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Enhancing Contributions of the Informal Sector to National Development: The case of Uganda

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Executive Summary

Regardless of the definition of the informal sector, there is wide spread consensus that the sector is important to the developing world. The International Labor Organization (ILO) estimated that in 1990, 21 percent of sub-Saharan Africa (SSA)'s 227 million labor force was working in the informal economy. As the informal sector continued to grow both in urban and rural areas, there was a decline or stagnation in the growth of formal employment. The informal sector's contribution to gross domestic product (GDP) is increasing, although not much is known in most countries because the sector hardly enters the official statistical records.

This study analyzes Uganda's informal sector size, contribution, formal-informal sector linkages, causes, constraints, and policies aimed at formalizing or enhancing its contributions. The methodology used involved a review of relevant policy documents, including UBOS's survey reports on the informal sector. Of particular relevance are the 2002/03 household survey (UNHS), which incorporated an informal sector module and the 2000/001 Uganda Business Inquiry (UBI) and the 2001/2002 Uganda Business Register. The household surveys documenting the informal sector in Uganda define the informal sector as an enterprise employing less than 5 persons.

Uganda's formal sector is small and insufficient to accommodate the growing number of skilled and unskilled job seekers in the country. As an alternative, the informal sector is growing in size and employs about 2.5 million people, that is, a tenth of Uganda's total population. Most of the informal sector establishments were started less than 5 years ago. The total number of households operating a household enterprise classified under the informal sector was about 1.8 million, representing about 36 percent of the total number of households. Survey evidence reveals that the informal sector constituted 150,138 businesses, which is 87 percent of the total 160,883 businesses.

About 39 percent of those employed in the informal sector are female. Seventy two percent of the women are more likely to be working proprietors compared to 67 percent of the men. Women are more likely to be unpaid helpers.

The informal sector activities are mainly concentrated in the central and eastern regions and least in Western Uganda. Using survey data, gross output from informal sector household enterprises was estimated at shs. 175.6 billion. Most of the gross output is contributed by the livestock, poultry, bee-keeping and fishing industry group followed by the mining, quarrying, and manufacturing industry. The survey also computed value added, which is the gross output less the value of intermediate inputs. The total value added from the survey was estimated at shs 110 billion. Livestock, poultry, bee-keeping, and fishing industry contributed 49 percent. Mining, quarrying and manufacturing contributed about 21 percent followed by trade and services contributing 19 percent.

We review the formal -informal sector linkages. These include market linkages, source of credit/capital linkages, and source of raw materials, equipment and machinery. In general, the linkages between the formal sector and informal sector are very low. There is

a need to strengthen the linkages through efforts such as encouraging registration of the informal enterprises, improve the financial status of the informal sector, and skills development among informal sector entrepreneurs.

The causes of Uganda's informal sector include the Uganda's political history and collapse of the economy in the 1970s, the lack of a clear policy a prior to address the costs of Structural Adjustment Programme (SAP), rising poverty, and the effects of HIV/AIDS epidemic.

The constraints to the informal sector include a large pool of unskilled labor, high cost of doing business, lack of capital, insufficient markets for produce, and insufficient, irregular and expensive electricity. The other constraints include lack of access to raw materials. These constraints are compounded by the lack of a clear national policy on the informal sector.

The government of Uganda's strategic policy framework, the Poverty Eradication Action Plan (PEAP) sets out policies to promote the small-scale enterprises. These include solid macroeconomic foundations to support economic growth and poverty reduction, investment in infrastructure, education, health, and implementation of decentralization. The establishment of institutions such as the Private Sector Foundation, the Uganda Investment Authority and Enterprise Uganda demonstrates the government's commitment to supporting the regulatory environment of small-scale enterprises. However, the lack of a national policy on the informal sector has manifested itself in the policy coordination challenges facing these institutions, ministries, and the informal sector participants. Donors have supported the PEAP and thus initiatives aimed at promoting the private sector. To a large extent, technical and financial support to lessen the above constraints is available from both bilateral and multilateral donors.

It is feasible, but takes time to transform the informal sector. First and foremost, it requires a national policy on the informal sector that stipulates its boundaries and sets out policies and incentives to support the sector. Little attention has been paid to the informal sector. We suggest that formalization should start by encouraging formation of informal groups bringing together informal sector participants with common locations or interests. Guidelines should be established on the kind of information requirements members are encouraged to keep. Registration should be voluntary and encouraged. Incentives should be designed to encourage entrepreneurs to promote growth of their establishments. Should implementation of a clear policy on the informal sector delay, then its contributions can be enhanced through provision of micro-finance support, skills development and provision of infrastructure. In addition, the government will have to maintain macroeconomic stability, political stability and continue implement policies to improve the business regulatory framework.

Terms of Reference

The informal sector in Africa could account for a significant portion of the GDP and employment. There is an ongoing debate in the literature whether the informalization of the African economies is a result of bottlenecks and red-tape that hinders smooth operation in the formal sector and hence compete with the formal sector or whether the sector is complementing the inadequacy of the formal sector. Relevant studies in the area and casual observation across the continent show that African economies are becoming increasingly engulfed by problems that are related to the growing informal sectors. Some of these problems related to the harmful impact of this unregulated sector on the economy in general and revenue performance of the government in particular. Formalizing the informal sector would be an important growth factor for our countries. With a formal status, businesses could obtain credit and expand easily. will have an appropriate safety net for their employees, contribute to government revenues and venture on technology transfer, among other things. This informalization of the economy is partly related to the problems related to the operation of the formal sector. It is a well known fact that high costs and time consuming legal procedures for setting-up and running businesses has driven many in our countries to operate without licenses. These and related issues call for an examination of the informal sector and the challenge and prospects as well as the implications of its formalization.

Justification

The idea of examining informal sector in Africa stems from the following considerations:

a. the informal sector is very large and growing at a very high rate yet little is known about its size, mode of operation and its major constraints.
b. the informal sector tends to absorb a large number of the unemployed and underemployed. Scanty data in some countries suggest that increasing number of units in the informal sector rather than expansion of the existing ones. The factors inhibiting the informal sector from growing to become formal deserve close scrutiny.
c. It is believed that marginalized and highly vulnerable segments of the population derive their livelihoods from participating in the informal sector. Thus, addressing the problems of this sector had direct relevance fro poverty reduction policies.
d. The informalization of an economy has detrimental implications on the capacity of the government to raise revenue which is crucial for development. This underscores the need to understand the sector. Finally,
e. Informalization leads to problems of regulation, problems of establishing support system to such business operation and hence hinder technology transfer and conducting good business practice.

On the above ground, it appears clear that there is a need to re-examine the increasing informalization of African economies.

Objectives/terms of reference of the study

The broad objective of the study is to examine the increasing informalization of the economy with the aim of understanding the sector, the rationale for its existence, its implications for government revenue collection and regulations and appropriate measures that could be taken to formalize it.

The specific objectives include:

1. determining the size of the informal sector, its contribution to employment and incomes and profiling of the informal sector (rural versus urban, gender, breakdown of sectoral activities)
2. consider the structure of the informal sector in sub-Saharan Africa and its intricate linkage with the formal sector by looking, among other things, its sectoral segments i.e. retailing, wholesaling and manufacturing to be able to assess whether there is scope of transforming this sector through infusion of resources and appropriate government legislative and institutional support amongst other things.
3. identifying the main reasons behind the ballooning of the informal markets, including the existence of cumbersome procedures for setting-up business, the peasantry nature of agricultural production and the scale of operation of the distributive trade and other service sectors of the African economies, among other factors;
4. Identifying the factors responsible for the difficulties in bringing the informal sector operators into the tax net and how institutional (including relevant incentive structure) and legislative support could help in this process;
5. Examine the role of donors, including the WB and IMF, in supporting the operators in the informal sector.

6. examining the feasibility and benefits of formalizing the informal sector as a strategy for bringing it into the tax net;
7. Suggesting, if formalizing it proves to be impossible, other alternative mechanisms for enhancing the contributions of the informal sector to national development effort through taxation

1.0 Background to the Study

1.Defining the informal sector is always an intricate issue. Different countries and different authors consider different dimensions of informality such as whether the establishment is registered or not, compliance with legal and tax obligations and a range of organizational characteristics reflecting the size, contribution or composition of the establishment. Regardless of the definition, there is wide spread consensus that the informal sector is important to the developing world. The International Labor Organization (ILO) estimated that in 1990, 21 percent of sub-Saharan Africa (SSA)'s 227 million labor force was working in the informal economy. By 1998, the informal sector was estimated to comprise 40 to 60 percent of urban employment. As the informal sector continued to grow both in urban and rural areas, there was a decline or stagnation in the growth of formal employment. The informal sector's contribution to gross domestic product (GDP) is increasing, although not much is known in most countries because the sector hardly enters the official statistical records.

2.Selected country evidence drawn from ILO (2002) illustrates how important the informal sector is to SSA. In Cameroon, 80 percent of all jobs created in 1992 were in the informal economy. In Ghana, 89 percent of the labor force is employed in the informal economy and in Nigeria, the informal sector employs 1/3 of urban labor force. In Kenya in 1995, the Informal sector employed 2.2 million people while the formal economy employed 1.6 million people. In Tanzania in 1990, the informal economy contributed 33 percent of GDP. In Angola, by 1990, 26 percent of all non-farm employment was believed to be in the informal economy. In Mozambique, 30-40 percent of urban households were dependent on the informal economy in the 1990's. In Swaziland, by the 1990's, informal sector contributed 22 percent of national employment compared to 10 percent in the 1980's. In Zambia, 43 percent of urban employment is in the informal economy. In Zimbabwe in 1996, the informal economy employed 1.56 million people as compared with 1.26 million people in the formal economy.

3. In this paper we address the specific objectives of this study with reference to the Ugandan economy. We begin with an overview of the Ugandan economy over the last two decades and then proceed to analyzing the extent, contribution, causes, and constraints of the informal sector. We discuss the extent of the formal-informal sector linkages, the feasibility and benefits of transforming the informal sector, the policies for enhancing informal sector contribution and the role of development partners in supporting the operations of the informal sector.

4. The Economic Recovery Program (ERP) implemented from 1987 onwards and the subsequent economic reforms helped to restore Uganda's economy to its present state. The 1990s witnessed a return of macroeconomic stability, improvement in social indicators and generally a decline in poverty. In addition, the economy grew at a rate above 6 percent per annum over the same period. The recovery and reconstruction program happened because of commitment to economic reforms by the government and the support from Uganda's bilateral and multilateral development partners.

5. Despite the impressive economic progress over the 1990s, recent economic and social trends have not been so impressive, particularly with regard to the acceleration of economic growth and poverty reduction. The slowed economic growth, stagnated export base and revenue generation, decline in savings and slowed growth in investments have lead to serious concerns over the implementation of Uganda's Poverty Eradication Action Plan (PEAP) and its sectoral strategic interventions, which among others are expected to create solid foundations for economic growth. The current GDP real growth rates are below the 7 percent set in the PEAP to meet the poverty eradication targets by 2017. The Plan for Modernization of Agriculture (PMA), which is expected to revamp the agriculture sector by transforming the sector to be commercial, thereby minimizing its subsistence nature and informalization is far from full implementation. Also, the Medium Term Competitive Strategy (MTCS) is far from its intended objectives, which if implemented would strengthen property rights, contract enforcement, tax administration, procurement procedures and reduce corruption. These and other initiatives discussed in this paper are crucial to the growth of the private sector and to the strength of the formal-informal sector linkages.

6. In Uganda, just like in the other SSA countries, the informal sector was believed to be important in the face of scarce statistical evidence. It is only recently that efforts to document its existence have received much attention from the government of Uganda. This is perhaps explained by the surge in data demands on firm and household behavior to feed into the implementation and monitoring of the PEAP progress. This demand is reflected in the recent Uganda Bureau of Statistics (UBOS)'s household surveys, business surveys and the 2002 population census. Thus, unlike before, to date it is possible to provide an analysis of the informal sector backed by reliable statistical evidence.

7. That said, the methodology used in this paper involved a review of relevant policy documents, including UBOS's survey reports on the informal sector. Of particular relevance are the 2002/03 household survey (UNHS), which incorporated an informal sector module and the 2000/001 Uganda Business Inquiry (UBI) and the 2001/2002 Uganda Business Register. The former survey covered rural establishments and the later covered urban establishments. The UNHS informal sector module collected information about household enterprises and rural-based small-scale establishments. These are businesses undertaken by households with or without a fixed location. It also collected data on inputs and outputs of these enterprises for the major items. The components of the informal sector module included livestock, poultry, bee-keeping, fishing, forestry, mining, quarrying, manufacturing, hotels, lodges and eating places, trade and services.

8. The household surveys documenting the informal sector in Uganda define the informal sector as an enterprise employing less than 5 persons. It is assumed that the probability that an enterprise is informal is high if it employs less than 5 persons and low if it employs more than 5 persons. The informal sector is composed of small-scale businesses, usually with self-employed activities, with or without hired labor. The sector exists in both rural and urban areas, although the magnitude depends on the type of activity in question. Establishments in the informal sector are characterized by low level of organization often on temporary premises, low physical and human capital, low

technology, limited access to organized markets and credit institutions Usually these establishments are not legally registered or recorded in official statistics and do not comply with legal obligations concerning safety, taxes and labor laws. Usually they are not supported by formal financing institutions. The sector is also characterized by free entry of labor, competition, subsistence wages, and low overheads. The results presented in the UNHS covered only the non-crop farming household enterprises and rural small-scale establishments. A household enterprise is defined as an economic unit owned by the household but without an identifiable location. An establishment is a business activity carried out with an identifiable fixed location and address. In the UNHS survey establishments having less than five paid employees irrespective of the number of working proprietors or unpaid family helpers were considered as small-scale establishments. The informal economy is largely comprised of micro and small-scale enterprises (MSEs), which employ about 90 percent of the total non-farm economically active population.

9. The analysis that follows is based on the above definitions. However, a word of caution is in order. The extent of the informality based on the present definition may underestimate or overestimate the informal sector. The choice of a cut-off of 5 persons may be questionable, but since the surveys looked at other dimensions of informality, we assume the data reflects the characteristics of the informal sector in Uganda.

2.0 Uganda's informal sector: Size, Contribution and Profile

10. The 2001/2002 Uganda Business Register (UBI) reported that the informal sector constituted 150,138 businesses, which is 87 percent of the total 160,883 business establishments (table 1).

Table 1. Number of formal and informal businesses by region, 2001/2002

Region	Establishment not stated*	Less than 5 employees	More than 5 employees	Total
Central	83	90209	6699	96991
Eastern	43	28365	1431	29839
Northern	23	9019	721	9763
Western	27	22545	1718	24290
Total	176	150,138	10,569	160,883

Source: Uganda Bureau of Statistics

* Did not state whether establishment is employs less than 5 or more than 5 employees

11. The 2002/03 household survey revealed that the total number of households operating a household enterprise classified under the informal sector were about 1.8 million, representing about 36 percent of the total number of households. Of these, 69 percent are working proprietors and 22 percent are unpaid helpers.

12. In terms of education/skills attained, 64 percent of the household members engaged in the household enterprises are able to read and write in a language they understand. Of these, 75 percent of the male and 53 percent of the female can read and write. About 19 percent of the household members engaged in household enterprises have never been to school. In addition, the survey revealed that about 96 percent of the household members engaged in household enterprises do not have formal vocational training. Only 13 percent of the household members reported to have received some informal vocational training. These statistics suggest the need to strengthen knowledge empowerment among the adults engaged in the informal sector.

13. Compared to the 1.2 million people operating an enterprise in the 1993/94 survey, the 2002/03 survey results show that the number of household enterprises increased (table 2). In the 1993/94 first monitoring survey (FMS), it was estimated that 32.9 percent of the households operated a non-crop household enterprise. In rural areas the percentage of households engaged in the informal sector increased from 35.9 percent in 1993/94 to 39.0 percent in 2002/03. On the other hand, the percentage of households engaged in the informal non-crop enterprise in urban areas was 15.9 percent in 1993/94 compared to 19.8 percent in 2002/03.

Table 2. Number of Informal Sector Households ('000) Operating Enterprises

Residence	Estimated households		Households with non crop enterprises		Proportion	
	1993/94	2002/03	1993/94	2002/03	1993/94	2002/03
Rural	3208	4095	1152	1596	35.9	39.0
Urban	563	844	90	167	15.9	19.8
Total	3771	4938	1241	1763	32.9	35.7

Source: Uganda Bureau of Statistics

2.1.1 Contributions to employment, output and value added

Employment

14. The informal sector employment includes the self-employed, paid workers, unpaid workers in family businesses, casual workers without fixed employer, sub-contract workers linked to informal enterprises, and sub-contract workers linked to formal enterprises. Also included in the informal sector are home-based workers who may include children, women, and market and street vendors.

15. It is argued that Uganda's formal sector is small and insufficient to accommodate the growing number of skilled and unskilled job seekers in the country. As an alternative, the informal sector is growing in size and employs about 2.5 million people of Uganda's 25 million people. The UBI reported that the average size of business for the informal sector is less than 2 persons per business while for the formal sector, employing 5 or more persons, the average size of business is 20 persons per business.

16. The 2002/2003 UNHS surveyed both regular and casual paid employees. Those employed include working proprietors and unpaid family helpers. The report showed that 45 percent of Uganda's population is economically active. Within this group, 79.6 percent of all workers are either self-employed or un-paid family workers. A recent study by the International Labor Organization (ILO) and the African Development Bank (AfDB) (2005) reported that 88.2 percent of the economically active women in Uganda are self-employed or unpaid family workers, and thus find themselves categorized within the informal economy.

17. Of the 2.5 million people working in the informal sector, about 40 percent are employed in mining, quarrying, and manufacturing. Trade and services employ about 30 percent. Sixty nine percent of the persons engaged in the informal sector are working proprietors followed by about 22 percent of the persons working as unpaid helpers. About 42 percent of the working proprietors are engaged in Mining, quarrying, and manufacturing and 36 percent of the working proprietors are engaged in trade and services.

18. The livestock, poultry, bee-keeping and fishing industry employ about 39 percent of the unpaid helpers. Mining, quarrying and manufacturing employ 35 percent of the unpaid helpers. Paid workers comprise about 92 percent compared to 54 percent of the unpaid family helpers (table 3). About forty four percent of the paid employees are employed in Mining, quarrying, and manufacturing. Twenty nine percent of the paid employees are engaged in livestock, poultry, bee-keeping and fishing. Most of the household enterprises rely on family members or kinship of labor.

Table 3. Total Persons Engaged in Informal Sector Enterprises by Sector

Industry	Working proprietor	%	Paid employees	%	Unpaid helpers	%	All employment categories	%
Livestock, poultry, bee-keeping, and fishing	233	13.1	70	29.3	218	38.7	521	20.2
Forestry	87	4.9	3	1.4	27	4.7	117	4.5
Mining, quarrying, and manufacturing	740	41.5	105	43.8	196	34.7	1040	40.3
Hotels, lodges, bars, restaurants, and eating places	88	4.9	6	2.6	27	4.9	121	4.7
Trade and services	634	36.6	55	22.9	96	17.0	784	30.3
Total	1782	100	238	100	563	100	2583	100

Source: Uganda Bureau of Statistics

19. In terms of ownership of the enterprise by region, 97 percent of enterprises owned in rural areas are under the management of a sole proprietor. Only a few

enterprises in rural areas are under partnerships (table 4). The same picture emerges in urban areas where 97 percent of the surveyed enterprises belong to sole owners followed by partnerships. In both rural and urban areas, very few enterprises were inherited, bought, or received as gift.

Table 4. Ownership of Informal Sector Enterprises by Region

Ownership	Rural Number ('000)	%	Urban Number ('000)	%	Total Number ('000)	%
Sole proprietor	1539	96.5	163	96.6	1702	96.5
Partnership	53	3.3	4	27	57	3.3
Others	2	0.0	-		1	0.0
Not stated	2	0.2	1	0.7	3	0.2
Total	1596	100	167	100	1763	100

Source: Uganda Bureau of Statistics.

20. About 39 percent of those employed in the informal sector are female. Seventy two percent of the women are more likely to be working proprietors compared to 67 percent of the men. Sixty two percent of the female paid employees were in the mining, quarrying and manufacturing industry compared to the 43 percent of males employed in the same industry. However, women are more likely to be unpaid helpers. About 26 percent of the women are unpaid helpers compared to 19 percent of the male unpaid helpers. About 61 percent of the males are engaged in non-crop farming household enterprises compare to 39 percent of the females.

21. In terms of industry breakdown and ownership, the UBI (2001/2002) reported that ninety three percent of the entrepreneurs in the fish sector are sole proprietors. In the mining and quarrying sub-sector, 410 persons are sole proprietors. Out of these, women own 45 percent of the quarrying businesses.

22. Eighty percent of the 11,968 businesses in manufacturing are small-scale mainly targeting local markets. These include manufacture of grain mill products, starches and starch products; manufacture of wearing apparel, which includes tailoring; manufacture of fabricated metal products; and manufacture of furniture. Most of the businesses in manufacturing, retail trade sub-sector employ an average of one or two people. Most of the establishments in the hotels, restaurants and bars sub-sector employ between 1 and 4 persons. The majority of businesses in the credit granting sector are in the informal sector. Only eight businesses in the credit business employ with over 50 persons.

23. In terms of region concentration, table 5 shows that in 1993/94 the informal sector enterprises stood at 33.7 percent in the North, followed by 28.7 percent in the East, 22.8 percent in Central and least in the West. However, 2002/2003 survey revealed that the enterprises concentration increased in the Central region to 31.8 percent and 32.1 percent in the East, but dropped to 24.8 percent in the North, and was the least in the West.

Table 5. Number of Informal Household Enterprises by Region

Region	1993/94 number ('000)	%	2002/03 number('000)	%	Change (%)
Central	283	22.8	562	31.8	98.2
East	356	28.7	566	32.1	59.0
North	418	33.7	437	24.8	4.5
West	184	14.8	198	11.3	7.6
Total	1,241	100	1,763	100	42.0

Source: Uganda Bureau of Statistics.

Output and value added

24. The 2002/03 survey measured the gross output of the informal sector establishments. Gross output is the total value of sales of goods and services sold out of the household enterprise. It includes the total gross sales of products, sales of goods and materials in the same condition as purchases, and services rendered to others.

25. The survey results indicated that gross output during the last 30 days preceding the date of the survey from household enterprises was estimated at shs. 175.6 billion. The livestock, poultry, bee-keeping, and fishing industry group contributed the highest proportion of gross output of 37 percent. The mining, quarrying, and manufacturing industry contributed 27 percent of the total gross output followed by trade and services industry contributing 24 percent. The forestry industry contributed the least proportion of gross output of 6 percent.

26. The survey reported results on value added, which is the gross output less the value of intermediate inputs. The intermediate inputs included none labor inputs such as raw materials for manufacturing enterprises, rent, transport, veterinary services, animal and chicken feeds, electricity, postage and communication. The total value added from the survey was estimated at shs 110 billion. Livestock, poultry, bee-keeping, and fishing industry contributed 49 percent. Mining, quarrying and manufacturing contributed about 21 percent followed by trade and services contributing 19 percent.

27. In terms of region, the survey results indicated that gross output and value added contribution by rural household enterprises was 87 percent and 91 percent respectively. The central and western regions contributed highest to both gross output and value added than the eastern and northern regions. Gross output was lowest in the northern region at shs 29 million representing 17 percent and value added was lowest in

the eastern region at shs 14 million roughly 13 percent. The western region contributed about 52 percent of gross output in the livestock, poultry, bee-keeping and fishing sub-industry. The north contributed about 95 percent of the gross output in the forestry industry. The central region contributed about 43 percent of the mining, quarrying and manufacturing gross output. The eastern region contributed about 39 percent of the gross output in hotels, lodges, bars, restaurants, and eating places. The central region contributed about 38 percent of the trade and services gross output. From the analysis, each of the four regions seems to have an advantage in specializing in a certain type of informal sector activity. In addition, initiatives for supporting off-farm enterprises are likely to boost informal sector performance,

Performance over time and duration of business

28. The 2002/2003 UNHS survey module on the informal sector included a question where respondents were asked to compare the performance of the activity in relation to a year ago for enterprises that had operated for at least one year. Of the total number of household enterprises surveyed, about 14 percent of the enterprises either operated for less than one year or did not state the performance of the business. Forty two percent of the household enterprises in urban areas reported declining performance of the enterprises compared to 35 percent in rural areas. Twenty seven percent of the rural household enterprises reported growing activity compared to 25 percent in urban areas. Most of the household enterprises, constituting about 37 percent responded that business had remained the same. About 27 percent reported growing business and about 36 percent reported declining business.

29. In terms of duration of business, the 2002/2003 survey collected information about the year in which the business was started. In rural areas, about 46.3 percent of the enterprises had been started less than 5 years ago and only 23 percent had stayed beyond 5 but less than 9 years. On the other hand, 55 percent of the enterprises in urban areas were setup less than 5 years ago. About 30.4 percent of the enterprises have been in existence for a period of over 15 years though the proportion is lower in urban areas. Urban establishments are fairly more recent compared to the rural establishments. Several reasons may explain this pattern. It could be that low income households in urban areas are diversifying sources of livelihood. It could be a consequence of unemployment and drop-outs that start up informal businesses. It could even be attributed to rural-urban migration. Rural dwellers may be moving to urban areas in search for better social facilities and opportunities.

30. On whether the businesses operate throughout the year or seasonal, the 2002/2003 UNHS established that almost three-quarters of the household enterprises operated 8 months or more during the previous 12 months prior to the survey. In contrast with the crop farming enterprises, most of the household enterprises are not seasonal. A similar pattern is observed in both rural and urban areas.

Extent of informality in cross border trade and tax evasion

31. Some studies define the informal sector to include the illegal activities. We review a tiny component of illegal activities based on the informal cross border trade (ICBT) survey conducted in late 2003 and early 2004. The survey found out that Uganda informally exported goods worth US $ 6.7 million and informally imported goods worth US $ 1.4 million. Thinking about the ICBT as a small part of the illegal/informal sector activities, then one asks a question about how much really do we know about the value of other informal sector activities such as black markets for foreign exchange, and others which are hard-to-capture in national statistics and thus, hard-to-tax.

3.0 Nature of linkages between formal and informal sector

3.1 A review of linkages

32. The World Bank (1989) noted that a key strategy for the promotion of the informal sector should be the strengthening of its linkages with the formal sector. A supportive policy and institutional regime for the formal sector is likely to result into the growth in size of the formal sector, expand its market boundaries, and facilitate the transfer of modern technology and managerial expertise to the informal sector.

33. The extent to which an informal sector enterprise will have backward and forward linkages with the formal sector will depend on several factors such as registration of the enterprise, total investment to date, entrepreneur's annual income, access to credit, number of workers, type of training received, previous work experience, future expansion plans, profitability of the enterprise, whether enterprise operates on a full-time basis, payment of rent on business premises, educational requirement for employees and year of establishment of the enterprise (Aminah, 2001). The location of the informal sector also matters when it comes to its links with the formal sector. Is the informal sector located in a low or high income area? Also formal sector enterprises are particularly attracted by the lower overhead costs in the informal sector, which in turn reduces the operating costs.

34. Backward linkages may involve the supply of necessary inputs for production from the formal sector. Such inputs include raw materials, equipment/machinery, finance, consumer goods, information and expertise as well as training of informal sector workers. Forward linkages entail the use of the informal sector's products and services as inputs into the formal sector's production process. Subcontracting which also plays a key role in linking both sectors can be regarded as a subset or appendage of forward linkages (Aminah, 2001). It involves formal sector to perform a specific or series of intermediate functions in the line of production.

35. As demonstrated above, Uganda's informal sector is important and thus calls for understanding how its characteristics affect its linkages with the formal sector. In addition, certain linkages if strengthened are more likely to enhance the contributions of the informal sector or lead to formalization of the informal sector. This section discusses the evidence on the backward and forward linkages.

36. *Market Linkage.* A sizeable number of formal sector products are sold in the informal sector. Likewise a sizeable number of goods marketed by the informal sector come from the formal sector, as the latter uses informal sector entrepreneurs to increase the its market. The 2002/2003 survey asked respondents on the sources of markets for their products. About 1.3 million constituting over 73 percent respondents revealed that the main source of market for their products were local consumers/passers-by. Local traders are the second main source of market for informal sector products. Over 90 percent of eating places/drinking places sell their products to local consumers/passers'-by whereas a sizeable proportion of mining, quarrying, and manufacturing industry enterprises sell their products to local traders only 10 percent of the informal sector households sell their output in shops or markets. Little linkages exist between the formal and informal sector.

37. Source of credit/capital linkage. Backward linkages with the formal sector may also be financial since informal sector operators require finance to run their enterprises. Generally, informal sector enterprises in Uganda face constraints to access credit. Women entrepreneurs are said to be more severely constrained to access credit compared to their male counterparts (Stevenson and St-Onge, 2005). The 2002/03 survey collected information on the sources of initial capital for establishing the enterprises. Over 90 percent of the enterprises were established using own savings. Only 6 percent of the enterprises were established using loans as the main source of capital. Loans are defined to come from friends, relatives, money lenders, banks, or financial institutions. Eight percent of the urban households engaged in the informal sector are more likely to access loans to start up businesses compared to the rural households. Lack of collateral is the main reason as to why household enterprise operators find it difficult to obtain loans from financial institutions. About 84 percent of the rural households and 67 percent of the urban households identified land as the major collateral to obtain a loan. In urban areas, houses are more likely to be used as collaterals. Usually commercial banks are less likely to enter into a contractual obligation with informal sector entrepreneurs. The financial linkage is weak partly because of the stringent conditions and collateral requirements demanded by the formal financial institutions, which may not be met by informal sector operators. To mitigate the problem of high interest rates to borrowing, commercial banks are argued to develop new financial products tailored to the conditions of the SMEs. In addition, a regulatory framework by the central bank to ensure that commercial banks operate within the law and do not take advantage of their clientele.

38. *Supply of raw materials, equipment/machinery.* The major sources of raw materials for formal sectors (e.g. large companies, foreign based companies and government agencies) are mainly other formal sector establishments. Informal sector businesses are not a major source of raw materials to the formal sector. This partly due to the poor quality of products from the informal sector and partly due to the lack of adequate information to cultivate trust in the formal sector about the quality of products.

39. *Formal sector sub-contracting with the informal sector is low*. The formal sector may sub-contract the informal sector to provide informal sector products as inputs or consumer goods. An example of such sub-contracting is common with the sugar-cane out growers (some informal) who provide sugarcane factories (formal) with sugarcanes as raw materials. Generally, most of the informal enterprises do contracts with other informal sector establishments or with small-scale formal enterprises. It is not common to find large companies or government agencies sub-contracting informal sector enterprises to provide inputs or consumer goods. Reasons to explain the poor linkage include the poor quality of informal sector products, lack of capital, and low capacity for production.

40. In general, the linkages are low between the formal sector and informal sector. The reasons to explain this pattern include the degree of registration of the informal enterprise, the financial status of the informal sector, the availability of credit facilities, the number and quality of employees within an informal sector, the skills and work experience of the informal sector entrepreneurs, and the location of the informal sector. In the next section, we outline possible mechanisms to strengthen the formal-informal sector linkages.

3.2 Strengthening the formal-informal sector linkages

41. *Registration of the informal enterprise.* Most formal establishments do not have linkages with the informal sector simply because the later are perceived to be illegal activities. Strengthening registration either among groups of informal establishments, or through trade unions or local council authorities is likely to improve the confidence of the formal sector. The registration should be voluntary to allow compliance from those who might resist doing so in suspicion of registration for tax purposes. Once registration has been done, the group members should be encouraged to keep records of their establishments. A possible incentive for registration is the ease with which those registered will be considered for vocational skill training programmes and other benefits.

42. *Financial status of the informal sector.* The financial status of the informal sector is likely to affect its linkages with the formal sector. Most informal establishments are constrained by investment resources including capital. Even for those with a strong capital base, it is difficult to prove since record keeping is generally poor among the informal sector establishments. In addition, most informal sector establishments do not have access to credit to purchase inputs and if they do, the costs associated with borrowing are too high. Access to credit is likely to improve the productive capacity of the informal sector and in turn improve the linkages with the formal sector. There is need to increase the scope for micro enterprises to have access to financial services. Micro finance provides an important ingredient in increasing the productivity of self-employment in the informal sector of the economy. However, a proper regulatory framework on the operations of the micro finance institutions is important. The bank of Uganda (BoU) has in place a new micro finance institutions act governing these institutions. However, a complete regulatory framework should recognize informal and community-based savings and credit associations, as well as community-based

organisations with credit programs, which bring financial services to the grass roots with little effect on the stability of the whole financial system.

43. *Skills development among informal sector entrepreneurs.* With low education and skills, informal sector entrepreneurs are likely to shun away from business negotiations with the formal sector and likewise the formal sector entrepreneurs are reluctant to enter business negotiations with the informal sector. Moreover, most informal sector entrepreneurs do not have enough work experience. Therefore, improving the skills of the informal sector is likely to strengthen the linkages with the formal sector.

4.0 Explaining the causes and constraints of the informal markets

Causes

44. *Uganda's political history and collapse of the economy in the 1970s.* The political turmoil and collapse of the economy in the 70s contributed to the development of a poor business culture and petty business mentality among some Ugandans. Although the political climate is calm in most parts of Uganda today, northern Uganda still faces insurgencies that have resulted in displacement of persons, contributing to worsening poverty and inequality levels in the country. As a result of the political insurgencies, people have become hesitant to invest in long term businesses, in addition to a multitude of constraints faced.

45. *Lack of a clear policy a priori to address the costs of Structural Adjustment Programme (SAP).* The retrenchment of public officers, poor retirement packages, and lack of policy to address the social aspects of adjustment prior to SAPs contributed to the ballooning of the informal sector. Many of those retrenched or retired had no opportunity and business advice to invest their resources in the formal sector. Many feared being taxed off their small capital and as a result, opted for the informal sector. Later on the programme for correcting the social aspects of adjustment known as Program for the Alleviation of Poverty and the Social Costs of Adjustment (PAPSCA) was launched.

46. *Rising poverty.* One of the challenges to poverty eradication in Uganda is the high concentration of low income earners in the informal sector. The informal sector is likely to be mostly dominated in those sectors with heavy population, particularly in the rural areas where agriculture is the main activity and in urban areas where trade and miscellaneous services are rampant. Evidence from UNHS survey data illustrated that between 1999/2000 and 2002/2003, there were significant inter-sectoral shifts by households. For example, Okidi et al (2002) find that the proportion of Ugandans living in households with crop agriculture as the main economic activity declined from about 68 to 52 percent. The share in non-crop agriculture and trade increased from 3 to 5 percent and 7 to 14 percent respectively, while that in manufacturing doubled to 7 percent. As

agricultural households shift from agriculture to non-agricultural self-employment, several possibilities can explain the shift. It could be due to the low returns in agriculture prompting diversification into non-agricultural enterprises, or the failure of the wage employment sector to absorb the labor released from agriculture (See Appleton and Ssewanyana, 2003). Households moving out of agriculture to join the non-agricultural self-employment are more likely to end up in the informal sector and not the formal sector. This is because formal sector jobs require skills that many people may not possess and the fact that the formal sector is not growing rapidly implies most of the people are employed in the informal sector. One would expect that as rural dwellers move to urban areas and as rural service provision improves, productivity in rural areas improves. This has not happened.

47. Some households in urban areas have fallen into poverty. Several reasons such as loss of jobs due to privatization or closure of firms and industries in certain areas, and the loss of loved ones due to HIV/AIDS are advanced to explain the vulnerability to poverty. An example is the case of Jinja town, formerly Uganda's main industrial town. The collapse of industries in Jinja resulted into unemployment of former factory employees, most of whom lacked adequate skills to take up alternative jobs elsewhere. The 2003 Jinja report from Uganda's Poverty Participatory Assessment Process (UPPAP) notes that the collapse of the factories also met a collapse in the demand of raw materials such as cotton, sugarcane, coffee, sorghum, timber, fish and horticulture products. Some rural farmers who used to supply factories in Jinja abandoned their farms or diverted to other activities for livelihood. These changes partly explain the increase in the informal sector in Jinja. To date, there is a vibrant informal sector in that town with many households engaged in bicycle transport business; dubbed *boda-boda*, metal works, wood fabrication, and cooked food vending.

48. The effects of *HIV/AIDS* can partly explain the growth of informal establishments in rural and urban areas. The active labor force has been and continues to be most vulnerable group to the pandemic. Yet at the same time, these are the people with the responsibility to support the young generation and the elderly. When an active member of a family dies of the disease, orphans are left with no one to support them. The situation is aggravated by the sale of accumulated assets to run the household. As households search for coping mechanisms, the informal sector is the first destination since start-up costs may not be high and the skills needed are easily acquired through learning by doing.

49. The informal sector project by ILO (2003) carried out in Uganda, Ghana, South Africa and Tanzania reported that despite Uganda's early declaration that HIV/AIDS was a public concern and the subsequent decline in HIV/AIDS to about 5-6 percent in 2001, there were no specific programmes for addressing HIV/AIDS in the informal sector. It

was not easy at the time to address problems in counseling, the access to medication, and advocacy against polygamy. The report revealed that young and unmarried informal sector workers were more vulnerable to HIV/AIDS than the older and married. Reasons advanced for the spread of HIV/AIDS included multiple sexual partners, some of the female casual laborers engaged in commercial sex, and failure to consistently use condoms for safer sex.

Constraints to the informal sector

50. The main constraints affecting the transformation of the informal sector or the growth of SMEs include the lack of entrepreneurial and management skills; limited access to and high cost of financing for SMEs; lack of business development support services; limited access to information on market opportunities; sources of competitive technologies; high cost of utilities and; poor economic infrastructure. These constraints limit substantially the productive capacity and efficiency of the informal sector in Uganda.

51. *A large pool of unskilled labor.* Survey evidence illustrates that about 55 percent of household heads have no more higher education than primary education. The low level of education/skills is likely to have contributed to the unchanged proportion constituting 77 percent of household heads engaged in self-employment as the main source of livelihood from 1992 to 2003 (Okidi et al, 2004). Efforts to improve the skills of informal sector participants such as adult literacy programmes and to the young generation in general will assist in improving the formal-informal sector linkages. Credit is due to the governments' efforts to implement the Universal Primary Education (UPE). The UPE programme is expected to boost the country's pool of skilled labor, particularly as completion rates from primary level education increase and if proposed universal secondary or vocational education is implemented. Despite challenges in implementation, UPE has increased access to primary education. However, the poor quality of education imparted remains a key concern. In addition, disparities in education outcomes (e.g. completion rates, grades at primary and secondary level examinations) exist between rural and urban areas.

52. *High cost of doing business.* Using the 1998 enterprise survey, Svensson (2001) found that in additional to high utility costs, some public officials demand bribes from entrepreneurs. These raise the cost of doing business and may work to promote the informality of establishments. This is exacerbated by the poor enforcement of contracts, delays and costs of registration and licensing of firms.

53. *Lack of capital.* About 52 percent of the respondents reported that start-up capital is the main problem in setting up enterprise. The problem of start-up capital is more pronounced in urban areas than in rural areas.

54. Insufficient markets for produce. The 2002/2003 UNHS survey revealed that 11 percent of the respondents reported that lack of markets. This suggests that lack of markets may not be a major problem among certain entrepreneurs. However, among the informal establishments, market availability and expansion is important.

55. *Not only is access to electricity limited, but also irregular and expensive*. Reinnikka and Svensson (1999) reported that due to unreliable and inadequate electricity, as many as 44 percent of medium-sized firms and 16 percent of small firms had purchased own power generators to complement on power supply. And that over half of the firms in agro-processing had invested in their own power generating capacity. The 2002/2003 UNHS revealed that 26 percent of households lived in communities with electricity. In semi-urban and urban areas where most of the informal sector activities are in manufacturing, trade and services, and hotels, lack of reliable power supply was revealed as a major problem. A 1998 Private Investment Survey revealed that on average firms loose an estimated 90 operating days a year due to power cuts. These losses translate into high cost of production and therefore reduce the competitiveness of private firms. The recent 12-hour load shedding in all parts of Uganda is yet to have a significant negative impact on informal sector growth and on the whole Ugandan economy. Few firms are likely to use electricity as utility prices have increased. Lack of the access to reliable power may reduce formal sector operations leading to lying off workers, cutting down on production, and a decline in national tax revenue.

56. The other constraints to informal sector business include lack of access to raw materials by the entrepreneurs. Some of the raw materials used by the informal sector are subject to high taxes. While the taxes should continue to be imposed, it is better to identify categories of goods used by the informal sector on which taxes are reduced. In exceptional cases, it may be possible to offer tax waivers for a specific period of time to allow certain businesses to grow and possibly graduate into the formal sector.

57. *Lack of a clear national policy on the informal sector*. This has led to poor quality of information dissemination on legal and regulatory practices including the registration procedures for informal sector businesses. In addition, some entrepreneurs in the informal sector lack basic tax education as to why taxes should be paid. The Uganda Revenue Authority has intensified the campaigns on tax education. In general, the lack of a clear policy defining the boundaries of the informal sector, its causes, constraints, potential and clear initiatives to improve formal-informal linkages have resulted in a growing sector, often thought of as parallel to the formal sector, yet with a sizeable population as beneficiaries and a potential tax base.

58. The above challenges constrain the government's efforts of bringing the informal sector into the tax-net. As rightly put in the Medium Term Competitive Strategy

(MTCS), one of the major challenges to Uganda's revenue mobilization is the large size of the informal sector. Uganda's tax revenue performance that has stagnated around 12 percent of GDP since 1991. Therefore, efforts to transform or support the informal sector are a must if Uganda is to broaden its tax base to generate high tax revenues and the same time seek out to support local entrepreneurships to boost private sector growth.

5.0 Initiatives to transform the informal sector

59. There is need for a clear policy stance on the informal sector in Uganda. Among the questions that we may ask ourselves is whether the informal sector has taken advantage of Uganda's trade liberalization. While the potential is available, the poor quality products and unreliability of informal sector production do not place the informal at a competitive advantage. For example, when the coffee sector was liberalized in 1991/1992, the outcomes included increased share of farm-gate prices that boosted the coffee farmers' incomes and exports earnings. The impact stretched to non-coffee and non-crop farming households in terms of increased incomes and reduction in poverty. At the time, non-agricultural enterprises increased in number. Some rural households were in position to recycle coffee earnings into off-farm enterprises and real assets. What was lacking at the time was a clear strategy on small-medium enterprises and informal sector establishments. Although the number of households running non-agricultural enterprises increased, the enterprises were quite small and many still face financial, infrastructure and organizational constraints. This phenomenon still characterizes 45 percent of Ugandan households running non-agricultural enterprises in Uganda.

60. The government's major role in Uganda's private sector driven economy is mainly to provide the necessary legal policy and physical infrastructure for private investment to flourish. The government of Uganda has put in place policies aimed at creating an enabling environment to encourage private sector participation in Uganda's economic growth. These include the exchange rate liberalization, tax incentives, deregulation of interest rates and trade liberalization.

61. Efforts to strengthen the forward and backward linkages are envisaged through the cluster approach stipulated in the MTCS. Under the approach, serious consideration is to be given to those sectors with a strong export potential, around which growth clusters can be developed. The approach provides an opportunity for linking the small operators (mainly in the informal sector) to the large firms (in the formal sector), and therefore provides the avenue for informal establishments to graduate to the formal sector. The inter-linkages promote technology transfer and innovation for improved productivity in the MSE sector. However, this approach is yet to be operationalised. The efforts by the Private Sector Foundation (PSF) and the Uganda Investment Authority to encourage inter-firm learning and establishment of forward and backward linkages in production are confronted with lots of challenges including policy coordination which impede the formalization of the informal sector.

62. Access to basic infrastructure services such as telecommunications, efficient transport, and power supply. The government has implemented reforms aimed at promoting efficiency these sectors. Access to telecommunications has improved significantly owing to the increased outreach by the three giants companies Uganda Telecom Limited (UTL), MTN and CELTEL.

63. The government with support from development partners has improved the road infrastructure. The Road Agency Formation Unit (RAFU) set up in April 1998 coordinates road construction and administration. Despite the improvements so far, the main challenge remains the maintenance of the roads, which if unattended to may reverse some of the gains in rural areas.

64. Despite the demonopolization of the former Uganda Electricity Board, a reform of the government's 1999 Power Sector Strategic Plan that allowed for the liberalisation of the power sector; the introduction of new private sector electricity infrastructure providers, and; the privatization of existing assets, the generation of sufficient electricity remains a challenge. However, the transmission and distribution of electricity has improved and the crackdown on illegal use of power and corruption is ongoing. The regulatory authority is operational and expected to improve coordination of electricity supply in Uganda. Efforts to intensify rural electrification have increased, but again with the increased power rationing, the gains to rural informal establishments are likely to be limited in the short run.

65. Reforms in the financial sector have continued since 1993. The government stipulates in the MTCS to increase the scope for private sector firms to access capital at reasonable cost, reduce risks associated with lending to the private sector, promote financial savings and restore public confidence in the financial sector, and to provide the incentives for diversification of financial products to cater for small and medium-sized enterprises. In addition, initiatives to facilitate informal sector lending are ongoing with support of commercial banks such as Centenary Rural Development Bank (CERUDEB) and microfinance institutions such as Pride Uganda, FINCA and some NGOs. However, the constraints to accessing credit require much more than regulation of the financial sector. On the side of government, there is need for a policy on the informal sector operations clearly outlining the tax and investment incentives and mechanisms to support promising informal establishments with a potential to become formal. On the side of the informal sector establishments, having a permanent physical address, a business plan/brochure, and well outlined organizational profile and record keeping are likely to improve the chances of access to financial resources.

6.0 The role of development partners

66. Bilateral and multilateral development partners are heavily involved in programmes to support the private sector development including small and medium enterprises (SMEs) in Uganda. Their participation takes two main forms: technical/policy support and financial support. In the following section, we review some of the activities based on a review of selected development partners operating in Uganda. Our aim is to collectively review the partners' initiatives in supporting informal sector activities in Uganda. We claim that initiatives in support of the PEAP do assist in the formalization of the informal sector or in enhancing its contributions to Uganda's development.

67. More recently, a core document, known as the Uganda Joint Assistance Strategy (UJAS) for 2005-2009 has been developed by seven development partners. The UJAS provides the basis for the partners' support for the implementation of Uganda's Poverty Eradication Action Plan (PEAP), a key policy framework for Uganda's development. The UJAS partners are the African Development Bank (AfDB), Germany, the Netherlands, Norway, Sweden, the United Kingdom's Department for International Development (DFID), and the World Bank Group. In addition to partners in the UJAS, several others partners such as United States Agency for International Development (USAID), International Monetary Fund (IMF), Japan International Cooperation Agency (JICA), United Nations Development Programme (UNDP), and International Labor Organization (ILO) provide support to Uganda's PEAP.

68. In 1995, the PSFU was set-up to support Uganda's private sector development. The PSFU executes private sector development projects on behalf of government. These include the Private Sector Competitive Project (PSCP), Business Uganda Development Scheme - Enterprise Development Support (BUDS-EDS), Business Uganda Development Scheme – Support for small enterprises (BUDS-SSE), Business Uganda Development Scheme – Energy for Rural Transformation (BUDS-ERT), and HIV/AIDS programme. These and more projects coordinated by the PSFU are testimony to the public-private partnerships and to the development cooperation by development partners in promoting strategies for economic growth.

69. **The International Monetary Fund (IMF)** supports Uganda's PEAP initiatives The Uganda government's economic program is supported by the International Monetary Fund (IMF) with a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF). The IMF offers technical assistance in areas of fiscal policy and monetary policy. The support from the IMF is keen to ensuring that government maintains macroeconomic stability, improving Uganda's tax system, and providing financial and technical support to Uganda's poverty reduction strategy.

70. **The World Bank.** The World Bank supports the PEAP in several projects. The World Bank funded the Private Sector Competitiveness Project (PSCP) aims at creating sustainable conditions for enterprise creation and growth that responds to local and export markets. Approved in 2004, the project is expected to reduce the cost of doing

business and encourages investment, will enable the private sector to be better positioned to respond to opportunities in specific categories of the market. The project aims at increasing the number of formal enterprises, the number of people employed and the number of skilled employees leading to an increase in output per worker. With regard to Micro, Small, and Medium Enterprises (MSMEs), the project outlines the expected benefits including changing enterprise behavior toward investment in skills, investment in skills for women, raising productivity and improving the quality, standards, and reliability of MSME producers participating in export value chains.

71. The Road Development Program for Uganda supported by the World Bank aims at improving access to rural areas and economically productive areas, and to progressively continue to build up sustainable road sector planning, design and program management capability including road safety management.

72. The Sustainable Management of Mineral Resources Project supported by the World Bank aims at assisting the Government of Uganda (GOU) implement its strategy to accelerate sustainable development, and reduce poverty by strengthening governance, transparency, and capacity in the management of mineral resources, with particular emphasis on community development in mining areas, and improve small-scale, and artisanal mining, in addition to promoting a socially, and environmentally sound development of the minerals sector, based on private investments.

73. The World Bank has supported research on the extent of the informal sector in Uganda. In addition, the Second Economic and Financial Management Project (EFPMII) assisted in the completion of the Uganda Bureau of Statistics (UBOS) building. The UBOS carries out survey implementation to inform the government on a wide range of issues including the recently conducted survey with an informal sector module, data of which this paper has relied upon.

74. As part of the on-going dialogue in the energy sector, the Government of Uganda has requested the Bank Group and other development partners' support for financing the Bujagali Hydropower Project as a Public-Private Partnership. The Bank Group has confirmed its support for the project. This project will be assist in alleviation the power deficiencies and in strengthening the rural electrification project. The World Bank also funds the BUDS-ERT project. The project aims at developing commercially oriented service delivery of energy and information and communication technologies (ICT) and small-scale renewable energy power generation by private enterprises.

75. The **USAID.** The USAID's involvement in supporting activities in the private sector including informal sector can be looked at in line with its support programmes to the small farmers, small and micro-enterprises (SMEs) and rural poor households, especially women. The support is in line with the government of Uganda's aim to encourage private sector growth and enhance its contribution to national development. To address some of the constraints discussed above, the USAID supports projects such as

Enterprise Uganda, Competitive Private Enterprise and Trade Expansion (COMPETE) and Support for Private Enterprise Expansion and Development (SPEED).

76. A report by USAID (2004) noted that significant progress has been made in expanding the financial resources available to small and medium enterprises through strengthening microfinance institutions and expanding guaranteed loan funds through commercial banks. Lending to small and medium enterprises increased by over $60 million from $35 million to $94 million. By 2002, USAID supported microfinance and bank clients located in rural areas had increased from nearly 403,000 to slightly over 477,000 clients.

77. Through its private sector programme called Private Enterprise Support, Training and Development Project (PRESTO), the USAID supports SMEs in entrepreneurship training, micro-finance, support to business associations and policy support. In the area of entrepreneurship development however, the PRESTO programme was only restricted to organizing entrepreneurship training workshops for over 200 entrepreneurs, without building local institutional capacity for post-training extension support.

78. The COMPETE project was designed to respond to Uganda's urgent need to improve the export competitiveness of its private enterprises in international markets so as to increase its foreign exchange earnings and boost domestic economic activity and employment. The COMPETE project selected three sectors in which to develop export competitiveness. These were coffee, fish and cotton. The information and telecommunications technology sector was also selected in support of creating competitiveness of the other sectors. The COMPETE projects works to identify the constraints to competitiveness confronting the sector, designing a short and longer-term strategy for both private and public sector. The COMPETE works closely with USAID'S SPEED program which provides assistance to small business and micro finance institutions operating in these sectors, as well as business development services to groups that work with producers and processors in the coffee, fish, and cotton sectors.

79. **The United Nations Development Program (UNDP).** The UNDP supports Uganda's PEAP through its support to Poverty Eradication through private sector development with special emphasis on the development of micro enterprises. The UNDP assists high growth small and micro-enterprises to become profitable and serve as models for other entrepreneurs. This is implemented by District Private Sector Promotion Centres and Village Savings and Credit Institutions, established to support start-ups as well as existing micro and small-scale enterprises to improve on their operations and obtain credit. The district private sector promotion centers are being strengthened to provide better business development services, including e-commerce. In addition, the government is being helped to establish a regulatory framework for micro-finance institutions to assist SMEs.

80. **Japan International Cooperation Agency (JICA) and Deutsche Gessellschaft fur Technische Zusammenarbeit (GTZ)**. The JICA supports Uganda's private sector development initiatives through support to skills development. Assistance to this sector

is being provided through the coordinated efforts of GTZ. GTZ advises the Ministry of Education and Sports (MoES) on the reform of the Business, Technical and Vocational Education and Training (BTVET) system in order to make it more responsive to the labour market and to improve access for all. In addition, GTZ together with the Swedish International Development Agency (SIDA) work in the financial sector in collaboration with the Bank of Uganda.

81. The **German Development Service (DED)** through PEVOT (Promoting Employment Oriented Vocational and Technical Training) aims to improve the level and relevance of skills, for certain occupations at selected pilot sites by promoting competence-based, modular training based on the Uganda Vocational Qualifications Framework (UVQF). The programme provides long-term support for institutions on national and local levels, and focuses, among other things, on organizational development and personnel capacity building. Activities include: support for the development of the UVQF (Uganda Vocational Qualifications Framework) and the UVQF secretariat to bridge the gap between what is taught in institutions and the real world of work, production, by the UVQF, of occupational profiles and standards, encouraging shorter, more flexible training which is more relevant to the labour market, advice on redrafting a needs-oriented BTVET and education policy, advice on legal and gender issues, promotion of a permanent steering committee for BTVET and its sub-committees, assistance to the MoES in the operation and implementation of the ESSP (Education Sector Strategic Plan), support for the Community Polytechnic (CP) programme of the MoES by introducing a new form of training delivery at pilot sites, mainstreaming of HIV/AIDS in the workplace and the promotion of mainstreaming elsewhere.

82. **European Union.** The EU support includes efforts in education, agriculture, road rehabilitation and improvement/expansion and private sector development. The EU has supported MSMEs through the BUDS-SSE project and the BUDS-EDS project. The project aims at encouraging the development and competitiveness of the Private Sector to Uganda. The project focuses on the needs of MSMEs in Uganda. The project that started in 2001 has assisted over 300 enterprises from 25 districts of Uganda, and, with an estimated over 1,500 beneficiaries. Training activities supported include book-keeping, day to day business management, better farming methods, IT, customer care, marketing, product improvement and improvement of consultants skills.

83. **The United Nations Conference on Trade and Development (UNCTAD)** assisted in the introduction of a modern data processing system (asycuda) into the customs clearance process that has aided in the faster clearance of cargo, improve revenue control and thus minimize tax evasion and will provide up-to-date, accurate information on trade in goods.

84. **The Department for International Development (DFID)** supports several projects in line with Uganda's PEAP. These include the Support to the Uganda Revenue Authority (URA) which aims at enabling the URA management to plan and

implement a modernisation programme in the revenue departments, with a particular emphasis on the custom and excise department which will result in year on year increases in efficiency and revenue collection. The Financial Sector Deepening Project which aims at deepening the capacity of Uganda's financial sector to meet the financial needs of poor rural and urban households, micro, small and medium enterprise on a sustainable basis. The Commercial Justice Service Reform which aims at putting in place a functioning and effective commercial court system which will survive and develop without external assistance. The project on Improving Business Development Services (BDS) which aims at developing and promoting BDS support approaches that are more inclusive of disabled people to enable them tp participate in or run small scale enterprises engaged in manufacturing. The project on Building HIV/AIDS Advocacy, Care and Prevention aims at improving the capacity of people infected and affected by HIV/AIDS to advocate for their rights and better cope with the effects of the epidemic. The HIV/AIDS Umbrella Programme aimed at supporting the implementation of the HIV /AIDS National Strategic Framework 2000-2005.

85. **The ILO.** The International Labor Organization in collaboration with several development partners such as the SIDA, the Italian government have supported programs relating HIV/AIDS prevention in the transport sector and in the informal sector. In addition, the ILO supports Business Development Services (BDS) to women entrepreneurs.

86. **The African Development Bank Group** supports several projects that directly or indirectly assist in private sector development. These projects include the ADB EDUCATION II PROJECT, the fisheries development project, the Mineral Resources Management and Capacity Building project/(SMMRP), the Central Uganda Road Maintenance and Upgrading Project and Road Sector Support Project 1 and the Rural Microfinance Support Project (RMSP). The Education II project aims at improve the quality of education through improvement and provision of school facilities, review of the primary and secondary education curriculum reforms and establishment of gender equity in secondary science Education. The aim of the fisheries development project is to increase incomes from fishing through availability of higher quality fish products and through strengthening of aquaculture research and development. The SMMRP aims at contributing towards stimulating investments in the mineral sector, increase revenues, resulting into rural development, regularize and improve small-scale mining, and put in place mechanisms to minimize and mitigate the adverse social and environmental impacts of mineral exploitation. The road sector projects aim at improving the road network to open up opportunities that further economic growth. The RMSP aims at increasingg access to financial services to support MSMEs in rural areas.

7 The feasibility of formalizing the Informal Sector

87. We have reviewed the status of the informal sector in Uganda. We have also pointed out the challenges and the consequences of informalization. To address these

challenges, the government is committed to the implementation of the PEAP. And the previous review, despite being ad hoc demonstrates the commitment of the donors in supporting private sector development in Uganda. These initiatives assist in boosting the firms' productivity, competitiveness in local and regional markets. However, the lack of a clear policy strategy on the informal sector that is derived from bottom-up planning processes undermines the current progress in supporting the sector. A key element of such a strategy should entail encouraging the formation of local informal group associations. These groups will provide a platform for policy dialogue among the informal sector participants and will constitute a frame upon which government designs incentives to support the sector. Entrepreneurs dealing in a similar activity in a particular location can be mobilized and encouraged to form organized informal initiatives. Entrepreneurs should be encouraged to document guidelines to assist their colleagues in terms of building technical capacity. Through such initiatives, entrepreneurs can address the problems of inadequate financial resources. As a group, it is much easier to bargain for suppliers of raw materials from a formal enterprise or even secure financial support.

88. Aminah (2001) suggests that encouraging informal enterprises to register is likely to improve the linkages with the formal sector. This suggestion is based on the findings that informal enterprises that are registered are more likely to have backward and forward linkages with the formal sector. A persuasive approach to register with the relevant authorities or unions is a step in the right direction. Registration should be encouraged and entrepreneurs should be informed of the likely benefits of doing so and that bureaucracy will be minimized in the process.

89. The availability of finance is a crucial challenge facing informal sector. Formal sources of finance have not been successful in meeting the credit needs of the informal sector. As a result, the informal sector remains small, with primitive production technologies, and with limited opportunities/linkages with the formal sector. With the stringent formal banking sector requirements for credit access, little opportunities are open for the informal sector to tap. The government should create an enabling environment for the informal sector to thrive. Schemes designed to enforce contracts and minimize default on loans as well as credit for sustained growth of informal sector business could be encouraged.

90. While government improves access to universal primary education and revitalizes technical/vocational education, there is an urgent need to develop specialized skills tailored to the private sector needs. Improvement in the vocational training and emphasis on education of informal sector workers will all enhance the productivity and linkages with the formal sector. The need for adequate training and retraining of informal sector entrepreneurs and workers. Such training should emphasize basic book-keeping and managerial skills as well as basic knowledge of equipment maintenance. In this regard, universities, research institutions and non-Governmental organizations can play a more proactive role in designing training programmes for operators of the informal sector.

91. A campaign or programme to increase partnerships between informal and formal sector. This could be through the media-TVs programme such the WBS TV's *Kola ngo omuddu* (literally encouraging people to work hard) programme. Deliberate attempts could be made so that informal sector enterprises producing household consumer items can be linked to large-scale trading enterprises. Informal enterprises fabricating auto spares parts can be linked to large scale assembly plants. Such links can increase productivity, technical and managerial expertise as well as innovative capacity of the informal sector.

8. Enhancing the contributions of the informal sector

92. At the macro level, sustaining low and stable prices, a competitive exchange rate and low interest rates are key factors to promoting investment in Uganda. In addition, instituting a national policy on the informal sector is important. The October 2000 Regulatory Cost Survey (MFPED, 2000a) found that taxation, customs and business start-ups were the three regulatory areas that posed the greatest costs on Ugandan enterprises. There is a need to offer tax incentives to allow informal establishments to grow. That way it likely that some will graduate to the formal sector.

93. The support to local government program is one area that the donors may address. The requirements for minimum assessment of local government performance should in our view be extended to include the measures undertaken by each local government to improve the working environment in its jurisdiction. The local governments can design and implement programmes to assist local entrepreneurs. Incorporating such conditions in the reward or penalty scheme for intergovernmental transfers is likely to incentivize the local leadership to pay attention to the local business climate. By creating opportunities for people to earn income on a continued basis and in established places known by the local leadership, there will be scope for formalizing the informal sector.

94. The formalization of the informal sector has a potential to expand employment opportunities, increase government tax revenues and to raise incomes of participants. Strategic interventions such as MTCS if fully implemented would assist in the process of transformation of the informal sector. Understanding why the informal sector has grown calls for understanding the constraints to the development of Uganda's formal sector. The constraints include low demand, poor infrastructure, lack of human capital, poor governance. Addressing these constraints remains a challenge to the MTCS.

95. The roles of the Uganda Investment Authority (UIA) ought to stretch and explicitly incorporate strategic efforts to strengthen formal-informal sector linkages. The UIA was established to assist business startup, especially by foreign investors. The UIA should spearhead encouraging formal foreign investors to re-invest in the informal/SMEs establishments in Uganda to strengthen their linkages. The UIA in conjunction with the URA should also design an incentive regime for informal sector establishments that graduate into the formal sector.

6.0 Conclusions and Recommendations

96. This study aimed at determining the size of the informal sector, its contribution to employment and incomes and profiling of the informal sector (rural versus urban, gender, breakdown of sectoral activities). It also analyzed the formal-informal sector linkages and the appropriate government legislative and institutional support to strengthen the linkages. We also examined the reasons behind the ballooning of the informal markets and identified the factors responsible for the difficulties in bringing the informal sector operators into the tax net and how institutional and legislative support could help in this process. We examined the role of donors, including the WB and IMF, in supporting the operators in the informal sector. We concluded by examining the feasibility and benefits of formalizing the informal sector as a strategy for bringing it into the tax net, and suggesting, if formalizing it proves to be impossible, other alternative mechanisms for enhancing the contributions of the informal sector to national development effort through taxation.

97. We find that Uganda's informal sector is a source of employment to a significant proportion of the population. It employs a significant number of households and women. The sector exists in both rural and urban areas. Different regions in the country are characterized by particular activities of the informal sector, signifying the diversity of informal sector activities. We also show that its contribution to gross output and value added is substantial and offers opportunity in broadening the tax base.

98. We also note the limited linkages between formal and informal sectors. The causes of Uganda's informal sector include the Uganda's political history and collapse of the economy in the 1970s, the lack of a clear policy a prior to address the costs of Structural Adjustment Programme (SAP), rising poverty, and the effects of HIV/AIDS. We also note that the informal sector is faced with constraints that impede its performance. The constraints to the informal sector include a large pool of unskilled labor, high cost of doing business, lack of capital, insufficient markets for produce, and limited, irregular and expensive electricity. The other constraints include lack of access to raw materials. These constraints are compounded by the lack of a clear national policy on the informal sector.

99. We find that the government of Uganda is committed to promoting the private sector. We also find that bilateral and multilateral donors are heavily involved in providing technical and financial support to develop private sector initiatives. Despite these efforts, we note that the transformation of the informal sector may not been realized in the near future. Transformation will start with the formulation and later on implementation of a national policy on the informal sector that stipulates its boundaries and sets out policies and incentives to support the sector. Despite its significant contributions, little attention has specifically been paid to the informal sector.

100. Informal sector contributions can be enhanced through provision of micro-finance support, skills development and provision of infrastructure. In addition, the

government will have to maintain macroeconomic and political stability as well as continue implementing policies to improve the business regulatory framework.

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