

Addressing informality in Egypt

Dr. Gita Subrahmanyam
London School of Economics

“Is it not strange that you should come to Cairo to work in a company that occupies a high-rise building with an elevator and uniformed office boys, only to find yourself hurled into a place underground where you take on the responsibility of hot and cold water, a black ful furnace that feeds on garbage, and a small workshop that makes jewelry? Your mother had thought you would become like a little moon that would light her way or a small sun that would warm her heart. Will you write to her and say: I finally found work in a ful furnace after ten days of continuous searching? When you enter it you come out black like a slave. Will you tell her that you sleep in a sticky place covered with water and soap and filled with naked men? That this was all you could find? Only this narrow dead end? That you were hungry and naked; that your underwear is filthy and that your shoes are worn out; that you want a hot meal with a lot of butter, and that you miss your days in Ismailiya; that spring will not return... and that you fear the winter?”

– Ismail Wali al-Din, [Hammam al-Malatili](#) (as translated by Samia Mehrez, 2010)

What is informality? Thirty 'synonyms'

- Black market
- Unorganised sector
- Hidden economy
- Marginal sector
- Shadow economy
- Extra-legal economy
- etc.

What is informality? Definitions

1. Informal enterprises (= 'informal sector')

- 'Unregistered and/or small-scale private unincorporated enterprises engaged in non-agricultural activities'
- Firms that evade or escape regulation (non-compliance or non-enforcement)

2. Informal employment

- 'By law or in practice, not subject to national labour legislation or entitled to social protection and employment benefits'
- Owners/employers and workers in informal sector firms, and informal workers in formal sector firms

3. Informal activities

- 'All economic activities that are – in law or practice – not covered or insufficiently covered by formal arrangements'
- Unregulated, evaded, hidden and/or illegal production

What is informality? Proxy variables

1. Informal enterprises (= 'informal sector')

- Number of workers (since small firms often escape regulation)
- Size of capital (since firms with low capital often remain small)
- Non-compliance with main legal requirements

2. Informal employment

- Lack of job contract
- Lack of access to social security or pension benefits
- Insecure or irregular conditions (casual, short-term, seasonal, own-account, outside establishments)
- Low wages (not subject to or paid below minimum wage)

3. Informal activities

- Direct estimates: tax audits or voluntary sample surveys
- Indirect estimates: velocity of currency demand; electricity consumption; national income vs expenditure

Egypt: data, definitions, proxy variables

- No single source of data (official or private) on informality and no single, uniformly applied definition
- Economic census (CAPMAS)
 - ‘Enterprise-based approach’ (emphasis on size)
 - Retail trading firms < 5 employees; manufacturing industries and repair services < 10 employees; unincorporated and unregistered business entities that do not maintain regular financial accounts
- Egyptian Labour Market Panel Survey (ERF/CAPMAS)
 - Informal enterprises and employment (emphasis on compliance)
 - Informal enterprises → non-compliance with main legal requirements (obtaining licence, registering business, paying tax, keeping accounts)
 - Informal employment → non-agricultural workers not covered by basic social or legal protections or unemployment insurance
- Myriad other definitions, indicators, data sources

Prevalence of informality in Egypt

% of informal enterprises based on:

Firm size - maximal interpretation (<10 employees)	93%
Firm size - minimal interpretation (<5 employees)	92%
Failure to comply with at least one legal requirement	78%

% of informal employment based on:

Lack of basic social/legal protections or employment benefits	51%
Employment outside establishments	48%
Low-paid (paid below minimum wage)	70%

% of informal activities based on

Electricity consumption indication of economic activity	68% of GDP
Currency demand method	37% of GDP

Informal employment as % of total non-agricultural employment

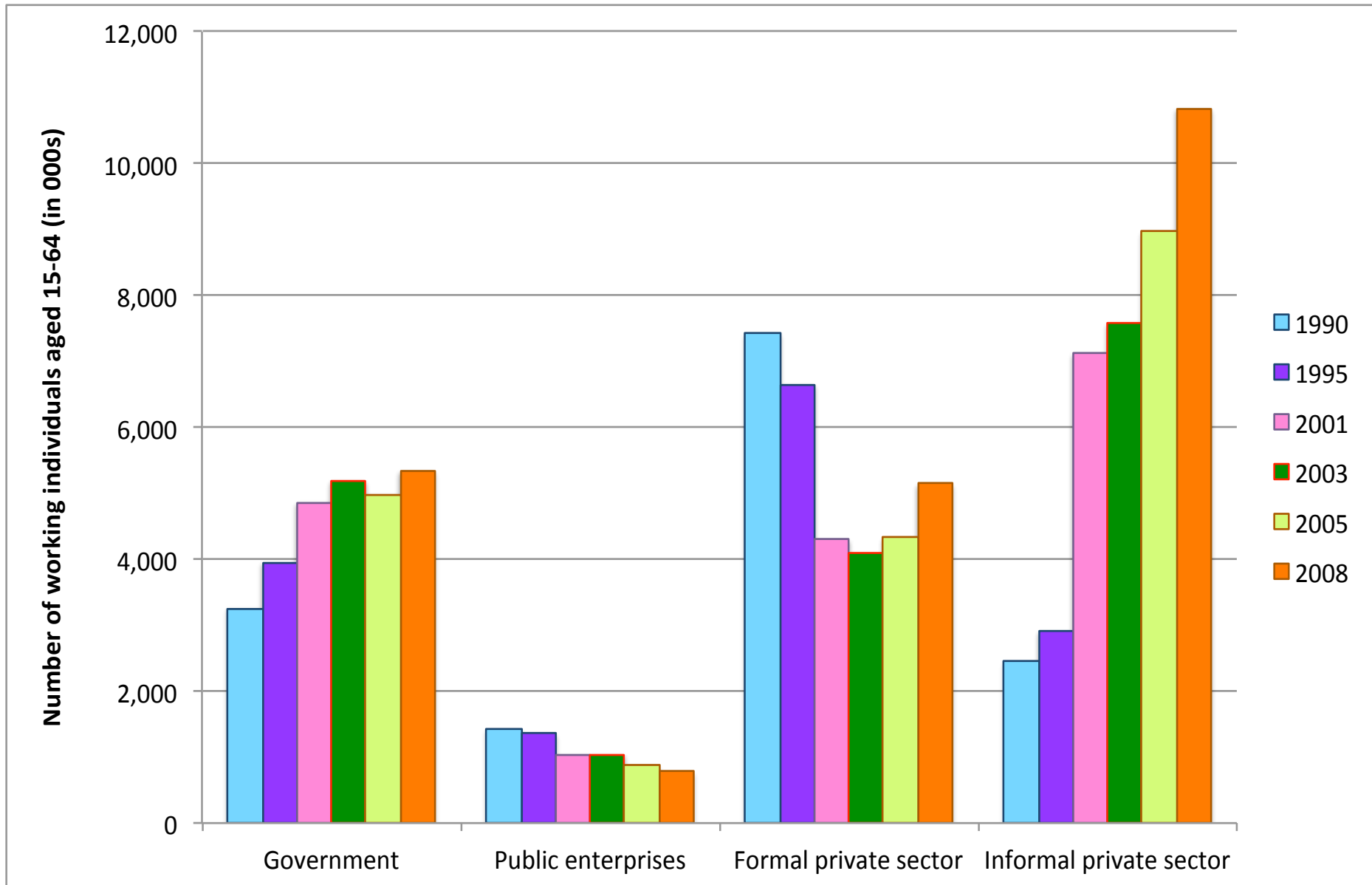
<u>Region</u>	<u>Point estimate</u>	<u>Range estimate</u>
South Asia	82%	62-84%
Sub-Saharan Africa	66%	33-82%
East and Southeast Asia	65%	42-73%
Latin America	51%	40-75%
Middle East and North Africa	45%	31-57%
Eastern Europe and Central Asia	10%	6-16%
Egypt	61%	51-70%

Source: International Labour Office (2013a) *Women and men in the informal economy: a statistical picture* (second edition; Geneva: ILO). Egypt figures from previous slide.

Informality not always so prevalent in Egypt

- 1960-1976: Informal employment ↓ from 41% to 24% of total employment due to increased formal sector opps
- Law No. 14 of 1964: guaranteed public sector jobs for all university and secondary school graduates
 - 1960-1981: Public employment ↑ from 16% to 32% of total employment
 - Controlled non-market public wages for growing number of graduates → strained public finances
- End 1980s: Egypt's fiscal situation became unsustainable
- 1991: Egypt adopted economic reform and structural adjustment package from IMF/World Bank

Labour market outcomes in Egypt, 1990-2008



Source: Nasser, H. (2011) 'Growth, Employment Policies and Economic Linkages: Egypt', *ILO Employment Working Paper*

Why has informality grown since 1990?

Freedom of choice perspective

- Free choice: People choose to operate informally because
 - informality offers greater benefits than formality
 - benefits of formality do not outweigh its costs
- Forced choice: People are forced into informality because
 - there are too few formal sector job opportunities
 - they are excluded from the formal sector

Main causes of informality, by freedom of choice

<u>Level of aggregation</u>	<u>Free choice</u>	<u>Forced choice</u>
Informal activities (macro level)	Weak rule of law Low trust in government Weak enforcement of regulations	Exclusion from formal sector
Informal enterprises (market level)	Higher profits in informal sector Formality: costs > benefits Preference for self-employment	Low access to credit High barriers to entry in formal sector Self-employment only option
Informal employment (household level)	Higher wages in informal sector Social protection: costs > benefits	Shortage of formal sector jobs Lack of skills required by employers Exclusion from formal sector

Incentives towards informality:
What are costs and benefits of
formally doing business in Egypt?

Costs of formally doing business in Egypt

Costs of compliance for firms not employing labour

<u>Legal requirements</u>	<u>Steps (number)</u>	<u>Time required</u>	<u>Costs involved</u>
Business registration (Cairo)	7 procedures	8 days	9.7% per capita income
Getting construction permit	21 procedures	179 days	109% per capita income
Enforcing a contract	42 procedures	2.7 years	26% of claim value
Paying corporate tax	17 payments	227 hours	16.8% of profits

Additional costs and constraints for firms employing labour

<u>Legal requirements</u>	<u>Steps (number)</u>	<u>Time required</u>	<u>Costs involved</u>
Social security contributions	12 payments	165 hours	25.8% of profits
Paid annual leave (average)			24 working days
Firing workers (equivalent cost)			128 weeks' wages
Third-party notification and approval (MoMM) even if only one worker is being fired.			

Benefits of formally doing business in Egypt

- Government support for MSEs
 - Start-up and growth services (Industrial Modernisation Centre)
 - R+D support (Egypt Technology and Innovation Centres)
 - Assistance attracting foreign investment (National Supplier Development Programme)
 - HOWEVER... Main beneficiaries: **medium-sized** industrial firms in Greater Cairo and Alexandria, not young service-oriented MSEs
- Access to formal credit channels
 - High collateral requirements (131% of loan amount) for loans; yet $\approx 90\%$ of individuals lack formal legal titles to real estate
 - Less than 6% of businesses – mainly **large** firms – have bank loan
 - Government plans to establish trust funds in each governorate to assist MSEs in obtaining microfinance not yet implemented

Costs of formality outweigh benefits for most firms

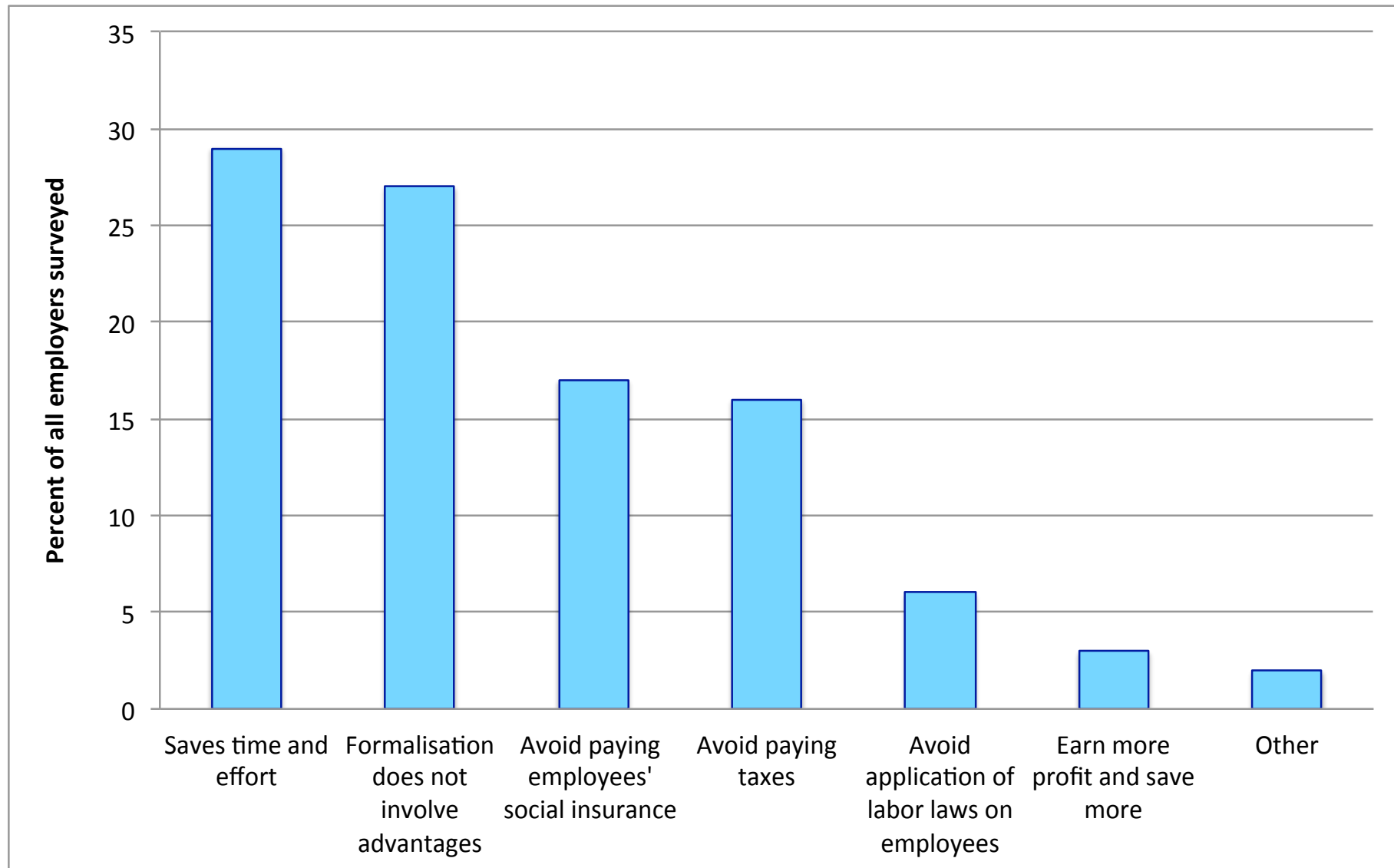
Distribution of businesses in Egypt, by size, in 2006 (CAPMAS)

<u>Category</u>	<u>Size</u>	<u>% of all firms</u>	<u>% employment</u>
Micro enterprises	1-4 employees	91.91%	58%
Small enterprises	5-49 employees	7.82%	22%
Medium-sized enterprises	50-99 employees	0.13%	3%
Large enterprises	Over 100 employees	0.14%	17%

Forced choice explanation: High costs of doing business formally and low access to credit = some firms cannot afford to formalise

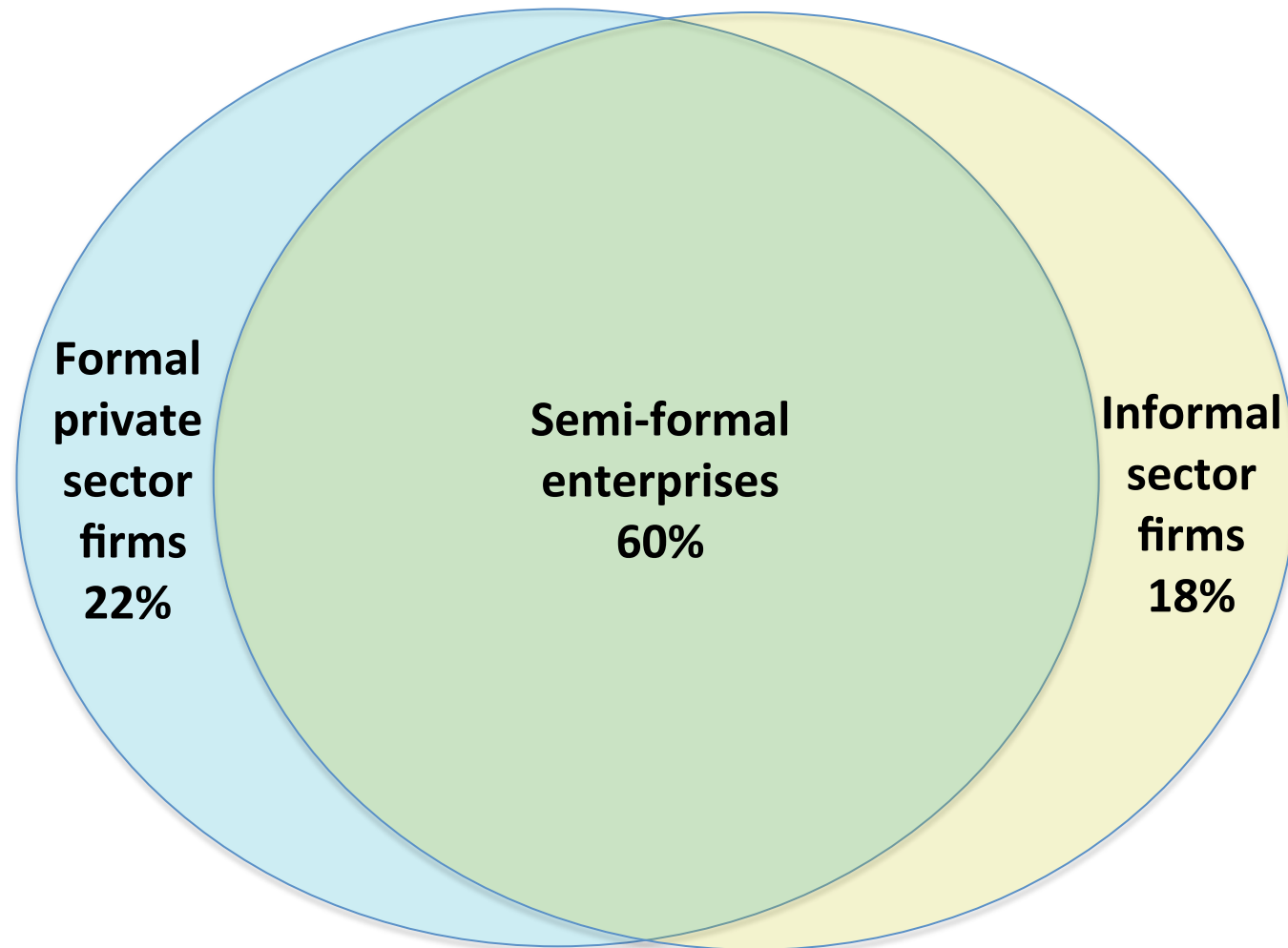
Free choice explanation: Low net benefits of formality and high competition from informal firms = some firms refuse to comply

Reasons for being informal in Egypt: employers' view



Source: El-Fattah, M. (2012) 'A Survey-Based Exploration of Satisfaction and Profitability in Egypt's Informal Sector', *Egyptian Center for Economic Studies Working Paper*, no.169 (Egyptian Center for Economic Studies).

Enterprise landscape in Egypt, 2011



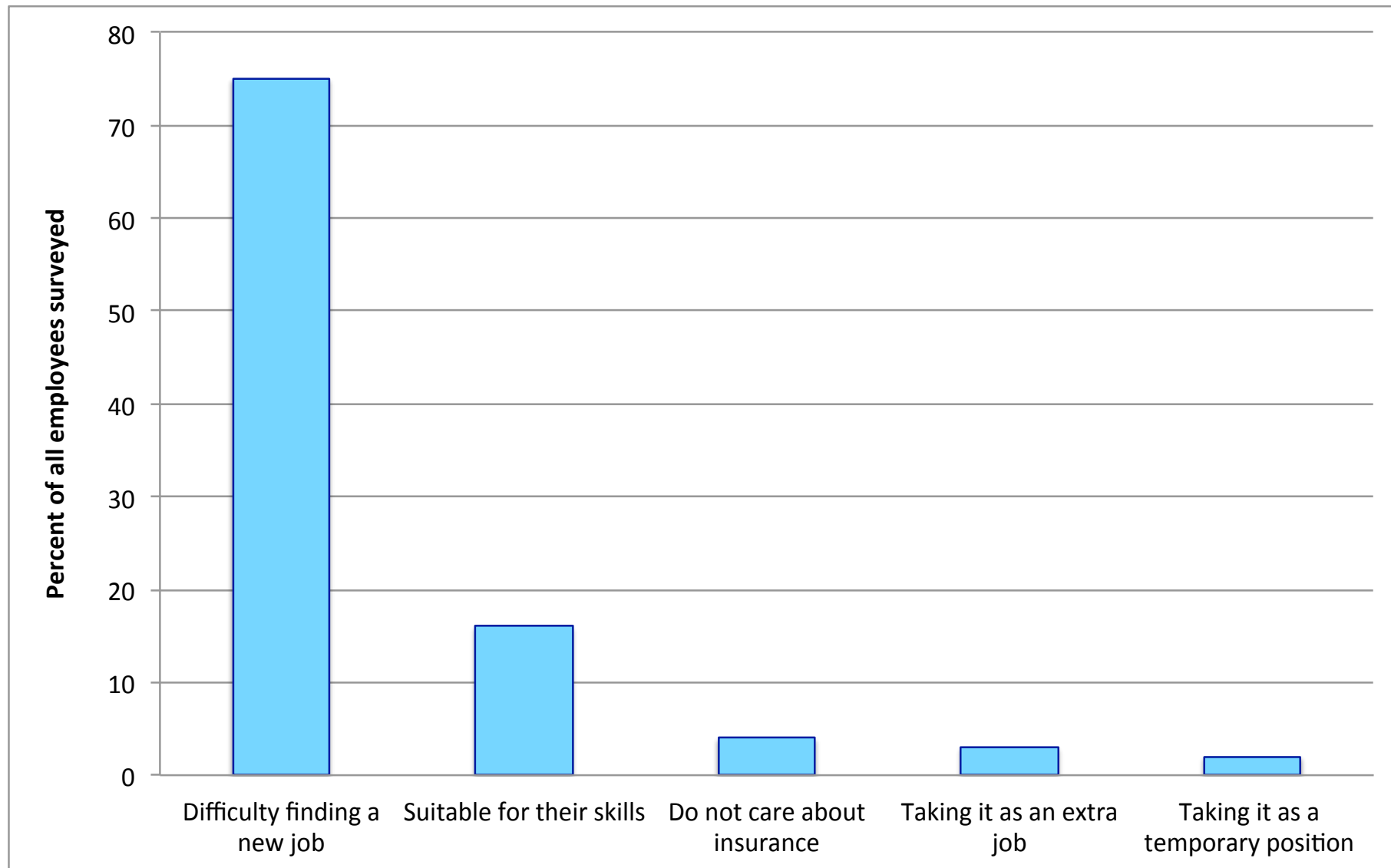
Based on data from: Ghanem, H. (2013) 'The role of micro and small enterprises in Egypt's economic transition', *Global Economy and Development Working Paper*, no. 55 (Washington DC: Brookings Institute).

Incentives towards informality:
What are costs and benefits of
being formally employed in Egypt?

Costs vs. benefits of formal employment

- Costs of formal employment
 - Social security: 14% of base salary up to a government-set ceiling
 - Income tax: 10-25% of income above EGP 5000
- Benefits of formal employment
 - Public sector and wage workers: pension; sickness, disability and maternity pay; private health care; unemployment benefits
 - Other registered workers: elementary medical care; basic pension
 - Low expected benefits: underfunded system + lack of inflation adjustment means pensions often fall below poverty line
- Pay and conditions
 - Public sector: 80% higher pay than formal private sector
 - Formal sector: 44% higher pay than informal sector
 - Shorter hours in public sector than in private sector
- Best jobs: public sector – educated youth queue for them

Reasons for being informal in Egypt: employees' view

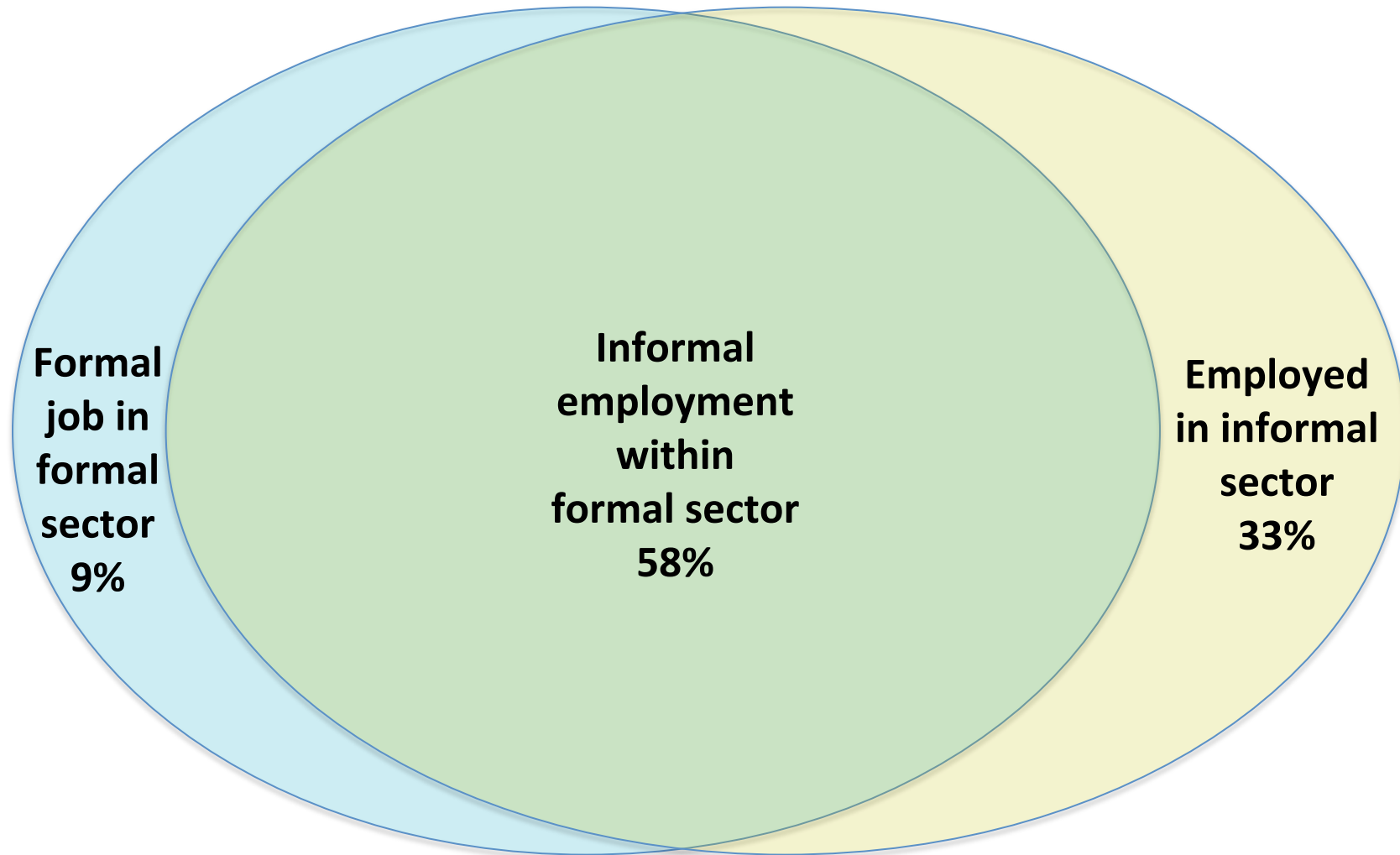


Source: El-Fattah, M. (2012) 'A Survey-Based Exploration of Satisfaction and Profitability in Egypt's Informal Sector', *Egyptian Center for Economic Studies Working Paper*, no.169 (Egyptian Center for Economic Studies).

Demographic trends and LM outcomes in Egypt

- Demographic transition in early 1980s → youth bulge
 - Growth in Egyptian labour force, peaking in 2005
 - Decrease in formal private sector job opportunities since 1990
 - Result: higher competition for fewer jobs
- Public sector job promise → growth in educational enrolments, especially secondary/tertiary levels
 - Skills mismatches: most students pursue social sciences/humanities
 - Poor educational outputs: rote learning rather than application
 - Result: lack of adequately skilled workers for private sector firms
- Implications for formal private sector hiring
 - Firms unwilling to bear costs of formally hiring poorly skilled new entrants with lack of work experience (↑ informal hiring)
 - Letters of recommendation more important than skills assessments in allocating limited formal sector positions (↑ social inequality)

Employment landscape for young people in Egypt



Source: Shehu, E. and Nilsson, B. (2014) *Informal employment among youth: Evidence from 20 school-to-work transition surveys* (Geneva: ILO).

Informality: stepping stone or dead end?

- Recent ILO school-to-work transition survey (5,200 youth)
 - Informal employment: means of overcoming skills mismatches
 - Informal job in informal sector: average age 22
 - Informal employment in formal sector: average age 23
 - Formal job in formal sector: average age 25
- ‘Graduation’ out of informal sector not open to everyone
 - Only 32% of formal sector workers previously employed in informal sector (ELMPS 2006)
- Most likely to graduate out
 - Males, well educated, urban dwellers, people from privileged backgrounds (parents who are wealthy and/or educated)
- Dead end for uneducated, rural, poor young women
 - 2/3 of informally employed women – unpaid family workers
 - 1/4 of all working women – self-employed (only option because of outdated social attitudes, discrimination, etc)

Why informality needs to be addressed

<u>Level of aggregation</u>	<u>Main consequences of informality</u>
Informal activities (macro level)	Free-rider problem - fiscal implications/encourages further informality Erosion of social norms - propensity toward lawlessness Inaccurate labour market information - limits effectiveness of social policies
Informal enterprises (market level)	Unfair competition by informal firms - encourages further informality Drive to remain 'under the radar' - deters growth and investment Lack of access to formal support - limits growth, productivity and innovation
Informal employment (household level)	Exploitation - low or no pay and insecure/poor working conditions for some Lack of legal recourse - workers unprotected by labour laws/trade unions Lack of social protection - most workers uninsured against income shocks

On the other hand....

Informal economy corrects many flaws of formal economy.
It is:

- Fast-growing and dynamic: Creates twice as many jobs as FPS. Contributes large share of GDP
- Low barriers to entry: Enables non-wealthy entrepreneurs
- Flexible: Free from burdensome regulations and patronage networks (skills mismatches are lower in informal sector)
- Market-driven: Wage rates determined by supply and demand, not collective bargaining. Groups do not fund services from which they are unlikely to reap benefits.
- Pro-poor: Offers refuge to workers excluded from formal sector. Empowers vulnerable groups.
- Resilient: Has thrived despite lack of government support. Domestic focus = resilient to external shocks.

Main options for addressing informality

1. Retain the status quo

- Deliberately leaving small firms unregulated space to grow
- Not appropriate option where informality is prevalent

2. Formalise the informal economy

- Bringing informal entities inside fabric of the legal economy
- ‘Sticks and carrots’
- Sanctions/controls punish those who are forced into informality

3. Informalise the formal economy

- Bringing formal economy closer to costs/flexibility of informal
- Relax regulations/lower costs – remove blockages to FPS growth
- Lowering compliance costs reduces incentives for informality

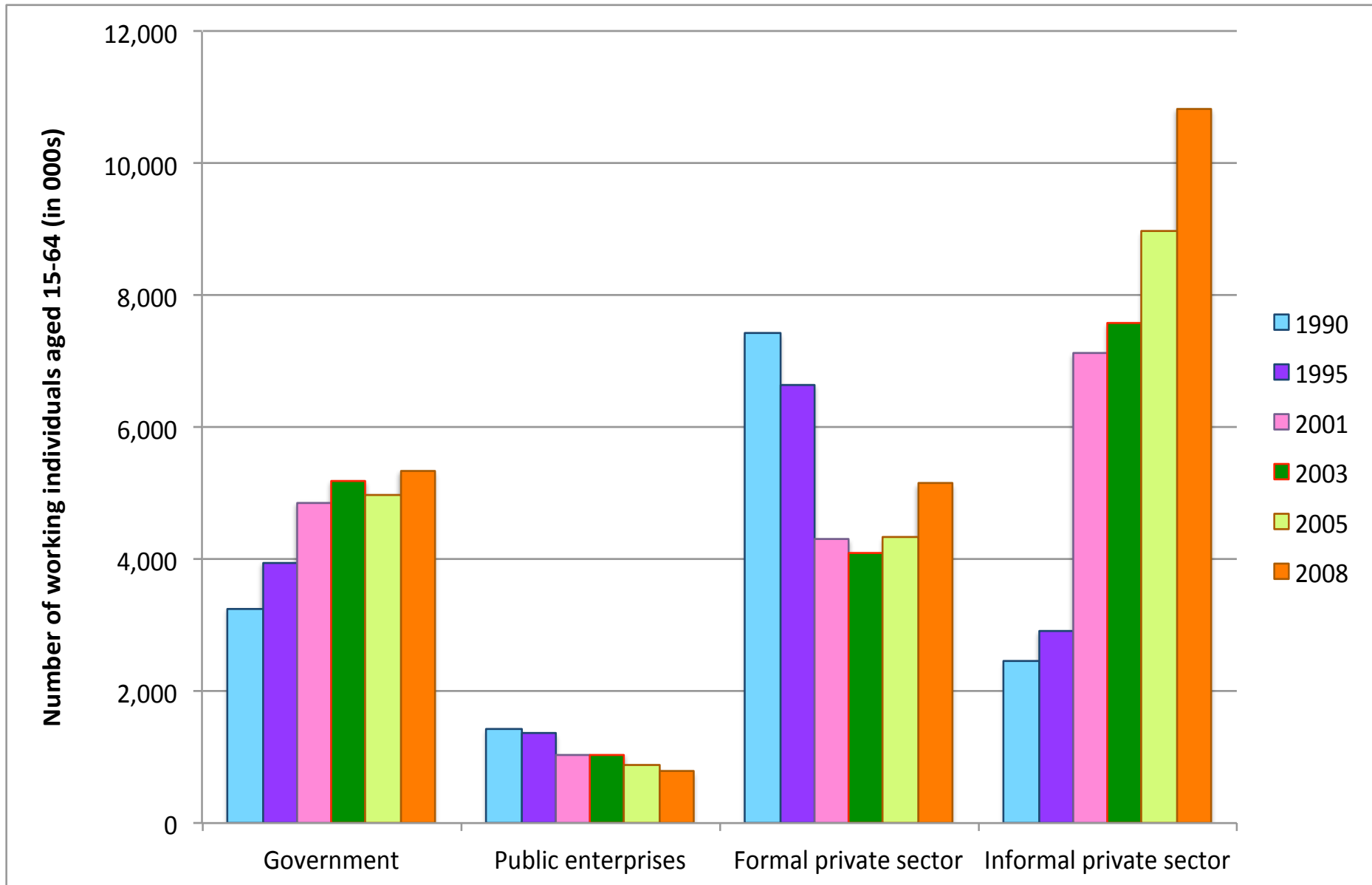
4. Unleash developmental potential of the informal economy

- Boosting informal firms’ and workers’ productivity/resilience
- Offering support/assistance to informal firms and workers

Egyptian government's response to informality

- Pre-2004: no measures specifically targeting informality
- 2004: Law No. 141 – Promotion of Small Enterprises
 - Measures to formalise informal enterprises
 - Tax breaks for new businesses; tax amnesty for existing firms
 - Increased penalties for tax evasion
 - Measures to informalise formal economy
 - Simplified, streamlined registration: one-stop shops set up
 - Lower costs: no minimum capital requirement and flat fees
 - Lower tax rates (income and corporate)
 - Measures to boost growth/productivity of informal firms
 - Outcomes
 - Formal registrations grew 35% from 2005-2012
 - Tax revenues as percentage of GDP increased year-on-year
- **HOWEVER:** Informality has grown faster than formality

Labour market outcomes in Egypt, 1990-2008

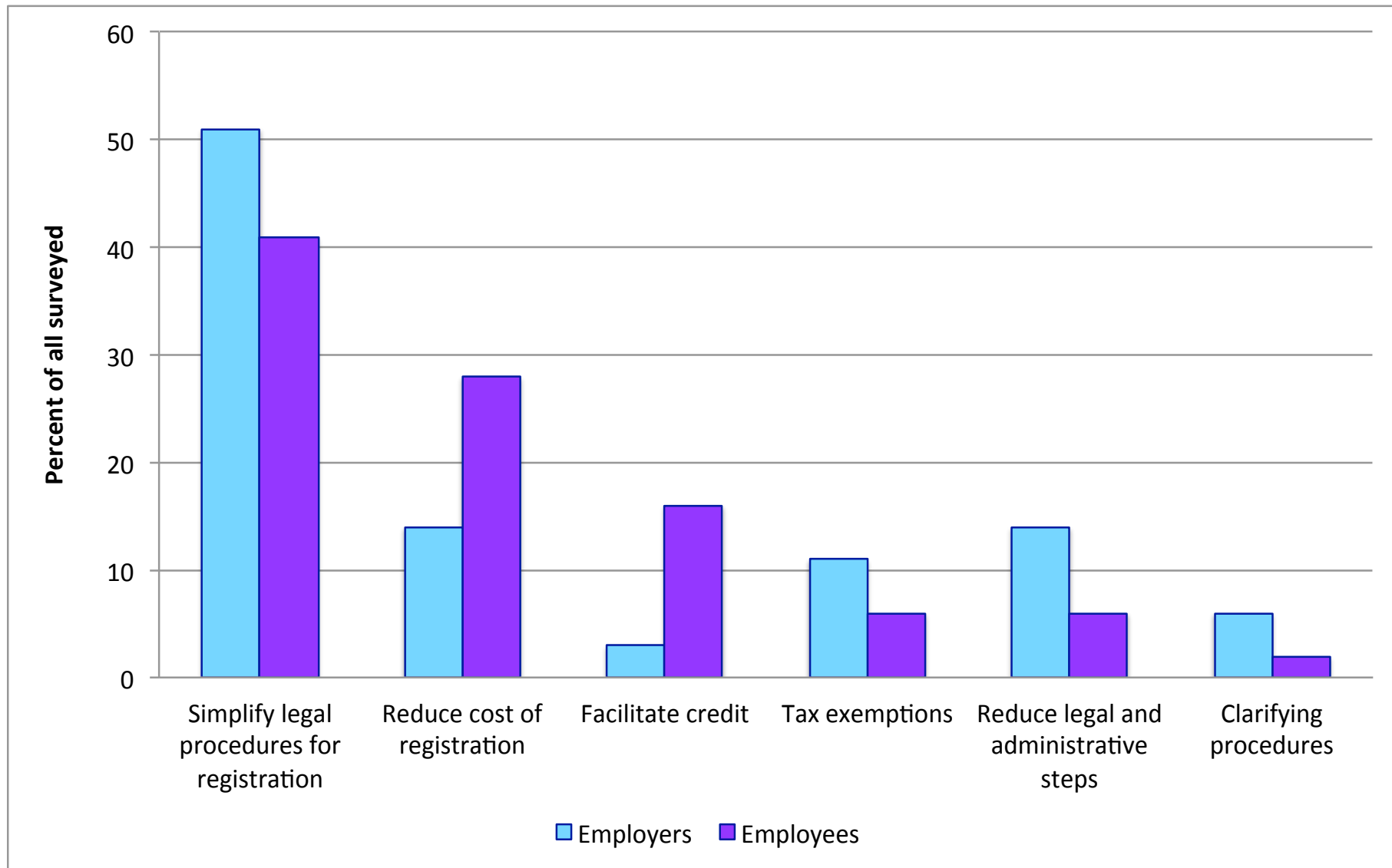


Source: Nasser, H. (2011) 'Growth, Employment Policies and Economic Linkages: Egypt', *ILO Employment Working Paper*

Problems with government responses

- Policy focused on informal enterprises in informal sector, not informal employment in all sectors
 - Only 18% of all firms in 2011 were in informal sector
 - 60% of informal firms and 58% of informal youth are semi-formal
- Informalisation measures did not fully remove barriers to formalisation
 - Costs/procedures of registration not low enough (see next slide)
 - Too few one-stop shops (ex-urban); e-registration partly available
- Formalisation policies likely displaced workers from informal sector to formal sector under informal arrangements
 - Explains why informal employment grew faster than formal
- Policies aimed at boosting informal firms' growth/productivity did not tightly target MSEs or remove barriers to credit access
- Plans to reform social insurance system not yet implemented

Actions for attracting informal actors to formal sector



Source: El-Fattah, M. (2012) 'A Survey-Based Exploration of Satisfaction and Profitability in Egypt's Informal Sector', *Egyptian Center for Economic Studies Working Paper*, no.169 (Egyptian Center for Economic Studies).

Key recommendations and
examples of effective practice

Integrated approach to addressing informality

<u>Level of analysis</u>	<u>Free choice</u>	<u>Forced choice</u>
Enterprise level	Formalise informal economy Strengthen rule of law	Minimise/clarify costs of doing business Targeted technical/financial assistance
Employment level	Reform social insurance system	Informalise labour market regulations Incentives to promote formal hiring Extend legal rights/assistance to workers
Pre-employment	Reorient graduate aspirations towards private sector	Reform education/training systems to overcome/avoid skills mismatches

PLUS: Improve knowledge and understanding of informal economy to ensure that policies are evidence-based.

Extending legal rights/assistance to informal workers

- Informal labour organisations (Shanghai)
 - 1990s: Closure of state-owned enterprises due to structural reforms → high unemployment and informality
 - 1996: Shanghai municipal government passed law allowing informal workers to freely form labour associations
 - Government role: provide assistance (public works contracts, training, social insurance, subsidised credit) through labour organisations to encourage growth and gradual formalisation
 - By 2001: over 14,000 informal labour organisations formed, 155,000 workers employed (97% had been unemployed)
- Relevance for Egypt
 - Means of detecting informal workers in formal sector firms
 - Medium for assistance (finance, training, social insurance)
 - Route for workers' incorporation into formal economy

Source: Howell, J. (2002) *Good Practice Study in Shanghai on Employment Services for the Informal Economy* (Geneva: International Labour Office).

Minimising/clarifying costs of doing business

- Online registration and payment systems
 - Transparent information on procedures/costs
 - Online payments to reduce corruption
- Mobile one-stop shops (Pakistan)
 - To dispense assistance to remote areas during 2011 floods
 - Could be used in Egypt to register rural businesses
- Creating a business-friendly environment (Estonia)
 - Lower start-up/operation costs and fewer legal procedures
 - Stronger property/contract rights and investor protections
 - Flat-tax rate regime with e-payment system
 - Informal employment: ↓ from 20% in 1998 to 7% in 2004
 - Kick-started formal private sector growth and dynamism

Sources: United Nations Development Programme (2011) 'Mobile one-stop shops help recover lost IDs in Pakistan', UNDP press release dated 28 Jan 2011; and Subrahmanyam, G. (2014) *Promoting crisis-resilient growth in North Africa* (Tunis: African Development Bank).

Extending technical/financial assistance to uneducated rural entrepreneurs

- Mobile banking (Ghana)
 - ‘Door-step’ financial service
 - Mobile banker facilitates micro-enterprise access to credit
 - Loans based on client assessment through personal contact
 - Collateral requirements based on client assessment
 - Potential for delivery of training (e.g. bookkeeping) and business development services as well as loan assistance
- Relevance for Egypt
 - Possible route for overcoming MSE credit risk issues
 - Potential for delivering accessible business services to disadvantaged groups in rural areas

Source: Palmer, R. (2007) ‘Formalizing the Informal Economy: Best Practices?’, in Norrag (ed) *Best Practice in Education and Training: Hype or Hope?* (Geneva: Norrag).

Reforming the social insurance system

- Most appropriate social insurance scheme
 - Simple yet flexible contribution scheme
 - Should accommodate informal workers' inconsistent income streams
- Main priority:
 - Provide informal workers with a means of accumulating savings in the event of unemployment, illness, old age or death
 - Linking social insurance to health insurance would narrow social inequalities between formal and informal workers
- Two options:
 - Public provision: with government matching contributions or subsidising premiums when informal workers unable to pay (means of extending social protection to the poor)
 - Private provision: micro-insurance tailored to the needs of low-income groups