, the term "informal cross-border trade" is used to refer to imports and exports of legitimately produced goods and services (i.e., legal goods and services), which directly or indirectly escape from the regulatory framework for taxation and other procedures set by the government, and often go unrecorded or incorrectly recorded into official national statistics of the trading countries.

Since the commencement of the EAC Customs Union in 2005, several official efforts are being put in place to increase formal trade links among Partner States. Despite the policy pronouncements to promote trade integration among EAC Partner States, formal trade links is still facing several constraints. Indeed, some of the constraints push traders into engaging in informal trade as there are also exclusive incentives that pull traders to remain in ICBT. Yet, the coexistence of ICBT with formal trade integration has not been officially recognised. There are no official purposive efforts to put in place an appropriate environment to streamline the activities of informal cross-border traders. Incidentally, some of the studies reviewed in this paper tend to suggest that it is the informal contacts that do strengthen regional integration networks and relationships more than formal links. While it may be relatively easy to eliminate constraints to formal trading, the same may not provide better incentives for traders already in the informal sector to shift or formalise their trading practices.

All the reviewed surveys in this paper suggest that ICBT still represents a significant proportion of regional cross-border trade in EAC.

Official statistics provided in this study indicate that Uganda has been maintaining an increasing negative trade balance with Kenya. On the other hand, the ICBT statistics indicate a positive trade balance. If the two sets of data (both for ICBT and official trade) were to be added together, it would be the case that Uganda's official trade data actually falls short by more than 80 percent of what should be Uganda's inter-EAC exports.

### Key Characteristic of ICBT Participants

***Who are the participants and how do they practice ICBT:*** The study has established that participants in the ICBT are both from informal and formal firms. Yet it is actually the formal firms who are stigmatising and fighting the informal one through the government. The informal firms engaging in ICBT do operate entirely outside the formal economy. But, the formal firms in this type of business are actually either fully evading trade-related regulations and duties by passing their commodities through "unofficial routes" or are partially evading trade-related regulations and duties even as they pass their goods through official routes. In the latter case, the traders involve illegal practices such as under-declaration of the quantities, weight or value of goods so as to pay lower custom duties (where custom duties are applicable); falsifying the description of products (mis-classification) so that they are treated as products subject to none or lower tariffs; mis-

declaration of country of origin to avoid any taxes that may be applicable; and bribery of customs officials and police officers.

**Education level, gender and age:** The study has shown that cross-border trade is increasingly becoming more complex and more people have completed their secondary education compared to two decades before. A majority of the players also fall in the age bracket of 20-40 years where 44.2 percent have completed secondary education, 25.8 percent have professional/semi-professional diploma and certificate and 10 percent have a degree, with the number of those with diploma, certificate and degrees rising by year.

**Type of good traded:** On the type of goods involved in ICBT, the study shows that informal cross-border trade in EAC concerns almost all types of goods –*staple food commodities* and even food aid that have a direct impact on regional food security; *low quality consumer goods* such as shoes, clothes, textile and vehicle and bicycle parts and even fake drugs; and, some of the goods reflect the same ones that benefit from export promotion schemes, such as textiles.

**Knowledge of the customs union protocol:** A remarkable finding is that many ICBT traders are well aware of the various general provisions of the Customs Union, including most of the regulatory requirements. However, some of them attribute their continued engagement in ICBT to presence of physical and technical barriers in formal trade; others to the incentives inherent in ICBT; and still others attach their socio-economic problems hindering beneficial engagement in formal trading.

**Mode of transportation across the border:** The main modes of transport used in ICBT are vehicles, bicycles, head/hand, motorcycles, wheel chairs, animals (donkeys), push carts, boats/canoe etc. People with disabilities, like those on wheel chairs are paid to help move small/light but valuable products e.g. sugar, salt, soap, cooking oil and plastics.

In most cases, the flows of ICBT goods appear to be in small quantities. Where big consignments are involved, they are usually divided into smaller quantities to avoid attention when passing across borders. Small quantities of goods are passed through official points which in when totalled accounts for a significant amount. These small quantities passed across the border are not necessarily sold immediately; they are piled in stores which are jointly hired by the traders until a reasonable volume is reached and the players jointly hire means of transport to haul their consignment to the rest regions of the country.

### **Push and Pull Factors for ICBT Growth**

The growth of ICBT generally represents a normal market response to overly cumbersome, rigid, time-consuming and inefficient bureaucratic export/import procedures and regulations, which are seen as significantly increasing the cost of both joining the formal economy and operating within it.

But, it is also established that ICBT markets in EAC pre-dates colonial and post-colonial state boundaries. For this reason, what we see continues today as ICBT is simply a longstanding indigenous pattern of trade that makes more sense than formal trade channels. In this perspective, ICBT is not significantly influenced by the factors mentioned above; rather, its

entrenchment is simply a re-establishment of the extensive barter trade and migration of people that were a feature of economic and social life predating colonisation in EAC.

Other push factors towards ICBT are based on the weak economies of EAC that have seen formal employment shrink, especially, following the inappropriately implemented structural adjustment programmes (SAPs) of the early 80's. The consequence has been a rise in rural-urban migration in search of often non-existent employment. Together with the low wages from the formal employment, retrenchments and generally underemployment, these have been key in pushing people to look for alternative ways to supplement their incomes, and ICBT has been one such alternative.

All in all, there are several reasons which explain the existence and continued growth of ICBT in EAC. There is no one reason that can be attributed to it; rather, a confluence of factors have conspired either as incentives that pull traders or as problems that push them to engage in ICBT.

### **Implications of ICBT to EAC**

#### *Positive implications*

ICBT contributes to the economies of EAC countries in various ways. It enables small-scale entrepreneurs to escape poverty and to meet the education, housing and other basic needs; ICBT traders employ people in their home countries and in the countries where they source their goods; and, it is also a supplementary source of family income to people who are under-employed and a source of employment to some people who were retrenched following economic restructuring that was occasioned by structural adjustment programmes (SAPs). Judging from the monthly values of income that traders realise from ICBT, it is apparent that the majority of ICBT participants survive on more than US\$2 a day which some of them would never have achieved under formal employment, especially considering the shrinking economies of EAC.

The number of people indulging in ICBT having degree-level education is rising. On the one hand, this is a pointer that that cross-border trade is increasingly becoming more sophisticated, requiring better education for one to be able to interact and trade smoothly across the borders; however, it also confirms that **most university graduates these days are without jobs or starting capital to pursue formal business. Thus, an increasing number of them resort to informal businesses including ICBT as a form of employment and means of income generation.**

A majority of the ICBT participants are between the age of 30 and 40 years. This is the age at which many people in EAC have married and have more responsibilities to take care of, but lack of formal sources income pushes them to look for other informal ways, including engaging in ICBT, in order to meet their family responsibilities, given the realities of our shrinking economies.

From a consumer's perspective, ICBT brings the benefit of lower prices of the informally imported products since they evade a lot of transaction costs. Some of the ICBT traders have establishments in the Cities (in Nairobi, for example, they can be located in Eastleigh residential estate) where they sell their products at more competitive prices compared to

same products purchased through formal channels and sold in supermarkets. **The low prices they offer have sometimes increased competitive pressure on firms operating in the formal sector;** in some cases, this has promoted price efficiency, especially, where the formal sector were initially raking in supernormal profits.

#### *Negative implications*

The fact that such important data as on ICBT misses from national statistics implies what has always been stated as GDP of EAC economies is often grossly underestimated. The consequences might actually be wrong perception about the real trade balances of these economies with each other, the trade benefits accruing to them from regional integration, and it might continue to give a wrong impression about the extent of the performance and direction of growth of regional trade in EAC since only formal trade statistics are used to make such judgments.

It is possible that as a result of the missing data on ICBT, EAC has been engaging in wrong policy prescriptions which might have led to some unintended negative impacts or unnecessary diversion of resources away from other important projects, thus impacting negatively the regional trade integration and development of EAC.

Contrary to the perceived benefits/advantages of ICBT, it is also true that formal firms are more productive than informal ones, due to scale and scope economies, access to capital and technology and more advanced methods of production and distribution. This suggests that significant productivity gains would be achieved in our economies by transferring production from low-productivity informal firms to more productive formal firms or by facilitating the formalisation of informal firms. In that case, thus, the unfair competition from ICBT players may have the long-run effect of reducing competition and as such may prevent the more productive formal firms from entering or expanding in the market. Therefore, because of the benefits associated with formalisation of businesses, formal firms may offer even lower prices in the long run if informality in business was eliminated. Thus, when assessing the benefits or harm to competition from ICBT, competition authorities should consider whether to focus their analysis on short-run or long-run competition concerns of ICBT.

A large informal sector could also deprive governments of needed tax revenue (such as VAT) which could have been reinvested into energy and infrastructure development, which are some of the critical priorities of EAC.

The study traced some of the ICBT practice involving some supermarkets in Kenya and, generally, big vendors of mainly electronics and telecommunication targets across the region. For instance, there were cases where these enterprises would import electronics and wrongly declare them as shoes; and, for some traders while they would correctly declare the nature of goods, it involved under-declaration of the quantities. These practices lead to massive tax evasion and unfair competition with other competitor traders who have paid taxes; it also denies the EAC economies huge revenues hence opportunity for increasing government expenditure that is a key component for economic growth.

The other negative effect of ICBT in EAC is that its mere existence breeds a culture of corruption among public administration officials, including traffic and border police force and Customs officials, who are seeking for economic rents from ICBT.

Further, ICBT may hinder further investments in local (formal) SMEs; these may include infant industries susceptible to ICBT competition, which constitute majority of the private sector in EAC and are key drivers of regional development. In addition, the incentive to innovate and invest (without effective intellectual property regime) could also be significantly reduced in an informal trading environment. Those who develop new products in the region are likely to gain from trading their products across the region through formal channels; otherwise, informal traders may ruin chances of such innovators ever recouping their investments in the innovation.

### **Conclusions**

There is no escaping from the fact that ICBT, as it evades trade tax, ICBT can limit possibilities of economic growth and development of EAC economies. It can create unhealthy competition with formal enterprises that have paid often punitive taxes and limit their growth potentials; this comes with a negative impact on the overall economy. However, it has also been observed that during economic downturn when formal private sector is shrinking and people are laid-off from employment, the informal sector provides an alternative source of employment. In some cases, many people select to engage in ICBT for lack of formal job opportunities; and to some others, entry into formal cross-border trade is often too restrictive.

Despite the perceived negative implications, this study has also established that it is mostly the formal firms that engage in ICBT and hurt the EAC economies more than small informal traders, which are basically survivalist enterprises. These formal have the know how to understand international trade rules better, and also know how to escape certain costs; they also have stronger economic power to deal in larger quantities than their small informal counterparts. The big formal firms engaging in ICBT are capable of ‘facilitating’ their way across borders through several informal ways, thus evade taxation and other regulatory measures and as a result deny governments massive revenue. **This point could also explain why it is mostly the names of small traders recurring in the Kenya Revenue Authority’s offence report (what is also known as C 52 book), because the big shots are able to bribe and get off their names from being recorded in the register to keep their public image untainted.** Yet, it is the same formal governments that are stigmatising and fighting the informal ones through the government.

While ICBT may provide short-term solution to a household’s livelihood needs, creating an economy with a higher proportion of formal enterprises and jobs is important to the long-term welfare creation, stability and poverty reduction. However, the fact that ICBT is still a reality in developed countries (countries that have existed for close to 300-400 years) should provide a reflection to the EAC region whether it thinks it can succeed in eradicating the practice or something else has to be done. While not refuting there could be effective ways to eradicate ICBT, the key issue to note is that where there are no policies or there are but hostile/strenuous countries policies to formal cross-border trade, a parallel ICBT will naturally emerge or strengthen.

Currently, there are many ICBT traders who do not know the essential basics of the EAC Customs Union Protocol and the opportunities and challenges it poses in their day-to-day. Traders exhibit no proper knowledge of Provisions such as a tariff-free environment (Articles 2 and 10), substantive tax reduction, trade liberalisation (Art 3-4), a standard system of valuation of goods based on principles of equity, uniformity and simplicity (Art 4), reduction of trade documentation and adoption of common standards of trade documentation and procedures (Art 6/7), non discrimination of goods/traders among EAC members (Art 15/21), enabling subsidies (Art 17/18), and, special economic arrangements Art 32).

Indeed, into the unforeseeable future, EAC should expect the practice of ICBT to continue growing. Although it may be difficult to eradicate ICBT, it does not help to stigmatise the practice and condemn it as an illegal or underground sector as some commentators have traditionally referred to it. Rather, the questions EAC ought to investigate through research and address are:

- a) What type of enabling environment is needed for ICBT, for example, in the context of how much can they be taxed without compromising compliance? What standards need to apply to them?
- b) Under what condition can the informal sector exist with the formal sector with little hurt to the economy?
- c) Are there any proven administrative measures that have managed to get informal sector to formal sector?

### ***Recommendations***

The informal economy is here to stay as an alternative to the shrinking formal sector; there is need to find them an enabling environment where it can coexist with the formal economy without hurting the economy. By creating such supportive environment for the informal traders across EAC, both EAC countries and informal cross-border traders stand to benefit more. To the EAC countries, it could be the start of a successful process of formalisation of the informal traders within EAC. Consequently, the EAC countries will be able to collect better information of the goods, values and quantities traded amongst them. Better information collected will improve the planning and decision-making of the EAC countries. In addition, the EAC countries will be able to increase revenue collection across borders to finance their national development as the need for traders to smuggle goods will have been reduced; and lastly, to the EAC countries, there will be more goods produced in the EAC countries, more employment and more people earning an income, thereby improving the standards of living in all the EAC countries.

Similarly, to the ICBT players, creating a conducive environment for their trade may mean better knowledge of the trader about their rights as they trade across the region, hence cases of paying bribes to border officials and smuggling goods across borders will be reduced. The trader will also benefit from payment of the correct amount of taxes (where taxes still apply) as opposed to the current case where, due to lack of information, they may be charged duties even on goods that are not supposed to attract any duties. Similarly, cases of harassment of traders and seizures and loss of goods will be reduced. Lastly, the cost and time of clearing the goods will be reduced resulting in lower prices of goods and higher earnings for the trader.

It will be important also for EAC countries to encourage and promote trade exhibitions involving informal traders across EAC borders.

Lastly, it should be recognised that if statistics is missing about informal sector then it will be difficult for the EAC governments to prescribe the sector suitable policies. The EAC countries should strive to have a common definition of what constitutes informal sector such that it can be well targeted with appropriate policies. There will be need for EAC governments to undertake an inventory of ICBT and set common thresholds for determining and classifying it otherwise the formal firms engaging in ICBT could easily be the biggest beneficiaries of any reforms that may be targeted at supporting the informal sector.

In all processes, it will be important to involve civil society organisations in formulating and implementing such policies that are supportive and beneficial to the growth and coexistence of ICBT in a formal economy. Involving them should be based on their ability to network, create awareness and encourage ICBT traders to reform their activities so that they may benefit from policy reforms. This should go along with the demystification of the term 'formalisation' to remove any negative connotations that may be currently labelled on it.

There is a need to undertake aggressive publicity and dissemination of the EAC Treaty, the CU Protocol, the Community's policies and other applicable laws and principles as provided for under Article 39 of the Protocol. There is also a need to educate government agencies on the CU Protocol including attitude change among customs officials and other border officials who continue to collect tax on duty-free goods and those seeking rent from ICBT, and monitor compliance.

ICBT is worldwide reality and requires official recognition including revising EAC CM to recognise it and provide it apt operational environment.

## Chapter 1: Introduction

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The East African Community (EAC) Partner States have a rich history of cross-border trade; a significant proportion of this trade is conducted informally. The term "informal cross-border trade" (ICBT) as used in this research refers to imports and exports of **legitimately** produced goods and services (i.e., **legal goods and services**), which directly or indirectly escape from the regulatory framework set by the government, and avoid certain taxes and regulatory measures, hence go unrecorded or incorrectly recorded into official national statistics of the importing or exporting countries.

ICBT is a special component of the informal economy; the overall informal economy constitutes a huge proportion of gross domestic product (GDP) of EAC economies (as discussed in Chapter two).

Traditionally, ICBT was considered a 'survivalist endeavour' worldwide and, therefore, it was always considered uneconomic for such traders to follow the official documentation formalities (Ndlela, 2006). In East Africa, specifically, up till now, physical and financial constraints being faced by the custom offices and border control points do not allow for efficient monitoring. Thus, ICBT has been ignored for a long time. However, as we will discuss in Chapter three; ICBT has not been ignored all together because it still remains an important activity for rent-seeking customs officials as well as police officers to the extent that these officers consider themselves fortunate to be posted at border control points; some go further to 'facilitate' their way to work at the border stations.

Unlike it was traditionally perceived, today ICBT involves both informal and formal firms (OECD, 2009) – small and big in size; their trade involves small as well as big consignments passed across official border crossing points (Peberdy 2002). The form of ICBT practiced by formal firms usually involves big consignments; small volumes that are frequently passed across the borders by informal firms and individuals also constitute significant quantities when added together; hence, it is important to consider the impact that ICBT may have on the economies of East Africa.

Since the launch of the EAC Customs Union (CU) in January 2005, some aspects of integration are taking place, especially, through official efforts aimed at strengthening of institutions and business environment to enhance formal cross-border trade interactions. However, these efforts are also prominent by their glaring lack of recognition of informal cross-border traders or measures to keep track of informal trading. Indeed, several studies conducted indicate that informal contacts strengthen regional integration, networks and relationships (Mwaniki, 2004). Yet, notwithstanding the efforts being made to promote trade integration among EAC Partner States, formal trade links is still faced with several constraints; the more or persistent these constraints remain, the more incentives there are for a parallel informal trade to grow. For this reason, informal cross-EAC trade continues to grow.

Further, while it may be relatively easy to eliminate constraints of formal trading, mere elimination of neither provides a sufficient condition for growth of formal cross-border trade nor incentives for traders who are already in the informal sector to turn to formal trading. According to Meagher (1997), ICBT simply reflects longstanding indigenous pattern of trade that makes more sense than formal trade channels. ICBT is not necessarily incentivised by the constraints facing formal trading; rather, the tendency to stick to ICBT should be understood simply as an old practice that is difficult to leave and its entrenchment today is simply a re-establishment of the extensive barter trade and migration of people that were a feature of economic and social life before colonisation. At that time people traded freely across borders and many still prefer the old way. In fact, those who are in ICBT prefer to continue trading, largely, the same way and they perceive formal integration being promoted under the evolving Customs Union and Common Market Protocols as an interference and a threat to their livelihoods (UNECA, 2009).

The stark reality is: No country is without an informal economy and the same goes for ICBT; differences are only in the degree and form, otherwise, developed countries that have been in existence for over two hundred years would not be having a share of informality in their economies. Therefore, if informal economy is here to stay, then ICBT will continue as its important sub-set, it is important that we assess its likely impact on EAC regional integration and development, especially, bearing in mind that much as ICBT denies government of revenues which could be invested productively, it is also an important source of employment and income generation for many poor people trying to eke out a living where formal jobs are shrinking.

## 1.1 Study Problem

Since ICBT players evade trade tax, an important source of domestic revenue for most EAC economies, ICBT can limit possibilities of economic growth and development of EAC economies. More importantly, ICBT can create unhealthy competition with those formal enterprises that have often paid punitive taxes hence contribute to limit their growth which can result into an overall decline in economic growth through lost employment and tax revenues. For that reason, both government and formal private sector players have sometimes conspired to cut down to size the informal sector.

However, it has been observed, particularly ever since the onset of structural adjustment programmes (SAPs), that during economic downturn when formal private sector lays-off its employees, it is the informal sector that provides an alternative source of employment. It might be that many people select to engage in ICBT because formal cross-border trade is too restrictive with respect to their socio-economic circumstances, especially, of peasant traders.

Unsurprisingly, it might be that formal firms engaged in ICBT, those that transact big volumes and high valued goods and services are even hurting EAC economies more compared to the many small informal firms and individual business people trying to eke a living out of ICBT to realise such rights as to food, shelter, education, clothing and health where government has failed to meet such obligations.

The fact that such important data on ICBT misses from national statistics might imply the stated GDP of EAC economies are often grossly underestimated. Such missing data might also lead to wrong perception about the real trade balances of these economies and might give a wrong impression regarding the extent and direction of growth of regional trade and benefits accruing to EAC Partner States since only formal trade statistics are used to make such judgments. Consequently, this can lead to wrong policy prescriptions which might lead to unintended negative impacts or unnecessary diversion of resources away from other important projects, thus impacting negatively the regional trade integration and development of EAC.

## 1.2 Objective

This study seeks to assess the implications of informal cross-border trade on regional integration and development of EAC economies and suggest policy recommendations on what must be done for beneficial coexistence of both informal and formal cross-border trade that will likely promote the desired goals of regional trade integration and development of EAC economies.

Consequently, the paper seeks to specifically address the following questions and policy issues, which are also its terms of reference:

- a) How important is informal cross-border trade in the EAC?
- b) How does ICBT affect EAC regional trade integration, specifically, the goals of increasing production, trade, and investment prized to steer development?
- c) What is the nature of the linkage between ICBT and formal trade in EAC?
- d) What policy measures should EAC put in place to expand their formal trading relationship or encourage traders to switch from ICBT to formal trading?

## 1.3 Analytical Methodology

For the purpose of clarity, the term "informal cross-border trade" is used in this research to refer to imports and exports of legitimately produced goods and services (i.e., legal goods and services), which directly or indirectly escape from the regulatory framework set by the government, and avoid certain tax and regulatory measures, hence go unrecorded or incorrectly recorded into official national statistics of the importing or exporting countries.

In order to realise the stated objective of this research, the paper;

- a) discusses the nature, status, features of ICBT to EAC;
- b) assesses the importance of ICBT to EAC by comparing its ratio with the total inter-EAC trade of EAC economies and GDP of these economies;
- c) discusses the nature of linkage between formal CBT and ICBT;
- d) analyses the push and pull factors that encourage growth of ICBT and their likely implications for increasing regional trade, production and investment;
- e) discusses the measures that could help address challenges (or promote benefits where a case can be identified) of ICBT; and, finally; and
- f) the paper uses the above information to assess the range of measures that could help lower the incidence of informal cross-border trade, especially if it can be

determined that the advantages of ICBT on poverty and livelihood confers less benefits compared to the disadvantages it causes on regional and economic growth.

The methodology adopted in undertaking this study is basically that of an in-depth review and analysis of existing studies and surveys, and where necessary, conducting targeted interviews with key stakeholders at selected border-points and expert inputs and opinions collected from presentation of this paper. The final product is then to be disseminated to the wider group of stakeholders to use it in their advocacy campaigns to influence appropriate policy directions in EAC.

## Chapter 2: Understanding the Informal Sector and State of ICBT in EAC

### 2.1 Nature and Magnitude of Informal Economy in EAC

There is no universally accepted definition of the informal sector. Many definitions have been offered that refer to this sector as unofficial, underground, hidden, invisible, shadow, parallel, second, unregulated, unrecorded, black, moonlighting, unmeasured and unobserved economy. Yet, there is no economy in the world without the informal sector.

In many developing countries, the informal economy represents the largest share of GDP compared to developed countries. In Africa and Latin America, for instance, it represents about 43 percent of official GDP, almost equivalent to the formal sector, compared to just about 16 percent in OECD countries; and, in Central and Eastern European countries, it constitutes approximately 40 percent (Table 1).

Although we don't have the exact recent measure of the informal economy anywhere in the world, due to complexities that defy measurability, but, as was observed by Schneider, this sector has been growing by an annual average of one percentage over the last decade in Africa.

Table 1: Average Size of the Informal Sector as a Percentage of GDP					
	Africa	Central and South America	Asia	Central and Eastern Europe and former USSR	OECD
(in percent)					
<b>1999-2000</b>	41.3	41.1	28.5	38.1	16.8
<b>2001-2002</b>	42.3	42.2	29.5	39.1	16.7
<b>2002-2003</b>	43.2	43.4	30.4	40.1	16.3
<i>Source: Schneider, 2002</i>					
<i>Note: The data pertains to 37 African countries, 28 Asian countries, 21 Central and South American countries, 25 Central and Eastern European Countries and former Soviet Union countries, and 21 OECD countries.</i>					

The informal economy in EAC, as with the rest of African countries, largely correspond to the micro, small and medium-scale enterprises (MSMEs) that are seen as semi-organised and un-regulated. In Kenya, these enterprises are responsible for employment of 7.5 million people or 80 percent of the country's total employment outside small-scale agriculture.

But players in the informal economy are not necessarily small businesses. Actually, the informal economy is composed of small and big players both from formal firms and informal firms. They range from professional consultants (such as lawyers, doctors, accountants and engineers), to fruit and vegetable vendors, public transport operators, food kiosks, hair-dressers/barbers, *jua-kali* manufacturers of all sorts of goods including artisans like

tinsmiths, ironmongers and blacksmiths; shoe shiners, miraa dealers, open air photographers, hawkers of all sorts of wares, painters, engravers, graphics and designers, carpenters, massage parlours, saloons and sand harvesters. Thus, informal sector participation has not only been linked with junior public and private sector employees – seeking for additional income to their salaries, but also with corporate executives; hence, it has developed as a means of extension of formal businesses.

At the same time, there are big formal firms which prefer to remain small but keep several branches of the same business (registered under different names and ownership) so that they can hide in the informal economy. They know that it is economically worthless for the taxman to track and arrest small businesses given the human resource and financial constraints of tax authorities; when, in fact, their intention is simply to evade certain taxation measures and regulations meant for big formal businesses – their basic aim is to maximise supernormal profits.

But the informal economy may also be characterised by simple labour intensive technology; may or may not have licenses from authorities and are not registered with the registrar of companies; ease of entry; small-scale nature of the activities; self-employment with a high proportion of family workers and apprentices; little capital and equipment; labour intensive technology; low skills; low level of organisation with little access to organised markets; unregulated and competitive markets; less formal credit; low education and training; cheap provision of goods and services; low productivity and low incomes; and lastly, most of the transactions are conducted mainly on cash basis, with very little or none through banks.

In addition, entrepreneurs in the informal sector, especially the small survivalist enterprises, depict a quick shift from one business to the next. Most of them have little tied capital and move from one economic activity to another quite rapidly depending on the changing profit margins of the businesses. **For example, if selling tomatoes today is more profitable than green maize yesterday, they would rather sell tomatoes.** It is therefore impractical for any authorities to require that such enterprises undergo formal registration.

## 2.2 State of Informal-Cross Border Trade in EAC

Several surveys (Ackello-Ogutu and Echessah 1997; UBOS and BOU, 2005, 2006, 2007; Little 2007; Mauyo et al, 2007; Regina, 2009; ReSAKSS, 2009; Evarist et al, 2009; ASARECA, Mwaniki, 2004) have tried to establish the profile, quantum and impact of ICBT and factors that drive its growth in EAC. Others (Masheti, 2009; and UNECA, 2009) have delved into analysing its gender dimensions; and some others (OECD, 2009) have been concerned with the reform measures to encourage ICBT participants to shift to formal platform. However, it is difficult to get an accurate picture of the extent of informal cross-border trade in EAC (and elsewhere) due to the lack of consistent measurement tools and reliable estimates on the subject.

Most ICBT surveys have been "one-off studies" or "snap shot surveys" concerned only with goods transported by land across borders and not those transported by air or sea, and/or ICBT taking place across remote porous border points which are not manned by police nor are the official crossing points with customs offices.

Furthermore, most of the surveys often use differing definitions of —"informal cross-border trade" and diverse monitoring methodologies (due to their different final objectives), which lead to data discrepancies and difficulties in comparing and aggregating data. What is needed is a systematic attempt, using universally accepted definitions and methodologies, to comprehensively monitor ICBT practices in the entire region, covering all products, all borders and all forms of transportation. Although such would be a very time-consuming and costly exercise, it would be worth every penny spent for the sake of prescribing appropriate policies. But, because such an exercise is yet to be undertaken by any researchers, figures included in this paper on the magnitude of ICBT should be interpreted with caution as rough approximations borrowed from inconsistent studies, subject to margins of error. Nonetheless, independently of the methodology used, all reviewed surveys in this paper suggest that informal cross-border trade still represents a significant proportion of regional cross-border trade in EAC.

In order to assess the extent of ICBT in EAC, let us first take a look at table 2 and consider the inter-EAC trade developments since the coming into force of the Customs Union in 2005. With this picture, we can then compare with data on ICBT in order to appreciate the likely implications on regional trade.

Table 2: Intra-EAC Trade (in USmn)										
	Kenya		Tanzania		Uganda		Burundi		Rwanda	
Trading Partner	2006	2008	2006	2008	2006	2008	2006	2008	2006	2008
To KNY			97.2	188.6	88.0	164.6	1.2	1.5	29.9	32.0
From KEN			169.1	198.0	401.0	511.3	35.4	30.3	69.4	173.0
<b>Balance</b>			<b>-71.9</b>	<b>-9.4</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-39.5</b>	<b>-</b>
					<b>313.0</b>	<b>346.7</b>	<b>34.3</b>	<b>28.8</b>		<b>141.0</b>
To TZA	253.6	422.4			13.7	30.5	0.0	0.0	0.9	1.1
From TZA	62.6	105.0			28.7	55.5	7.6	16.8	8.3	47.3
<b>Balance</b>	<b>191.0</b>	<b>317.4</b>			<b>-15.0</b>	<b>-25.0</b>	<b>-7.6</b>	<b>-</b>	<b>-7.4</b>	<b>-46.2</b>
							<b>16.8</b>			
To UGA	385.7	611.2	20.5	36.5			1.2	1.6	1.9	6.9
From UGA	13.9	75.5	5.3	6.6			16.9	34.5	61.6	167.9
<b>Balance</b>	<b>371.8</b>	<b>535.8</b>	<b>15.2</b>	<b>29.9</b>			<b>-</b>	<b>-</b>	<b>-59.8</b>	<b>-</b>
							<b>15.7</b>	<b>32.9</b>		<b>161.0</b>
To BUR	30.3	50.3	31.0	15.0	20.6	45.4			0.4	6.2
From BUR	4.7	1.1	1.0	0.4	0.2	0.9			4.0	6.0
<b>Balance</b>	<b>25.6</b>	<b>49.2</b>	<b>30.0</b>	<b>14.6</b>	<b>20.4</b>	<b>44.5</b>			<b>3.7</b>	<b>-0.2</b>
To RWA	66.1	129.4	9.1	19.8	30.5	136.9	3.1	3.5		
From	2.9	0.4	0.1	0.0	0.5	2.9	1.0	3.1		

RWA										
<b>Balance</b>	<b>63.2</b>	<b>129.1</b>	<b>9.0</b>	<b>19.8</b>	<b>30.0</b>	<b>134.0</b>	<b>2.1</b>	<b>0.4</b>		
<b>To EAC</b>	735.8	1213.4	157.8	259.9	152.8	377.4	5.5	6.6	33.0	46.2
From EAC	84.1	182.0	175.5	205.0	430.4	570.6	60.9	84.7	143.4	394.2
<b>Balance with EAC</b>	<b>651.6</b>	<b>1031.4</b>	<b>-17.7</b>	<b>54.9</b>	-	-	-	-	-	-
					<b>277.6</b>	<b>193.2</b>	<b>55.5</b>	<b>78.1</b>	<b>110.4</b>	<b>348.0</b>
<i>Source: EAC Secretariat, 2009</i>										

Table 1 tells us several things. If we consider the initial three EAC Partner States, we see that each of them has had an overall growing positive trade balance with the region between 2006, one year after coming into force of the Customs Union, and 2008. But, specifically, Uganda has been a net importer both from Kenya and Tanzania. However, Uganda's positive trade balance with the region is as a result of its positive trade with both Rwanda and Burundi. We also see that a year after joining the EAC Customs Union, the three initial EAC Partner States have increased their exports into the two countries, with most exports into the two countries coming from Kenya and Uganda. Except for Uganda, imports of Kenya and Tanzania from Burundi and Rwanda have fallen in 2008 compared to their levels before joining the EAC CU. The trade balance between Rwanda and Burundi has slipped into a deficit and while trade balance between Burundi and Rwanda remains positive, it can be seen that it can be seen that the change is a negative one in 2008 compared to the level in 2006.

As compared to other member countries, Tanzania exports much of its produces to Kenya (US\$188.6mn by 2008); imports much as well from Kenya (US\$198.0mn). In both years, over 96 percent of Tanzania's inter-EAC imports and exports came from and went to Kenya. With respect to Rwanda's inter-EAC exports in 2008, about 70 percent went to Kenya compared to 44 percent and 43 percent of its inter-EAC imports coming from Kenya and Uganda respectively.

Table 2 above also shows that Kenya exports most of its products to Uganda followed by Tanzania and most of its imports are from Tanzania. The rates of trade between Kenya and Burundi and Rwanda are still low, but we see a dramatic increase of more than a 100 percent in 2008 of its exports to Rwanda from the levels in 2006. Overall, both Burundi and Rwanda have experienced increased inter-EAC trade in 2008.

According to Table 2, Uganda maintains an increasing trade deficit with Kenya. However, according to ICBT statistics provided by Uganda Bureau of Statistics (table 3), Uganda has been keeping a positive trade balance with Kenya. Similarly, while official flows from Uganda to Kenya, Tanzania and Rwanda indicate an amount of US\$132.2mn in 2006, the data on ICBT trade that is not recorded in the official national statistics shows that Uganda informally exported to the three countries goods worth US\$143.4mn, which is more than the official flows by eight percent. If the two sets of data were added together, Uganda would record exports to the three countries amounting to US\$275.6mn compared to just US\$152.8mn indicated as its total inter-EAC exports. One therefore sees that the official flows fall short by more than 80 percent of what should be Uganda's inter-EAC exports.

Table 3 also shows that the informal exports flowing from Uganda to its five neighbouring countries – Kenya, Rwanda and Tanzania (EAC), Democratic Republic of Congo, and Sudan – amounted to an estimated US\$231.7mn in 2006, corresponding to around 86 percent of official export flows to these countries over the same period, or 46 percent of total (i.e., formal and informal) export flows to these countries.

<b>Table 3: Extent of ICBT between Uganda and its Neighbours (in thousand US\$)</b>									
Trading Partner	Exports			Imports			Net Balance		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Kenya	107,042	96,882	86,013	44,214	63,880	7,037	62,828	33,002	78,976
Rwanda	7,340	25,046	39,104	681	694	405	6,659	24,352	38,699
Tanzania	2,842	21,518	38,486	607	4,255	2,886	2,235	17,263	35,600
<b>Subtotal – EAC</b>	<b>117,224</b>	<b>143,446</b>	<b>163,603</b>	<b>45,502</b>	<b>68,829</b>	<b>10,328</b>	<b>71,722</b>	<b>57,354</b>	<b>153,275</b>
DRC	73,964	80,453	156,534	19,550	11,288	18,242	54,414	69,165	138,292
Sudan	9,119	7,842	456,373	820	517	8,669	8,299	7,325	447,704
<b>Subtotal</b>	<b>83,083</b>	<b>88,295</b>	<b>612,907</b>	<b>20,370</b>	<b>11,805</b>	<b>26,911</b>	<b>62,713</b>	<b>76,490</b>	<b>585,996</b>
<b>Total ICBT</b>	<b>200,307</b>	<b>231,741</b>	<b>776,510</b>	<b>65,872</b>	<b>80,634</b>	<b>37,239</b>	<b>134,435</b>	<b>133,844</b>	<b>739,271</b>
<b>Total formal CBT</b>		<b>268,842</b>			<b>430,366</b>			<b>-161,524</b>	
<b>TOTAL</b>		<b>500,583</b>			<b>510,999</b>			<b>-10,416</b>	
<b>Share ICBT vs. Formal trade</b>		<b>46% Vs. 54%</b>			<b>16% Vs. 84%</b>				

*Source: Author's computation from Uganda Bureau of Statistics' Surveys (2005, 2006 and 2007)*

On the other hand, informal imports were estimated at US\$80.6mn, corresponding to approximately 19 percent of official flows from these countries or 16 percent of total imports (formal and informal) from these countries. But, what is more important to note is the finding that these ICBT values represented an increase compared to 2005 informal trade flows. Informal exports flows from Uganda to Rwanda and Tanzania, in particular, have experienced the most important steady annual growth over the past three years between 2005 and 2007.

### 2.2.1 Comparing ICBT between Uganda and EAC Counterparts

The UBS surveys done in 2005, 2006 and 2007 are the most comprehensive surveys that have attempted to unravel the quantum of ICBT in the EAC for most number of goods than any other recent study. The surveys found that 25 percent of petroleum fuel (petrol, diesel and paraffin) consumed in Uganda is smuggled from Kenya, costing the Ugandan government about US\$1.2mn annually in lost tax revenue (Ackello-Ogut, 1996).

### ***ICBT between Uganda and Kenya***

- Agricultural commodities are the leading informal exports to Kenya estimated at 65.4 percent of total ICBT and worth estimated at US\$56.2mn, followed by industrial/manufactured products valued at US\$29.6mn and other products valued at US\$0.2mn.
- The **main agricultural commodities according to rank during 2007 are maize, fish, beans, ground nuts, and bananas**, while, the main **manufactured are Shoes (both second hand and new), clothes and petroleum jelly**.
- During 2007, the amount of maize grains informally exported to Kenya fell from 123,173 tonnes in 2006 (worth US\$19.6mn) to 58,212 tonnes in 2007 (valued at US\$10.3mn). This significant reduction in the quantity of maize grains exported to Kenya could be attributed to the high domestic and regional demand after the floods which devastated the northern part of Uganda and the food scarcity in South Sudan where maize flour was among the food items exported to these regions.
- The fact that agricultural commodities informally exported to Kenya were mainly food stuffs highlights the interstate dependence of regional states during food scarcity.
- Meanwhile, the leading agricultural ICBT imports during 2007 were **coffee (unprocessed), rice, potatoes (Irish), and peas** with values estimated at US\$2.5mn in 2007. There was a general reduction on informal imports bill on these products compared to 2006. For instance, the amount of rice was estimated at US\$3.4mn in 2006, but drastically fell to US\$0.80mn in 2007 due to reduction in its exports to avert food crisis in Kenya.
- With regard to manufactured/industrial ICBT imports, polythene bags remained as the main product although its value reduced remarkably from US\$25.6mn in 2006 to US\$5.6mn in 2007, which could be **attributed to the Ugandan government policy that limited the importation of polythene bags of less than 30 microns**. Other commodities that featured highly among the main industrial ICBT imports to Uganda were **clothes (new and second hand), cooking oil and sugar**.

### ***ICBT between Uganda and Tanzania***

- The main ICBT exports to Tanzania has been rising from US\$2.8mn in 2005 to US\$21.5mn in 2006 and then to US\$38.5mn in 2007. **Agricultural products take the lead and they include beans, maize and bananas** whose total value was estimated at US\$3mn.
- The major industrial ICBT exports to Tanzania comprised of clothes (second hand and new), human medicine, polythene bags and shoes estimated at US\$5.6mn, US\$5.3mn, US\$5.0mn, US\$4.5mn, and US\$4.0mn respectively thus totalling US\$24.4mn. The other industrial products exported were Match boxes, alcohol/spirits, maize flour and boutiques.
- Similarly, informal imports have increased from US\$0.6mn in 2005 to US\$4.3mn in 2006 and then dropped to US\$2.9mn in 2007. In 2007, **major imported agricultural products from Tanzania were beans, unprocessed coffee, fish, and rice** with a total value stood of US\$1.4mn.
- Major industrial products informally imported were medicine, cooking oil, ghee and sugar estimated at US\$0.2mn, US\$0.1mn, US\$0.1mn and US\$0.08mn respectively.

### **ICBT between Uganda and Rwanda**

- As with the rest, ICBT between Uganda and Rwanda has continued to increase from US\$7.3mn in 2005, US\$25.0mn in 2006 and then to US\$39.1mn in 2007. The trend suggests that ICBT between Uganda and Rwanda is likely to increase following the entry of Rwanda into the EAC regional bloc.
- Major informal agricultural exports from Uganda were **maize grain, beans, bananas and sorghum** estimated at a total of US\$9.7mn.
- On the other hand, the **major industrial products exported to Rwanda were maize flour, shoes and clothes** which accounted for US\$7.8mn, US\$6.6mn and US\$5.0mn in 2007 respectively.
- Uganda’s **informal agricultural imports from Rwanda were peas, passion fruits, avocados** estimated at a total of US\$0.07mn, US\$0.07mn and US\$0.18mn, while the overall informal import bill on industrial products from Rwanda was valued at US\$0.09mn in 2007 compared to an estimated value of 0.70 million in 2006.

## **2.3 Key Characteristics of ICBT in EAC**

### **2.3.1 Nature of Informality**

As we saw in the previous section, participants in ICBT are both from informal and formal firms. Those from the informal firms operate entirely outside the formal economy, and those from formal firms are fully evading trade-related regulations and duties by avoiding official border crossing posts and passing their commodities through “unofficial routes”. In other instances, they may partially evade trade-related regulations and duties even as they pass their goods through official routes that have border crossing points and customs offices yet involve in illegal practices such as **under-invoicing** (i.e., reporting a lower quantity, weight or value of goods so as to pay lower import tariffs), **misclassification** (i.e., falsifying the description of products so that they are misclassified as products subject to lower tariffs), **mis-declaration** of country of origin, and/or **bribery of customs officials** (see table 4).

<b>Table 4. Types of Informal Cross-border Trade</b>		
<b>Category A</b>	<b>Category B</b>	<b>Category C</b>
<b>Informal (unregistered) traders or firms operating entirely outside the formal economy</b>	Formal (registered) firms fully evading trade-related regulations and duties (e.g., avoiding official border crossing posts).	Formal (registered) firms partially evading trade-related regulations and duties by resorting to illegal practices (e.g., under-invoicing).
<i>Source: OECD, 2009</i>		

### **2.3.2 Education, Age and Gender**

Recently, it has been observed that most ICBT traders fall between the age of 25 and 39 and have had some secondary education (Peberdy, 2002; Little, 2007; COMESA, 2007; and UNECA, 2009). An important share of ICBT traders are *female traders* for whom profits from informal trade often constitute the sole source of earnings and economic empowerment. According to the UNECA (2009) survey, 44.2 percent of the women engaged in ICBT fall

within the age bracket of 20-40 years and have completed secondary education – specifically, the majority are in their 30s and 40s; those with professional/semi-professional diploma and certificate constitute around 25.8 percent, while those with degree constitute 10 percent. As we realise from these studies, although most ICBT participants have completed secondary education and more, the number of those with professional/semi-professional diploma and certificate and degrees is rising by year.

### 2.3.3 Type of Goods

Interestingly, informal cross-border trade in East Africa almost concerns all types of goods (i.e., agricultural and manufactured). An important proportion of the informal flows concerns *staple food commodities* such as maize, beans, rice, fish, groundnuts, bananas, and even food aid that have a direct impact on regional food security. They also concern *low quality consumer goods* such as shoes, clothes, textile, medicine and vehicle and bicycle parts (Ackello-Ogutu, 1996 and UBS, 2007); and, one can see that nearly all the goods involved in ICBT are the same as those that are usually recorded in the formal regional trade statistics. In fact, some of the ICBT goods reflect the same ones that benefit from export promotion schemes, such as textiles.

### 2.3.4 Awareness of Cross-border Trade Regulations

A remarkable fact about ICBT participants is that many of them are well aware of various provisions of the customs union at least in general terms including most of the regulatory requirements. However, they attribute their continued engagement in ICBT to the presence of physical and technical barriers that formal traders are exposed to (EAC, 2008); others remain in it because they have no other alternative to survive out of their poor socio-economic circumstances.

### 2.3.5 Transport and Storage Facilities/Capacity

The long distance wholesalers are the major participants in ICBT. As soon as they reach the border towns, they divide their goods into smaller quantities and involve different modes of transport to carry them across the border, depending on convenience and volume. **The main modes of transport used include: vehicles, bicycles, head/hand, motorcycles, wheel chairs, animals (donkeys), push carts, boats/canoe etc.** The people with disabilities in wheel chairs often come in handy, especially, to help for move across the border some small/light but valuable industrial products such as sugar, salt, soap cooking oil and plastics.

### 2.3.6 Size of Consignments

ICBT flows usually consist of small quantities. Because of the small volumes per transaction, it is usually uneconomic for such traders to follow the official documentation formalities (B Ndlela, 2006), even though a significant amount are passed through the official crossing points (Peberdy 2002). However, since this is done repeatedly, the quantities passed across the border end up being significant. But, ICBT is not only conducted in small quantities. Big consignments are also usually divided into smaller quantities to avoid attention when passing across borders or if the whole lot is passed through, they are either under-invoiced or misclassified, or mis-declared. Once goods have crossed the border through the various informal means, they are piled-up in stores which are jointly hired, especially, by

wholesalers. The stocks are accumulated to a reasonable volume in these stores for a week or more and the traders again team up to hire Lorries to transport them to various destinations in the importing country.

### Chapter 3:

## Push and Pull Factors Influencing ICBT in EAC

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According to Perry et al. (2007), the **level of corruption** in the country and the **rigidity of labour regulations** (e.g., ability to hire and fire workers) are positively correlated with the incidence of informality. Similarly, **increased taxation, social security contributions and (labour market) regulations** are important drivers of informality (Schneider, 2006). With regard to ICBT, Hernando De Soto (2000) sees its growth as representing a normal market response to **overly cumbersome, rigid, time-consuming and inefficient bureaucratic export/import procedures and regulations**; these factors can significantly increase the cost of both joining the formal economy and operating within it.

However, the literature explanations above fall short of providing an understanding of the origin of informal trade, in the first instance. In EAC, many cross-border markets pre-date colonial and post-colonial state boundaries when there were no cross-border procedures to be followed. Hence, what continues today as **ICBT could simply reflect the longstanding indigenous patterns of trade that make more sense than formal trade channels** (Meagher 1997). **The tendency to stick to ICBT should therefore be understood simply as an old practice that cannot be expected to die out easily.** In this perspective, ICBT is not significantly influenced by the high transaction costs or rigidity and bureaucratic customs procedures; rather, **its entrenchment is simply a re-establishment of the extensive barter trade and migration of people that were a feature of economic and social life predating colonisation in EAC.** Then, people traded freely across borders and many still prefer that old way. The UNECA (2009) study analysing the gender dimension of cross-border trade in EAC finds that the women involved in ICBT **prefer to continue trading, largely, the same way as they have done for many decades gone by**; these traders show little evidence of knowledge of the EAC Customs Protocol. In actual fact, **they are less motivated to know how the Protocol can benefit them** and they perceive the opening up of trade under the evolving EAC Customs Union Protocol and promotion of formality as an interference and threat to their livelihoods.

Other studies (Meagher, 1997; Peberdy 2000; Little 2001; Meagher 2003; and Matorova, 2008), however, concur that the main push factors towards ICBT are to be based on the **lack of formal employment fuelled by inappropriate economic reforms** (such as structural adjustment programmes, SAPs), **rising rural-urban migration in search of often non-existent employment**, and, **low wages from the formal employment pushing people to look for other ways to supplement their incomes.** According to these studies, **the recent rise of the informal sector, and growth of ICBT, is mainly a structural backfire to the market liberalisation policies** of the 1980s and 1990s; it is an indictment on the SAP policies which prematurely exposed EAC economies to unfair external competition and also reduced the government interventionist policy spaces and as thus ended up creating more poverty and unemployment than they were meant to create them. There is no need to explain the fact that poverty and unemployment would inevitably push people to the search for alternative sources of income, and ICBT is one such alternative. Meagher (2003:57) concludes that for many parts of Africa **the overall effect of SAP has resulted in a significant**

**expansion of informal cross-border trade** and that, today, the informal sector is responsible for a majority of jobs created annually.

The literature on informal economy abounds with several reasons explaining its continued existence and growth in EAC. To surmise this analysis, we can say that there is no one cause for growth of ICBT; rather, an array of factors has conspired either as incentives that pull traders or as problems that push them to engage in ICBT. In the context of EAC, some of these factors are discussed here under.

**The informal cross-border traders, especially small-scale traders, have little knowledge of the benefits of trading within EAC;** they also have inadequate information on the existing trading opportunities. This is exacerbated by there being no simplified written rules that the traders could refer to; if at all, the available information is not in a reader-friendly format – they exist only as legal texts such as protocols. It is therefore, difficult for the traders, especially given their near-nil technical knowledge, to know their benefits and rights when trading within EAC. This has resulted into situations where customs officers exploit the traders’ ignorance by, for instance, demanding duties on goods that are not supposed to attract duties.

Generally, the rise in transaction costs deriving from requirements of compliance with formal trading procedures is significantly high relative to the profit margins of the small-traders – considering they don’t enjoy economies of scale as their large formal counterparts. For instance, the requirements and process in registering business and complying with import-export regulations is excessively burdensome; naturally, this plays a role in attracting many traders into the informal trade. Such costs have been estimated to even constitute as high as 15 percent of the total trade transaction value (OECD, 2002). Some of the activities responsible for escalating the transactions costs are presented in Table 5.

<b>Table 4: Activities Contributing to High Trade Transactions Costs</b>	
<b>Direct costs</b>	<b>Indirect costs</b>
Complete and supply documents to the relevant authorities (e.g., customs declaration, certificate of origin, phyto-sanitary certificate, bill of lading etc.)	Long delays at the border in clearing goods causing depreciation costs (e.g., due to spoilage of perishable food products).
Payment of border agency fees and charges (e.g., administrative and inspection fees, license fees, consular fees, terminal handling charges, etc.)	Unreliable customs clearance and arbitrary application of regulations, leading to lack of predictability in the trading environment
Compliance with other formalities which bear additional expenses (e.g., conformity assessments with technical regulations, insurance, pre-shipment inspections, customs brokers, etc.)	Loss of business and foreign investment opportunities (e.g., for goods that need to be delivered just-in-time), leading to loss of international competitiveness
Transportation and storage costs	
<i>Source: OECD, 2002</i>	

The experience of most small traders is that when they follow the formal channels of trade, their costs of transactions rise significantly, especially, given little scale economies as they deal in small quantities of goods. It is generally difficult, for instance, for the small traders to acquire certificates of origin which are issued away from the border stations yet their businesses are stationed at these borders. Hence, some of them would rather take shortcuts than spend time and resources looking for these certificates. A small informal trader could be dealing in tomatoes today, if they are in high demand and the next day in wheat or maize depending of the how demands for these products swing across borders. They could also have a mix of several different classes of goods in very small quantities. Given this nature of trade, it is not economically practical for them to acquire all the necessary documents, such as business registration and obtaining certificates of origin, for each of the products they deal in.

Due to the long delays at the border before goods can be cleared, not only does this lead to depreciation costs, but traders are also forced to spend unplanned nights as they await clearance of their goods, this can take several days depending on the nature of the good being cleared. This raises fears, especially, for women traders with regards to their own security as there are also no safe affordable accommodation provisions at the border towns. It also exposes their goods to robbery or they are compelled to incur additional cost of hiring a security person to guard against such. As a result, some traders have opted for informal ways of importing goods if that may help them avoid the costs associated with delayed clearance at the borders.

Related to the above point is the finding that the slow process of clearance of goods at the border may be a deliberate practice to obtain economic rent/bribe ('facilitation payments') from traders who naturally would want their clearance to be expedited. Under such cases, a trader may be allowed to pass without undergoing full checks as may be required. Traders are, therefore, attuned to this corrupt culture and they engage in informal trade with justified confidence.

It is worth noting also that such corrupt deals involve mostly the formal firms (described in category B and C under section 2.3 of this study) that engage in ICBT and their practice could be hurting the EAC economies more than is perceived of small informal traders. The formal enterprises engaging in ICBT are well endowed with better education and so they understand international trade rules better than their small informal counterparts which are merely survivalist enterprises; they also have stronger economic might to be able deal in larger quantities than small-scale ICBTs; and, because of their stronger economic might they are also able to afford 'facilitating' their way across borders through several informal ways, thus evade taxation and other regulatory measures.

Other push and pull factors explaining the continued existence and growth of ICBT in EAC are embodied in the fact that it is generally easy to enter ICBT than to follow the long bureaucratic process involved in formal business. Besides, certain ICBT activities are more profitable and viable only to small businesses.

The increasing growth of ICBT was also established to be connected positively to the weakness of economies of EAC. The relapse of the formal sector employment, traced mainly to the advent of structural adjustment programmes (SAPs), has seen the informal sector grow by absorbing the labour force being laid-off from the modern private sector, especially, over the last two decades when EAC economies have been experiencing economic downturn. Retrenchments, low pay in formal jobs, inflation and currency devaluations are also factors that have created pressures on real wages and search for informal income supplements.

The increase in rural-urban migration in search of often non-existent employment was also established to be playing a role in the growth of the informal sector as a viable alternative source of employment.

Another factor that was established by the study is that individual traders and businesses that are not registered at all and escape domestic taxes and regulations are most likely to conduct trade informally since most of their operations (whether domestic or international) are informal.

Poor infrastructure at the official border posts also emerged as a factor that increases costs of trade and may sometimes push traders to unofficial trade in order to avoid further incurring costs of clearance at the border-crossing posts.

Difficulties in getting entry permits into neighbouring countries when cross borders also emerged as contributing factor to informal cross-border trade. At the time of this study, Burundians paid exorbitant costs (between US\$50-200) for visa to Tanzania. In this case, some traders from Burundi have been pushed to engage in ICBT with Tanzania in order to avoid such high costs. The 90 days permit was also said to provide a short provision for traders, some of whom are not able to arrange proper documents to obtain a passport.

Non-recognition of one Partner State's trade documents by customs officials of another Partner State, especially where documents have not been harmonised contributes to increasing costs of following the formal trade channels.

Lack of proper education on the part of traders was also established to make traders timid of seeking the necessary information on how they could benefit from available opportunities of the EAC Customs Union, hence, such traders would rather engage in informal cross-border trade.

Changes in the fiscal policy also had an influence on the scale of ICBT. For example, according to the UBS (2007) study, the decline in informal imports from Kenya was seen to be occasioned by a ban on imports of polythene bags which dominated the informal imports sector in the previous years. Similarly, appreciation of the Kenyan shilling relative to other EAC countries was also established as making imports from Kenya somewhat expensive thereby affecting informal trade considerably.

Tariff and cross-border price differentials also contribute to ICBT growth. The volume of informal trade imports from Uganda to Kenya was observed to have reduced in 2006 as

Ugandan traders found the neighbouring countries like Sudan and DRC offering higher prices than Kenya. This direction of trade was also related to the political stability and economic recovery which was setting in Sudan.

Food insecurity conditions in one Partner State and food abundance in another Partner State was also established to have the effect of providing incentive to engage in ICBT as traders rush to make quick profits by transferring food products from the country with abundant food to the one with deficit. Furthermore, measures that negatively affect access to trade finance can motivate small firms and entrepreneurs to trade informally. For example, where traders have had difficulties in contracting formal credits, they have sometimes turned to informal sources of generating finance, e.g. ICBT.

Finally, cross-border trade (whether formal or informal) is likely to be influenced by the quality of road and transport infrastructure. Poor roads system can result in poor access to a country's own domestic market or to its established (official) border posts; they also raise costs of business and reduce profits for traders. In this case, traders would often choose to use the most effective and economical route, hence possibly avoiding formal border posts where they would be subjected to other costs.

## Chapter 4:

# Implications of ICBT on EAC Integration and Economic Growth

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As stated in most of the literature reviewed in this study, ICBT contributes to the economies of EAC countries in various ways. It enables small-scale entrepreneurs to escape poverty and to meet the education, housing and other basic needs for a significant number of dependents as well as creating employment opportunities for a number of people. Often, ICBT traders employ people in their home countries and in the countries where they source their goods, some of whom would otherwise have no employment as formal-sector employment has been shrinking.

In some cases, ICBT is a second job to civil servants and private sector employees who are under-employed; it has also provided employment to some people in the region who were unduly retrenched following economic restructuring that was occasioned by structural adjustment programmes (SAPs). For those who are under-employed, ICBT has provided a supplementary source of family income. Judging from the monthly values of income that traders realise from ICBT, it is apparent that the majority of ICBT participants survive on more than US\$2 a day which some of the people would never achieve under formal employment.

As we saw in section 2.3, a growing number of ICBT participants are degree holders. The rise in the number of graduates involved in ICBT business is a pointer that that cross-border trade is increasingly becoming more sophisticated, requiring better educated people, but also because **most university graduates these days are without jobs or starting capital to pursue formal business. Thus, an increasing number of them resort to informal businesses including ICBT as a form of employment and means of income generation.** We also observed that a majority of the ICBT participants are between the age of 30 and 40 years. This is the age at which many people in EAC have married and have more responsibilities to take care of, but lack of formal sources of income pushes them to look for other informal ways, including engaging in ICBT, in order to meet their family responsibilities, given the realities of our shrinking economies.

From a consumer's perspective, ICBT brings the benefit of lower prices of the informally imported products since they evade a lot of costs. Some of the ICBT traders have establishments in the Cities (in Nairobi, for example, they can be located in Eastleigh residential estate) where they sell their products at more competitive prices compared to same products purchased through formal channels and sold in supermarkets. In addition, **the low prices they offer have sometimes increased the competitive pressure on firms operating in the formal sector.** In this perspective, informality may have the effect of promoting price efficiency, especially where the formal sector were initially raking in supernormal profits.

However, contrary to the perceived benefits/advantages of ICBT, it is also true that formal firms are more productive than informal ones, due to scale and scope economies, access to capital and technology and more advanced methods of production and distribution. This

suggests that significant productivity gains would be achieved more in our economies by transferring production from low-productivity informal firms to more productive formal firms or by facilitating the formalisation of informal firms. In that case, thus, the unfair competition from ICBT players may have the long-run effect of reducing competition and such may prevent the more productive formal firms from entering or expanding in the market. Therefore, because of the benefits associated with formalisation of businesses, formal firms may offer even lower prices in the long run if informality in business was eliminated. Thus, when assessing the benefits or harm to competition from ICBT, competition authorities should consider whether to focus their analysis on short-run or long-run competition concerns of ICBT.

In addition, the incentive to innovate and invest (without effective intellectual property regime) could be significantly reduced in an informal trading environment. Those who develop new products in the region are likely to gain from trading their products across the region through formal channels; otherwise, informal traders may ruin chances of such innovators ever recouping their investments in the innovation.

A large informal sector could also deprive governments of much needed tax revenue (such as VAT) which could have been reinvested into energy and infrastructure development, which are some of the critical priorities of EAC. However, in the case of EAC, this study established that it is mostly the formal firms (described in category B and C under section 2.3 of this study) engage in ICBT that hurt the EAC economies more than is perceived of the small informal traders. These formal enterprises understand international trade rules better, and also know how to escape certain costs; they also have stronger economic might to deal in larger quantities than their small informal counterparts which are merely running survivalist enterprises. The big formal firms engaging in ICBT are capable of 'facilitating' their way across borders through several informal ways, thus evade taxation and other regulatory measures and as a result deny governments massive revenue. **This point could also explain why it is mostly the names of small traders recurring in the Kenya Revenue Authority's offence report (what is also known as C 52 book) because the big shots are able to bribe and get off their names from being recorded in the register to keep their public image untainted.**

The study traced some of the ICBT practice involving some supermarkets in Kenya and, generally, big vendors of mainly electronics and telecommunication gadgets across the region. For instance, there were cases where these enterprises would import electronics and wrongly declare them as shoes; and, for some traders while they would correctly declare the nature of goods, it involved under-declaration of the quantities. These practices lead to massive tax evasion and unfair competition with other competitor traders who have paid taxes; it also denies the EAC economies huge revenues hence opportunity for increasing government expenditure that is a key component for economic growth.

From the Uganda Bureau of Standards' surveys of 2005, 2006 and 2007, it can be established that EAC economies involve in significant trade with each other but a big percentage is in the informal form, hence such statistics miss out in the official national statistics which our policy makers rely on in stipulating policy directives. In this case, ICBT

could influence the development of economic policy objectives by skewing the reliability of (trade, income and labour market) data.

The other negative effect of ICBT in EAC is that its mere existence breeds a culture of corruption among public administration officials, including traffic and border police force and Customs officials, who are seeking for economic rents from ICBT.

Furthermore, ICBT may hinder further investments in local (formal) SMEs; these may include infant industries susceptible to ICBT competition, which constitute the majority of the private sector in EAC and are key drivers of to regional development.

While ICBT may provide short-term solution to a household's livelihood needs, creating an economy with a higher proportion of formal enterprises and jobs is important to the long-term welfare creation, stability and poverty reduction. Yet, the fact that ICBT is still a reality in developed countries (see table 1) that have existed for close to 300-400 years should make EAC think twice whether it can succeed in eradicating the practice. Indeed, into the unforeseeable future, EAC should expect ICBT practice to continue growing. As it may be difficult to eradicate ICBT, it does not help to stigmatise the practice and condemn it as an illegal or underground sector as some commentators have traditionally referred to it. Rather, the questions EAC ought to investigate through research and address are:

- d) What type of enabling environment is needed for ICBT, for example, in the context of how much can they be taxed without compromising compliance? What standards need to apply to them?
- a) Under what condition can the informal sector exist with the formal sector with little hurt to the economy?
- b) Are there any proven administrative measures that have managed to get informal sector to formal sector?

## Chapter 5: Conclusions and Recommendations

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The three founding Partner States of EAC have a long history of regional integration. They share a common history, culture, and infrastructure, and have relatively uniform agro-climatic conditions (UNCTAD 2005). With the expansion of the region to include Burundi and Rwanda, the EAC market is now a very large market that any firm wanting to invest would envy. Unlike Kenya and Tanzania, Burundi, Rwanda and Uganda are all landlocked and rely on the other two countries for access to sea ports. The five countries are members of the World Trade Organisation (WTO) and other trading arrangements. However, other than Tanzania which is the only Partner State member of the Southern African Development Community (SADC), the rest four Partner States are members of the Common Market for Eastern and Southern Africa (COMESA). Trade between among the five countries is carried out through both formal (regulated and recorded) and informal (unregulated and unrecorded) channels.

It is clear that informal cross-border trade occurs largely through unofficial routes established around formal ones at border townships and on the deep seas. For instance, at the Tanzania-Kenya border trade occurs at Tanga (Horohoro, Deep Sea and Ngome), Holili (Makuyuni and Korongoni), and Tarakea (Mbomayi), Namanga and Sirari. On the Tanzania-Uganda border, trade occurs mainly at the Mutukula, Bukoba and Kyaka border points. On the Uganda-Kenya border, trade occurs mostly at Busia, Malaba and across Lake Victoria.

From the studies reviewed, ICBT is spurred by several factors, including rigid, time-consuming bureaucratic procedures. But, ICBT also re-establishes the extensive barter of goods and migration of people that were a feature of economic and social life before colonisation. Other than the two, several other factors contribute to the growth of ICBT across EAC that it is difficult to pin-point just a handful causes.

Informal trade accounts for over 95 percent of trade in livestock and up to 60 percent for staple grains (Ackello-Ogutu and Echessah 1997; Little 2007). Moreover, informal regional trade brings much gain in terms of regional food security and efficiency in resource allocation. Informal trade contributes to food stability by improving the supply of goods.

Going by the OECD (2009) report entitled “Informal Cross-Border Trade and Trade Facilitation Reform in sub-Saharan Africa”, informal exports to Uganda’s five neighbouring countries were estimated at US\$231.7mn in 2006. This is equivalent to about 86 percent of Uganda’s official exports to these countries. Informal imports were estimated at US\$80.6mn, roughly 19 percent of official imports from these countries.

Available surveys have shown that a substantial proportion of informal cross-border trade in the region involves staple foods like maize and rice, cattle, and low-quality consumer products including clothes, shoes, and electronics. Informal trade, worldwide, plays an important role as an alternative source of employment, especially during economic downturn when modern private sector is laying-off their employees. Informal trade can spur

entrepreneurial activity and regional trade; can contribute to greater regional food security and food stability by improving the supply of foods from surplus regions to deficit regions within the EAC community; and, it can enhance income revenues and provide employment opportunities for poorer households to meet their basic needs of health, education and shelter, an obligation which their governments have failed to meet.

While ICBT may provide short-term solution to a household's livelihood needs, creating an economy with a higher proportion of formal enterprises and jobs is important to the long-term welfare creation, stability and poverty reduction. As a matter of fact, the long term, ICBT could have several negative economic and developmental impacts. Firstly, it creates unfair competition to formal trade, which reduces the incentives to invest in the formal economy while lowering business opportunities in regional and global markets. This all, in turn, diminishes the prospects for economic development in sub-Saharan Africa. Secondly, it compromises the measures put in place on health, safety, and environmental concerns. For instance, agricultural commodities traded informally do not go through sanitary and phytosanitary controls. Thirdly, informal trade erodes government revenues, with millions of dollars being lost annually in unpaid customs duties and value-added tax (VAT). These losses are significant to countries in the EAC region where trade taxes account for some 25 percent of total tax revenue, and where VAT collected at border stations accounts for more than 50 percent of total VAT revenue.

A survey conducted by the World Bank in the five EAC Partner States between February and June 2008 confirmed concerns of the local business communities regarding the many non-tariff barriers they encounter in cross-border trade.

ICBT is one activity that is still shrouded by considerable controversy, myths as well as ignorance. Talking about formalisation of ICBT is itself an open-ended argument as there is no common denominator among EAC Partner States of what formalisation means. More importantly, if EAC is to pursue formalisation of ICBT, then other than striking a common ground on what that means, it would need to engage ICBT players in rigorous sensitisation first on what it means to be formalised and how the traders stand to benefit from formalisation. This will be necessary in order to debunk certain wrong assumptions hitherto held about business-implications of formalisation.

Although governments in EAC have different views on the concept and measurement of informal economy, and ICBT in particular, it is commonly agreed that ICBT is not disappearing any soon but growing. If it was possible to stamp it out, then the industrialised countries that have been in existence for over 300 years would not be having components of informal economy or ICBT.

In spite of the significant contribution of ICBT within EAC economies, our policy-makers have continued to ignore this form of trade and ICBT flows do not appear in official trade statistics. It is this fact that has led to a situation whereby official trade flows have been understated in EAC – giving a wrong perception about the performance and achievements of the integration of the Partner States. But, by ignoring ICBT statistics, EAC Member States could be overlooking a significant proportion of their trade and could lead to wrong policy implications.

Once ICBT is widely recognised as being part of economies and that it is a legitimate activity in alleviating poverty, then, enabling and supportive policies can be developed and implemented. For instance, we would be able to determine an enabling taxation and standards regime to govern ICBT. Supportive policies could seek to utilize the potential of ICBT and increase the multiplier effect that ICBT already has on, for example, education and health care.

In order to intervene in the ICBT problem, there is need to recognise and acknowledged it as a part of our economy. As it is now, ICBT is simply seen as evasion of taxation and other statutory payments in cross-border trade, hence labelled illegal, rather than as an opportunity for poverty alleviation where the government has failed to offer alternative. While it may be difficult to eradicate ICBT, it does not help to stigmatise the practice and condemn it as an illegal or underground sector as some commentators have traditionally referred to it. Rather, the questions EAC ought to investigate through research and address are:

- a) What type of enabling environment is needed for ICBT, for example, in the context of how much can they be taxed without compromising compliance? What standards need to apply to them?
- b) Under what condition can the informal sector exist with the formal sector with little hurt to the economy?
- c) Are there any proven administrative measures that have managed to get informal sector to formal sector?
- d) Under what circumstances will the size of an informal economy improve or hinder competitive pressures in the formal sector and thus affect long-term prospects of increased production, trade and investment in EAC.

## ***Recommendations***

The informal economy is here to stay as an alternative to the shrinking formal sector; there is need to find them an enabling environment where it can coexist with the formal economy without hurting the economy. By creating such supportive environment for the informal traders across EAC, both EAC countries and informal cross-border traders stand to benefit more. To the EAC countries, it could be the start of a successful process of formalisation of the informal traders within EAC. Consequently, the EAC countries will be able to collect better information of the goods, values and quantities traded amongst them. Better information collected will improve the planning and decision-making of the EAC countries. In addition, the EAC countries will be able to increase revenue collection across borders to finance their national development as the need for traders to smuggle goods will have been reduced; and lastly, to the EAC countries, there will be more goods produced in the EAC countries, more employment and more people earning an income, thereby improving the standards of living in all the EAC countries.

Similarly, to the ICBT players, creating a conducive environment for their trade may mean better knowledge of the trader about their rights as they trade across the region, hence cases of paying bribes to border officials and smuggling goods across borders will be reduced. The trader will also benefit from payment of the correct amount of taxes (where

taxes still apply) as opposed to the current case where, due to lack of information, they may be charged duties even on goods that are not supposed to attract any duties. Similarly, cases of harassment of the trader and seizures and loss of goods will be reduced. Lastly, the cost and time of clearing the goods will be reduced resulting in lower prices of goods and higher earnings for the trader.

It will be important also for EAC countries to encourage and promote trade exhibitions involving informal traders across EAC borders.

Lastly, it should be recognised that if statistics is missing about informal sector then it will be difficult for the EAC governments to prescribe the sector suitable policies. The EAC countries should strive to have a common definition of what constitutes informal sector such that it can be well targeted with appropriate policies. There will be need for EAC governments to undertake an inventory of ICBT and set common thresholds for determining and classifying it otherwise the formal firms engaging in ICBT could easily be the biggest beneficiaries of any reforms that may be targeted at supporting the informal sector.

In all processes, it will be important to involve civil society organisations in formulating and implementing such policies that are supportive and beneficial to the growth and coexistence of ICBT in a formal economy. Involving them should be based on their ability to network, create awareness and encourage ICBT traders to reform their activities so that they may benefit from policy reforms. This should go along with the demystification of the term 'formalisation' to remove any negative connotations that may be currently labelled on it.

There is need to undertake aggressive publicity and dissemination of the EAC Treaty, the CU Protocol, the Community's policies and other applicable laws and principles as provided for under Article 39 of the Protocol. There is also a need to educate government agencies on the CU Protocol including attitude change among customs officials and other border officials who continue to collect tax on duty-free goods and those seeking rent from ICBT, and monitor compliance.

ICBT is worldwide reality and requires official recognition including revising EAC CM to recognise it and provide it apt operational environment.

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