

How Might EAC Reduce Negative Implications of Informal Cross-Border Trade to Support Regional Trade Integration and Development?

All economies without exception comprise of both formal and informal sectors in varying degrees. The informal cross border trade (ICBT) is an important segment of the informal economy because of its ability to impact more than one country. This is especially evident in the East African Community (EAC), where a significant proportion of cross-border trade amongst Partner States is conducted informally. ICBT markets in EAC pre-date the colonial and post-colonial state boundaries so that what continues today is simply a longstanding indigenous pattern of trade that makes more sense than formal trade channels. The growth of ICBT can be seen as a normal market response to overly bureaucratic, inefficient, and cumbersome export/import procedures and regulations that significantly raise the cost of doing business in the formal channels. Corruption, often given in the form of 'facilitation payments', also plays a factor in fuelling the growth of ICBT.

Informal cross-border businesses often do not pay taxes, and as a consequence deny governments some much needed revenue for investment. In addition, they compete unfairly with formal businesses that have often paid punitive taxes. The small-scale ICBT players routinely lack the capital and expertise to be as productive as big enterprises, leading to less innovation and trade in low standard products, hence lower standards of living. Furthermore, since workers in the sector lack health benefits and other safeguards, they have to save more for emergencies, resulting in less casual spending that further drags down economic growth. The big formal firms engaging in ICBT are in fact, the ones hurting EAC economies the most as they regularly handle bigger import volumes from third party countries who would normally pay custom duties, as opposed to their counterpart survivalist enterprises who usually trade in EAC-originating goods.

Certainly, were it possible to eradicate or fully formalise the informal sector, most industrialised countries that have been in existence for over 300 years would not be having an informal sector today. Having a big informal sector is not something to be cheerful about; however, over the last three decades the frightening scale of underdevelopment that has characterised EAC economies has seen the informal sector provide an alternative source of employment. Without the informal sector, many of the people being laid-off their employment from the formal private sector those being retrenched from the public sector, and the majority who are underemployed in the region would have nowhere to go. This has brought a policy paradox to those who criticise the informal sector; how can each economy establish an appropriate operating environment for the informal sector without hurting the overall economy? This is the jigsaw policy puzzle that each country must solve for itself under its own context as there cannot be a one-size-fits-all solution.

This Policy Brief seeks to present the implications of ICBT on EAC regional trade integration, specifically, under the goals of increasing production, trade, and investment prized to steer development; the nature of the linkage between ICBT and formal trade in the EAC and suggest policy measures to expand formal trade links in a beneficial manner including for small-scale traders.

Introduction

There is no economy in the world without an informal component (see table 1), including the most industrialised countries that have been in existence for over the past 300 years. However, this sector continues to receive negative reception, especially, among Economists who think the world would be a perfect place

without the informal economy. This negativity is characterised not only by the lack of a universal definition of the sector, but also by the various adjectives used to describe it such as: unofficial, underground, hidden, invisible, shadow, parallel, second, unregulated, unrecorded, black-market, moonlighting, unmeasured and unobserved economy.

Table 1: Average Size of the Informal Sector as a Percentage of GDP
(in percent)

	Africa	Central and South America	Asia	Central and Eastern Europe and former USSR	OECD
1999-2000	41.3	41.1	28.5	38.1	16.8
2001-2002	42.3	42.2	29.5	39.1	16.7
2002-2003	43.2	43.4	30.4	40.1	16.3

Source: Schneider, 2002

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.

An important component of the informal sector is the ICBT since its effects do spill-over between any two trading countries¹. The EAC Partner States have had a rich history of cross-border trade; much of which continues to be conducted informally. However, since the commencement of the EAC Customs Union in 2005, there has been several policy pronouncements to promote trade integration by increasing formal trade links. This has sometimes meant fighting and coercing the informal sector to formalise their activities or else face punitive charges. Incidentally, it is in fact the larger formal firms, rather than the small survivalist firms who cause the majority of harm to EAC economies.

Key Characteristic of ICBT Practice

Who are involved and how do they practice ICBT?

Practitioners of ICBT consist of both formal and informal firms. The majority of the informal firms operate entirely outside the formal economy and most of the goods they transact attract little or no custom duties since they originate mostly from within the EAC. On the other hand, formal firms handling large volumes of non-originating goods also continue to practice ICBT by passing commodities through “unofficial routes”, thus fully evading trade-related regulations and custom duties. Others, partially evade these regulations and duties by participating in other 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 to qualify for nil or lower tariffs), **mis-declaration** of country of origin to avoid associate tariffs and regulations, and/or **bribery** (see table 2).

What are their education levels, gender and age?

A majority of the players in ICBT are aged between 20-40 years; 44.2 percent have attained secondary education and 25.8 percent have professional/semi-professional diploma and certificate. Those with diplomas, certificates and degrees make up 10 percent of the total but their numbers are rising each year. This indicates two things: firstly, cross-border

trade is becoming increasingly sophisticated and requires better education to survive in it; and secondly, most graduates are jobless and have no starting capital to pursue formal business the result being an increasing number of educated labour resorting to informal employment including ICBT.

What goods do they trade?

ICBT in the EAC involves a wide variety of goods – *staple food commodities* (even food aid which has a direct impact on regional food security) and *low quality consumer goods* such as shoes, clothes, textile, vehicle and bicycle parts as well as counterfeit drugs. Some of the goods, such as textiles, are included in sectors benefit from government export promotion schemes, and the latter ones are smuggled into the domestic market duty free.

Mode of ICBT transportation

The main modes of transport used in ICBT are motor vehicles, bicycles, head/hand, motorcycles, pack animals (donkeys), push carts, boats/canoe etc. People with disabilities riding on wheel chairs are also involved in moving small but valuable products e.g. sugar, salt, soap, cooking oil and plastics.

What volumes do they handle?

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. But, since these small quantities are passed repeatedly, they end up being significant. The small quantities passed across the border are not necessarily sold immediately; they are piled in jointly-owned stores until a reasonable volume is reached and the players jointly hire means of transport to haul them to their final destinations.

What are the key factors that fuel the growth of ICBT?

The growth of ICBT generally represents a normal market response to the presence of physical and technical barriers in formal trade which are perceived to significantly increase the cost of both joining the formal economy and operating within it. The inherent

Table 2: Types of Informal Cross-border Trade Practice

Category A	Category B	Category C
Informal (unregistered) traders or firms operating entirely outside the formal economy.	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).

Source: OECD, 2009

incentives for ICBT also promote its own growth and to some traders the various socio-economic constraints hinder their ability to successfully engage in formal trade. Corruption, too, plays a factor in fuelling the growth of ICBT; those who are able to make 'facilitation payments' have their clearance expedited, often, without proper checks. This rent-seeking behaviour means that officials who are posted at the border stations are considered fortunate and some of them even bribe their way into these positions. For the traders who cannot 'facilitate' their way, they are left exposed to the vagaries of night-time robberies when they have to spend unplanned nights at the border towns as there is no decent affordable accommodation. As a result during their next passage these traders are forced to set aside some money to 'facilitate' their clearance.

Other important push factors towards ICBT are based on the weak economies of the EAC, which has experienced shrinkage in formal employment. A rise in rural-urban migration in search of often non-existent employment also leads people to informal sector employment. Together, the low wages and underemployment in the formal economy also push people to look for alternative ways to supplement their meagre wages, and ICBT has been one such alternative.

Implications of ICBT to EAC Trade Integration and Development

ICBT, as it evades taxes, can limit possibilities of economic growth and development of economies. It can create unhealthy competition with the formal enterprises that have paid often punitive taxes thus limiting their growth which can result into an overall decline in economic growth through lost employment and further loss in tax revenues. ICBT may also hinder further investments in local (formal) SMEs while they are still susceptible to competition. In addition, the incentive to innovate and invest could also be significantly reduced in an informal trading environment.

It is also true that formal firms are more productive than informal ones, due to scale and scope economies that they enjoy. This suggests that significant productivity gains would be achieved more in EAC 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, 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. As a matter of fact, because of the benefits associated with formalisation of businesses, formal firms may offer even lower prices in the long run if informal trade were to be eliminated.

Furthermore, mere existence of ICBT breeds a culture of corruption among the rent-seeking public administration and customs border officials.

However, much as every government wishes to eradicate or cut down to size its informal sector, lost in this endeavour are the benefits associated with ICBT and the informal sector as a whole. Incidentally, as both public and formal private sectors of EAC economies have been laying off their employees over the last three decades, it is the informal sector that has been providing a soft landing pad as an alternative source of employment; ICBT has been one such alternative. Also overlooked, is the fact that many people decide to engage in ICBT because formal cross-border trade is often too restrictive. This is accompanied with serious socio-economic constraints that hinder the possibilities of beneficial trade through formal channels.

From a consumer's perspective, ICBT brings the benefit of lower prices of the informally imported products. Similarly, the low prices that ICBT traders 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 was initially raking in supernormal profits. Incidentally, the informal contacts strengthen regional integration networks and relationships more than formal links.

Conclusions and Recommendations

ICBT still represents a significant proportion of regional cross-border trade in the EAC. A lack of vital data on ICBT implies that there has been a gross underestimation of gross domestic product (GDP) in EAC economies. This, in turn, means that there has been misconstrued perceptions on a number of issues including: the actual balances of trade of EAC economies with each other, trade benefits that have accrued to Partner States from regional integration, and the performance and direction of growth of regional trade in the EAC. Consequently, wrong policy prescriptions may be prescribed leading to unintended negative results such as diversion of resources away from important projects, thus impacting negatively the regional trade integration and development of EAC.

To solve the problem of ICBT, the government should approach it by dealing with the factors that drive its growth and not fighting the traders who are merely eking a living out of the business.

The fact that ICBT is still a reality in developed countries (including countries that have existed for close to 300-400 years) should be a point of reflection to the EAC region whether it can succeed in eradicating the practice altogether. Indeed, into the unforeseeable future, the EAC should expect ICBT to continue growing as an alternative source of employment besides the public and formal private sector. In that case, what would be important for the sector is to establish an enabling environment with measures that will reduce its negative impact on the economy.

By creating a supportive environment for the informal traders, both the EAC countries and ICBT traders stand

to benefit more. To the EAC countries, it could be the start of a successful process of formalisation of the informal traders. Consequently, this will enable the countries 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 trade may lead to a better understanding of 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 they are sometimes charged duties 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 should be recognised that if statistics on the informal sector are missing, it may be difficult for the governments to prescribe the sector with any suitable policies. Therefore, deliberate efforts must be made by the EAC governments to first develop a common definition of what constitutes an informal sector in such

a way that it can be targeted with the appropriate policies. Secondly, they must also make deliberate efforts to construct an inventory of the number of informal traders including the trends of growth in the sector. Thirdly, set a common threshold for determining and classifying the informal sector otherwise the formal firms engaging in ICBT could easily be the biggest beneficiaries of reforms aimed at supporting small-scale informal traders.

To end the stigmatisation that has damaged the image of ICBT, it is important that EAC governments start to encourage and promote trade exhibitions involving informal traders across EAC borders.

In all the processes recommended above, it will be important to involve civil society organisations in formulating and implementing such policies that are supportive and beneficial to the informal traders including ICBT traders. 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 unwarranted fears that are currently labelled or associated with it.

There is also 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.

Furthermore, government agencies should be educated on the CU Protocol and promote 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.

REFERENCES

Victor Ogalo, (2010). *Informal Cross-Border Trade in EAC: Implications for Regional Integration and Development*. A CUTS publication under BIEAC Research Series.

ENDNOTE

1. As there is no agreed definition, the term "informal cross-border trade" as is used in this paper refers to imports and exports of legitimately produced goods and services (i.e. legal goods and services so that we immediately delink it from trade in unlawful/illegal goods), which are directly or indirectly escaped from the regulatory framework for taxation and other procedures set by the government, and, as such, often go totally or incorrectly unrecorded into official national statistics of the trading countries.

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