

Striving for Better Jobs
The Challenge of Informality in
the Middle East and
North Africa Region

OVERVIEW

Roberta Gatti
Diego F. Angel-Urdinola
Joana Silva
Andras Bodor

SEPTEMBER 2011



Cover photo by Toufik Berramdane

Contents

Acknowledgments	v
Introduction	vii
Background	ix
1. Understanding Informality	1
2. Informality in MENA: Levels and Trends	5
3. Who are Informal Workers?	11
4. Informality among Firms	17
5. Informality in MENA: Exclusion or Choice?	21
6. Barriers to Coverage and Policy Options	25
7. References	35
Figures	
Figure 1. Informality and Economic Development	2
Figure 2. Informality in MENA vis-à-vis Other Regions	6
Figure 3. Informality Rates for Selected non-GCC Countries	8
Figure 4. Annual Growth Rates of Informality	9
Figure 5. Informality Rates by Quintile of per Capita Consumption for Selected Countries	12
Figure 6. Employment Status by Age for Selected Countries, Urban Areas Only	13
Figure 7. Informality Rates by Highest Educational Level Completed	14
Figure 8. Informality and Firm Size	15
Figure 9. Unregistered Firms, by Region	18
Figure 10. Highest Level of Education of Managers in Formal and Informal Manufacturing Firms in Egypt	19
Figure 11. Transitions of Originally Informal Salaried Private Sector Males	21
Figure 12. Estimated Formality Premium by Gender in Different Countries	22

Acknowledgments

This study is the product of the collaborative effort of a core team led by Roberta Gatti and comprising Diego F. Angel-Urdinola, Joana Silva, and Andras Bodor (principal authors), Kimie Tanabe (data management), and May Wazzan, with important contributions from Mohamad Alloush, Carole Abi Nahed Chartouni, Anne Hilger, Arvo Kuddo, and Matteo Morgandi.

Many colleagues have provided useful inputs at different stages of the study, including Surani Abeysekera, Rita Almeida, Luca Etter, Alvaro Forteza, Maros Ivanic, David McKenzie, Jaime Saenz, Amina Semlali, and Andrew Stone. Background papers were written for this report by Mohamad Alloush, Diego Angel-Urdinola, Andras Bodor, Mehdi Benyagoub, Carole Abi Nahed Chartouni, Yoonyoung Cho, Yohana Dukham, Mario di Filippo, Norman Loayza, Daniela Marotta, Shaumik Paul, Amina Semlali, Joana Silva, Kimie Tanabe, Tomoko Wada, and George Wellner. Amy Gautam and Laura McDonald edited this document.

We are grateful to the participants of the consultations held in Cairo (September 2010), at the ILO-World Bank labor market course in Turin (October 2010), and in Tunis (March 2011) for their insights into the nature of informal employment in the Middle East and North Africa region. We thank our peer reviewers, Ahmed Galal, William Maloney, and Milan Vodopivec, for their guidance; Gordon Betcherman and William Maloney for useful discussions; and Caroline Freund, Robert Holzman, Jean-Pierre Chauffour, Prof. Alia Abdel Monem El Mahdi, Sherine El-Shawarby, Santiago Herrera, Ruslan Yemtsov, and the participants of the brainstorming workshops that were held in Washington in October 2009, October 2010, and May 2011 for their valuable comments. Through this report, four new surveys were co-sponsored (Egypt youth, Morocco youth, Lebanon Labor Force Survey, Syria employer-employee matched module). We acknowledge the productive collaboration to structure the questionnaires with Gloria La Cava, Yaa Oppong, David Robalino, Haneen Sayed, and Tara Vishvanath. We are grateful to the Social Security Corporation of Jordan for sharing data on social security contributions.

This work was supported by the Arab World Initiative. We thank Shamshad Akhtar and Steen Jorgensen for their strategic guidance.

Introduction

This document provides an overview of the World Bank’s report *Striving for Better Jobs: The Challenge of Informality in the Middle East and North Africa*. Informality is a complex phenomenon, encompassing unpaid workers and workers without pension or health insurance coverage, small or micro-firms that operate outside the regulatory framework, and large registered firms that might decide to partially evade corporate taxes and social security contributions. The report looks at informality through a human development angle and focuses specifically on informal employment. In line with this approach, the working definition for informality adopted in the report is “lack of social security coverage” (usually understood as pensions, or if a pension system does not exist, as health insurance), which captures well the vulnerability associated with informal employment. While there is a great deal of heterogeneity across countries, informality is widespread, and some MENA countries are amongst the most informal economies in the world. Evidence from this and other studies indicate that informal workers in most MENA countries are engaged in low productivity jobs, more so than in comparator countries. Informal workers in the region are generally paid less for otherwise similar work in the formal sector and their self-reported work satisfaction is low. Moreover, the data underscore the presence of important mobility barriers between formal and informal employment. While extending social security coverage is likely to bring about welfare improvements in and of itself, it will be necessary to remove existing barriers to the creation of high-quality jobs to promote long-term inclusive growth and, thus, formality. Policies that can support this process include those that:

- 1) Foster competition;
- 2) Realign incentives in the public sector;
- 3) Move towards labor regulations that promote labor mobility and provide support to workers in periods of transition;

- 4) Enhance the productivity of informal workers through training and skills upgrading; and
- 5) Reform existing social insurance systems and introduce new instruments for coverage extension.

Background

The report was completed as a revolutionary wave of demonstrations and protests swept across the Arab world. The Arab Spring was sparked on 18 December 2010 by the self-immolation of Mohamed Bouazizi, a Tunisian street vendor who set himself on fire to protest the confiscation of his possessions and in response to harassment and humiliation inflicted on him by a municipal official and her aides. His act became the catalyst for the Tunisian Revolution (also known as the Jasmine Revolution), which toppled the twenty-three-year old Tunisian regime and set the country on the path to democracy. The Tunisian revolution ignited dramatic uprisings in several other MENA countries.

That millions of young people were chanting “dignity” and “social justice” throughout the Arab world points unmistakably to deep-seated feelings of exclusion and persistent inequality of opportunity. Along with demanding democracy, respect for human rights, and better governance and accountability, young Arab individuals are striving for the opportunity to realize their potential and aspirations in a region rich in human and physical capital. While economic growth has been sustained for a number of years in many countries in the region, this has not resulted in the creation of an adequate number of jobs and has succeeded, at best, in generating low-quality, informal jobs. The report addresses one margin of exclusion: informal employment and the vulnerabilities and lack of opportunities associated with it. The report has two main objectives: (1) to provide an understanding of the extent, determinants, and challenges of informal employment, by bringing together new evidence, data, and country-specific analyses; and (2) to open up and inform a debate on feasible policy options that promote decent work, support a more inclusive development process, and better manage vulnerability by extending social security coverage.

As informality in the MENA region involves the vast majority of workers outside of the public sector, and since many of the intended benefi-

ciaries operate outside of the reach of existing systems, the report's findings point to the need to rethink policy making, especially with regard to those policies pertaining to labor market and social security reform. The report analyzes the constraints that prevent informal workers from becoming formal and discusses policy options to effectively address them. While the current transitions in MENA are accompanied by important challenges, they also provide new opportunities to improve living standards and equity. Achieving this will require, above all, a new and inclusive social dialogue open to a broader set of actors, particularly to those whose voices have traditionally not been heard, such as youth, women, the unemployed, and informal workers.

This overview first describes the magnitude of the informality phenomenon in the MENA region vis-à-vis other regions of the world and, to the extent possible, its evolution over time and macroeconomic determinants. Section 2 provides a detailed profile of informal workers in the region. Section 3 describes the characteristics of informality in micro-firms that operate outside the regulatory framework and in larger firms that do not fully comply with social security contribution requirements and tax obligations. Section 4 discusses earnings, job mobility patterns, attitudes, and workers' self-rated job satisfaction to provide a better understanding of the quality of jobs in the informal sector. The evidence corroborates that important segmentations exist between formal and informal jobs, and that much of the observed informality is likely due to barriers to mobility into better jobs; in some countries, these barriers are linked to the prominent role of the public sector as the main employer. Finally, Section 5 discusses policy options for effectively expanding coverage of health insurance/pension systems and promoting the creation of better quality jobs.

The geographic scope of the report was largely determined by the availability of data. In addition to using existing datasets, this project co-sponsored four new surveys, undertaken in 2009 and 2010 in Egypt, Lebanon, Morocco, and Syria. In all of these, questions related to social security coverage, job characteristics, workers' attitudes, and willingness to contribute to social security were included.

Understanding Informality

This report looks at informality through a human development angle and focuses particularly on *informal employment*. Informality is a complex phenomenon, comprising unpaid workers and workers without social security or health insurance coverage, small or micro-firms that operate outside the regulatory framework, and large registered firms that might partially evade corporate taxes and social security contributions. Three indices are commonly used to measure informality: (i) the Schneider Index,¹ which uses a broad set of country correlates to estimate the share of production not declared to tax and regulatory authorities; (ii) the share of employed workers without social security coverage; and (iii) the prevalence of self-employment. Defining informality as “lack of social security coverage” captures well the vulnerability associated with informal employment and, as such, is the working definition in this analysis.

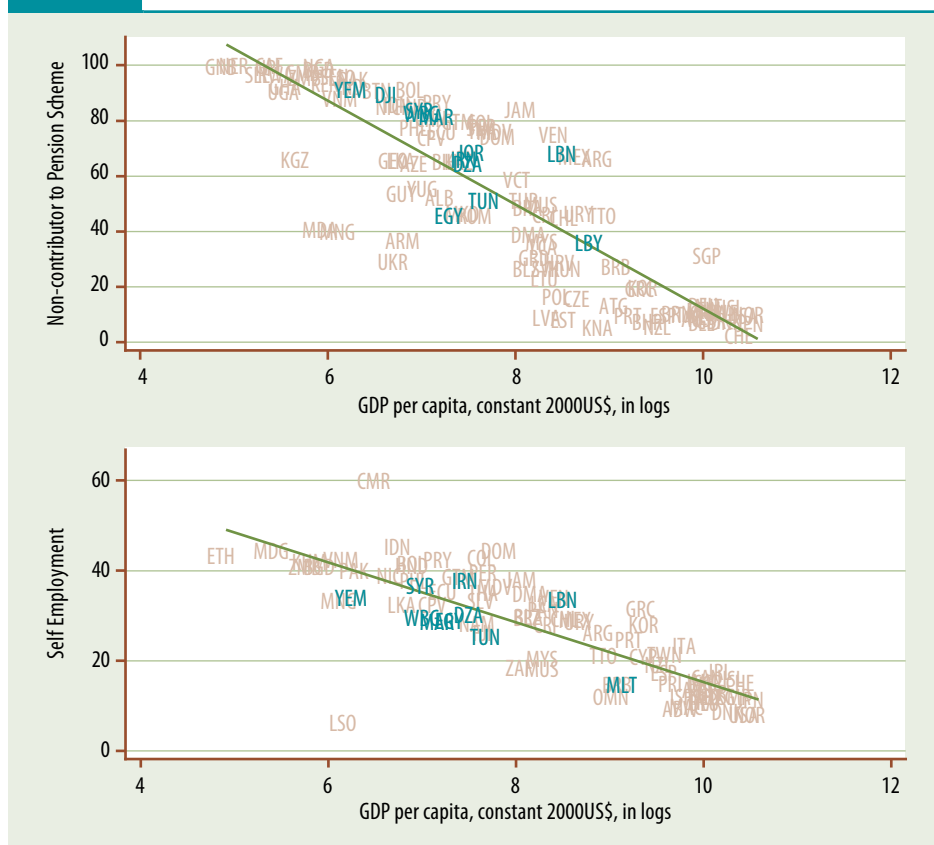
Informality is a fundamental characteristic of underdevelopment and has costs and benefits. As depicted in Figure 1, a larger informal sector is often associated with lower gross domestic product (GDP) per capita. For most countries in the region, the share of informal to total employment is aligned with the level that their economic development would predict. Informal employment is associated with costs and negative externalities that may be a source of economic slowdown. For example, a large informal sector implies that a heftier tax burden will fall on the formal sector. This may hold back new and productive firms—precisely those firms that have the potential for driving growth in a dynamic economy. In addition, informal activities use and congest public infrastructure without contributing to tax revenues necessary to maintain them. Moreover, workers involved in the informal sector often lack a written contract regulating their work relationship and/

¹ Schneider (2004) developed a Multiple Indicator-Multiple Cause (MIMIC) model to quantify the size of the informal economy as a percentage of GDP.

or pension and health insurance coverage. This exposes them to significant occupational risks, including a potentially less safe and decent work environment, as well as to risks related to old age and health problems. Nevertheless, informal employment has some benefits for the labor market and population, as it provides employment to a significant portion of the population; may be a source of innovation and entrepreneurship (many firms start operating informally when they are small and formalize as they grow); and serves as a safety net in periods of transition (e.g., during times of economic downturn).

Informality can be the result of exclusion or of a rational choice by entrepreneurs or workers who decide to opt out of the formal labor market. Traditionally, informality has been considered the result of involuntary exclusion of workers due to high and distortive regulation (De Soto, 1989). Other factors affect workers' and firms' decisions to work informally, including myopia (i.e., lack of awareness about retirement needs and health risks) and limited information, both of which might be associated with exclusion margins, such as geographic location and low

Figure 1. Informality and Economic Development



Source: Loayza and Wada 2010.

human capital (i.e., poor people in remote areas and/or uneducated agricultural workers may not have access to social security systems but would join them if they could). Some workers and firms decide to opt out of the formal economy as a result of a rational cost-benefit evaluation (Perry et al., 2007). These reasons for informality are not mutually exclusive, and likely coexist in a continuum. In all cases, since widespread informality implies high vulnerability, there is a clear rationale for government intervention. On the one hand, when involuntary exclusion from formal employment is predominant (e.g., small firms can survive only if they avoid paying taxes, or salaried workers would like access to social security but cannot find jobs with coverage), then policies that reduce existing barriers are needed to improve welfare. Such policies might include rationalizing regulations to create a level playing field for small and large firms to compete fairly, as well as tackling labor market reform. On the other hand, when more workers and firms opt out of the regulatory system based on a rational choice, then policy interventions that rebalance the perceived costs and benefits of participating in the formal sector are needed. Such policies can focus on improving the quality and outreach of key public services; enhancing communication and transparency about social services; and redesigning and extending instruments for better management of health and age-related risks.

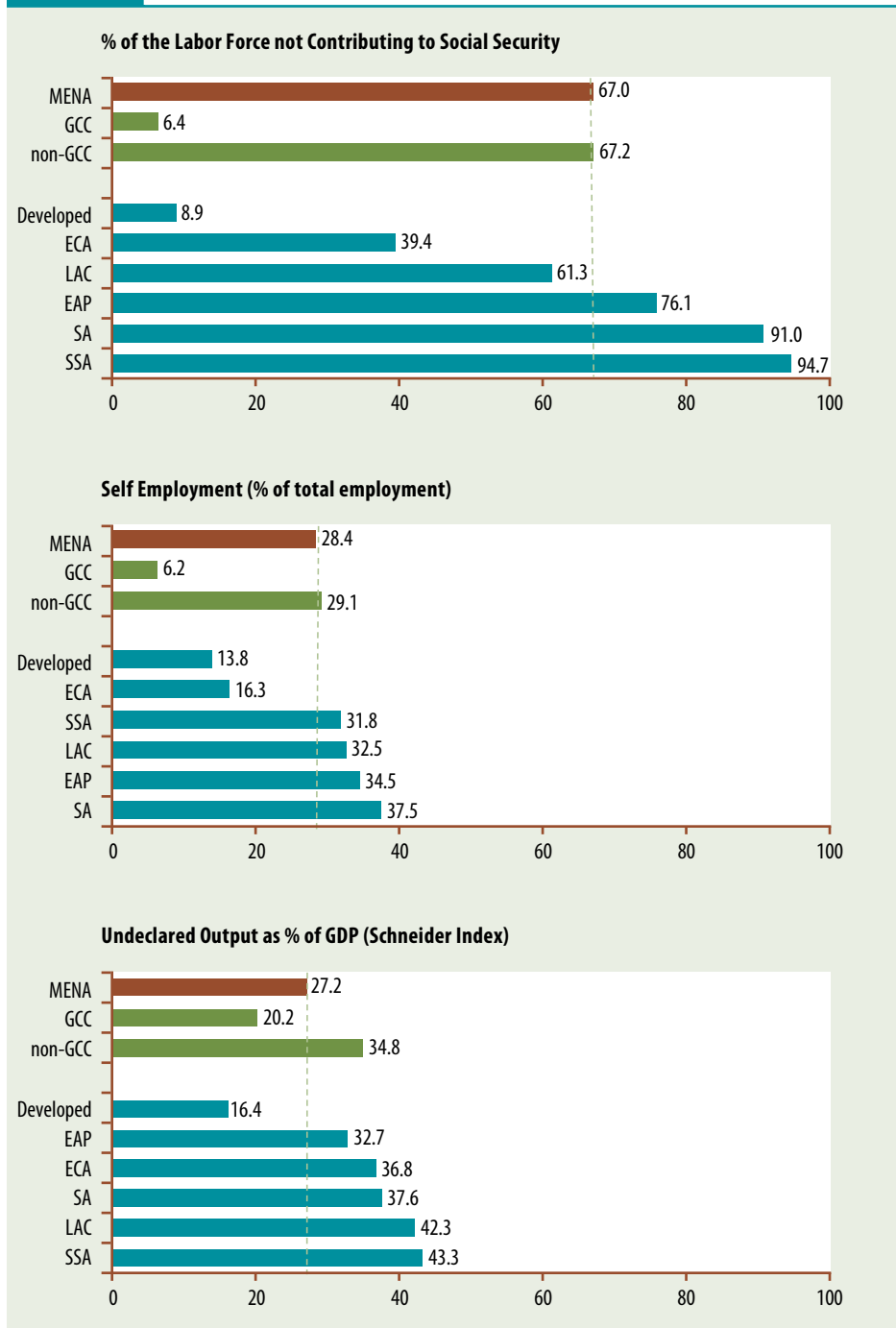
Informality in MENA: Levels and Trends

There is a consensus that while growth has occurred in the MENA region in the past decade, much of it resulted in the creation of informal jobs rather than quality formal jobs.

The MENA region displays lower employment and higher unemployment rates than any other region in the world. While economic growth was sustained in the years prior to the 2008 financial crisis and employment growth was positive (and particularly high for women), high population growth has continued to put pressure on labor markets to absorb an increasing number of new entrants. Moreover, in the past decade, jobs were created mainly in low value-added service sectors, most of which are associated with high rates of informal employment, such as construction, commerce, and transport. This process may have prevented the benefits of economic growth from being shared fully among poorer segments of the population and has led to increasing informality.

A typical country in MENA produces about one-third of its GDP and employs 67 percent of its labor force informally. This means that more than two-thirds of all workers in the region may not have access to health insurance and/or are not contributing to a pension system that would provide them with income security after retirement. From a fiscal perspective, about one-third of total economic output in the region remains undeclared, with considerable implications for government revenue. In MENA, the difference between the share of the labor force engaged in informal employment and the share of GDP that is produced informally (as captured by the Schneider Index) is larger than, for example, in Latin America (Figure 2). Although there are many caveats to these comparisons, this evidence suggests that informal jobs in MENA are, on average, associated with a lower level of productivity than in other regions at comparable levels of development. This interpretation is supported by evidence on earnings showing that informal workers systematically earn less than formal workers in MENA.

Figure 2. Informality in MENA vis-à-vis Other Regions



Source: Loayza and Wada 2010.

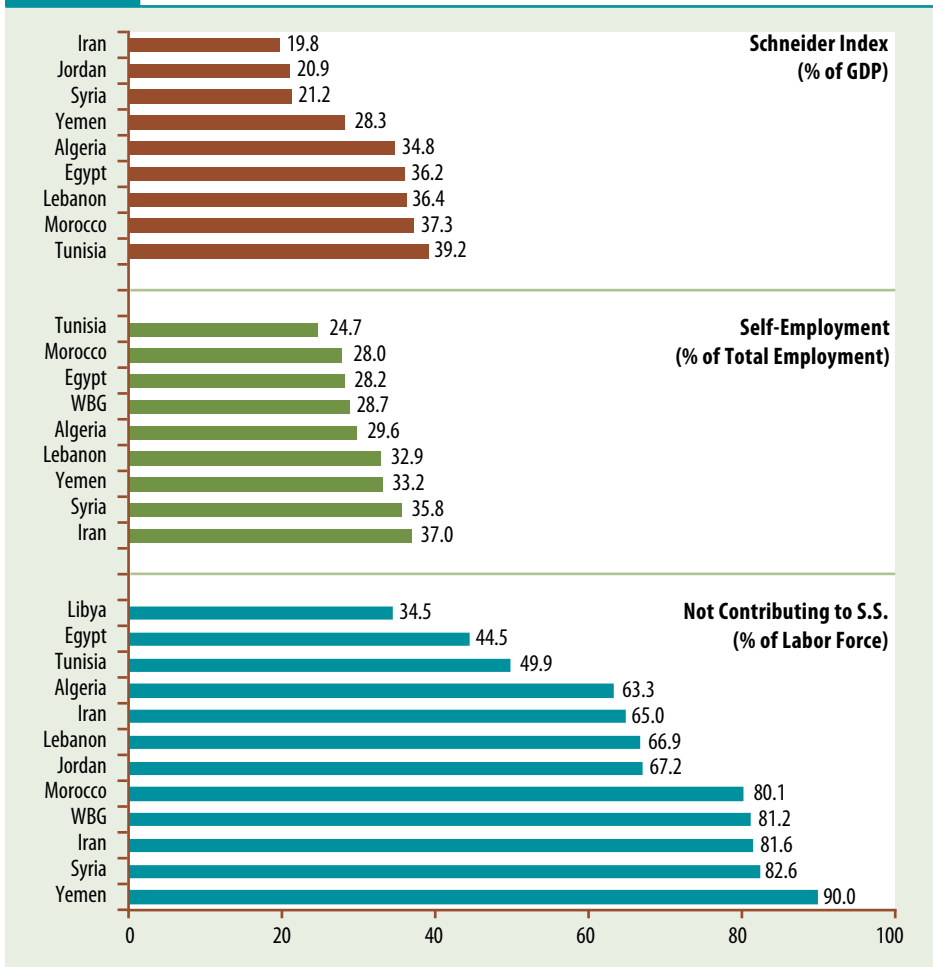
Note: GCC = Gulf Cooperation Countries.

There are important variations in the prevalence of informality across countries in the region. Countries in the MENA region are quite heterogeneous in terms of size, role of the public sector, availability of resources and labor, economic development, and productive and demographic structure, all of which influence the size of the informal economy. Informality is higher in countries such as Morocco and Yemen, where the share of agricultural employment relative to total employment is high, and lower in Jordan and Egypt, where the public sector accounts for 30 to 35 percent of overall employment (Elbadawi and Loayza, 2008).² A country's productive structure is also an important driver of informality: energy rich countries (e.g., Iran, Syria) tend to display high rates of informal employment (about 80 percent) but have rather low informal output as a share of GDP (about 20 percent, as measured by the Schneider Index) (see Figure 3). This gap likely indicates that most of these countries' output is produced by a small formal working force in the capital-intensive energy sector, while the majority of the informal working force is engaged in low-productivity jobs.

Informality in MENA has been rising in recent years. Data indicate that informality has been increasing rapidly in the entire developing world, as measured by the annual growth rate of the Schneider index between years 1999 and 2004. The increase in informality in the MENA region is comparable to that in Europe and Central Asia (ECA) but lower than that in Latin America, East Asia, South Asia, and Sub-Saharan Africa (Figure 4). On the contrary, when measured by the share of self-employment to total employment, informality has been decreasing in all developing regions but MENA. Yet, the share of self-employment to total employment in MENA (at 29 percent) remains somewhat lower than in other developing regions such as Latin America and South Asia (at 33 and 38 percent, respectively). Given these trends, self-employment in the MENA region is likely to increase to and eventually align with the levels observed in other developing regions.

² Given the weight of the public sector in overall formal employment, changes in the size of the public sector are likely to affect overall informality trends, especially given that private formal employment growth remains limited and has not been sufficient to offset the recent downsizing of the public sector in many countries (Rodman, 2007).

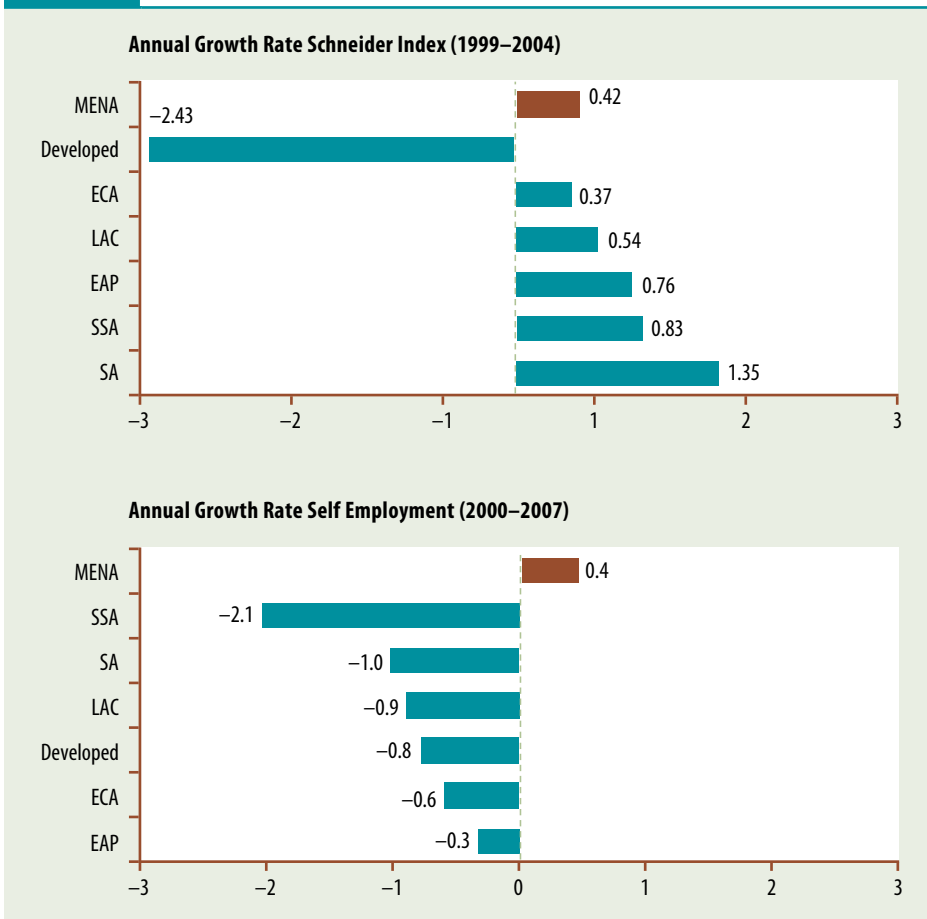
Figure 3. Informality Rates for Selected Non-GCC Countries



Source: Loayza and Wada 2010.

Note: Time periods are as follows: Schneider Index, average 2001–2004; Self-employment; 1999–2007; Not contributing to social security (S.S.), 2000–2007.

Figure 4. Annual Growth Rates of Informality

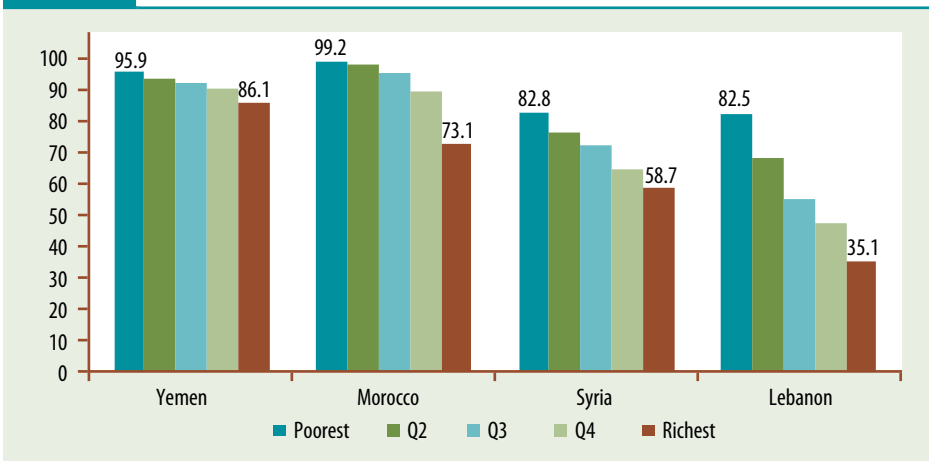


Source: Loayza and Wada 2010.

Who are Informal Workers?

Informality is highest among poor workers. Overall in MENA, informality decreases as wealth increases. In countries like Lebanon, the share of informal employment is significantly lower among the wealthiest segments of the population. Nevertheless, in some MENA countries, informality is so widespread that it remains significant even among the wealthier segments of the population. In Yemen and Morocco, for instance, more than two-thirds of all workers who belong to the richest households work in the informal sector (see Figure 5). In Egypt, Yemen, and, to a lesser extent, Morocco, an interesting pattern emerges, whereby informality decreases with income/wealth but unemployment increases with income/wealth. This correlation suggests that in these countries, programs targeted at informal workers would be addressing the working poor, while interventions targeted at the unem-

Figure 5. Informality Rates by Quintile of per Capita Consumption for Selected Countries



Source: Angel-Urdinola and Tanabe 2011.

Note: Consumption aggregate was not available for Morocco for 2010 at the time of completion of this report. Hence in this table, data for Morocco are from the 2001 Living Standards Measurements Survey (LSMS).

ployed (while a clearly visible and often vocal category) would reach those who can afford to be unemployed, i.e., those who are relatively better off.

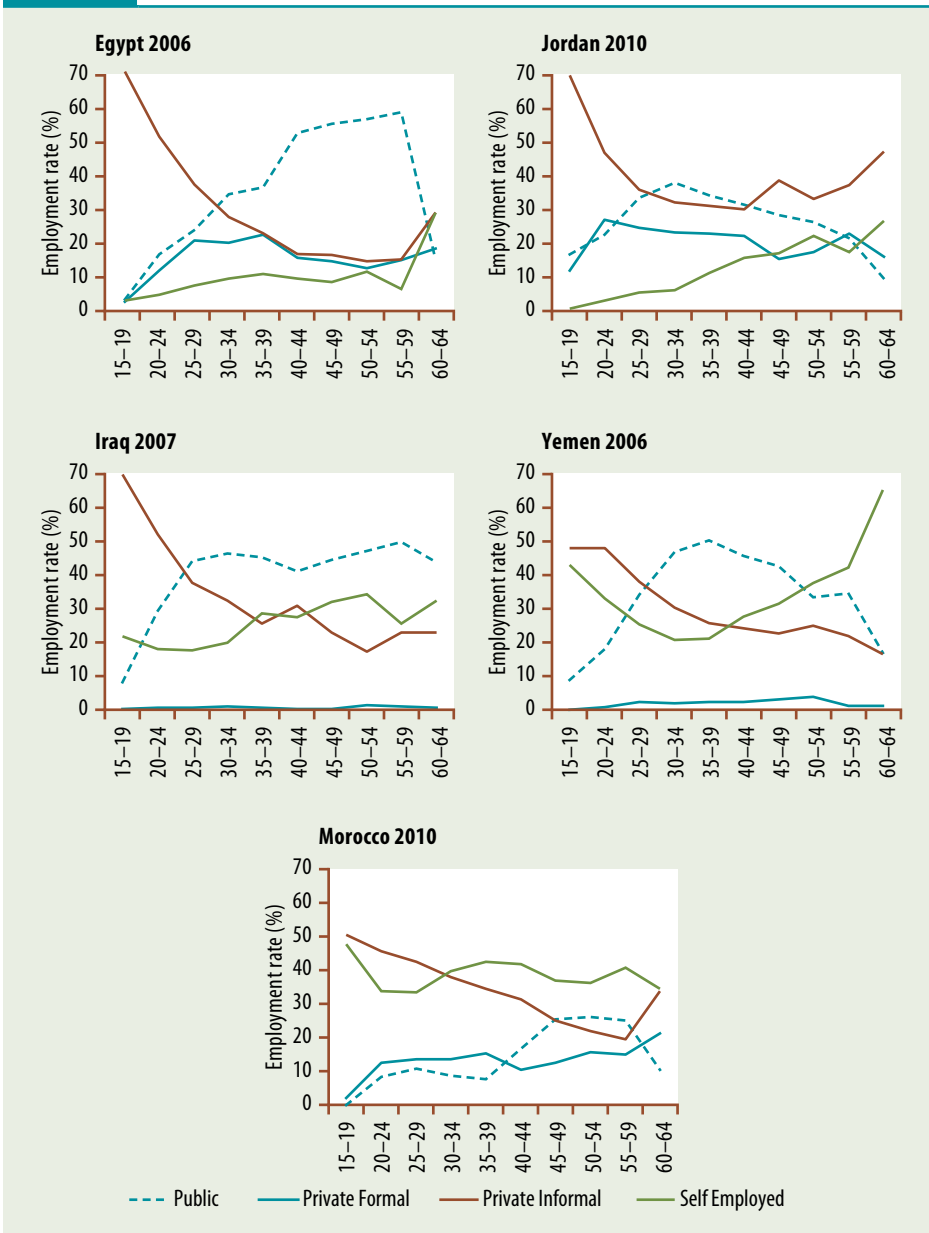
There is an important transition from informal employment into public sector employment as young individuals reach prime age adulthood. Figure 6 illustrates employment patterns by age for urban workers in a selected group of countries. Informality rates are very high among youth between the ages of 15 and 24. After age 24, informality decreases rapidly until individuals reach 40 to 45 years of age. After age 45, informality rates fall to between 20 and 30 percent. This rapid decrease in informality rates goes hand in hand with a rapid rise in public employment, suggesting that a large portion of younger informal workers enter into public sector jobs as they become adults. These trends are very different from those observed in Latin America. For example, in countries like Mexico, while informality rates also decrease by age, the observed transition occurs not between informality and public employment, but between informality and self-employment, with many young individuals becoming entrepreneurs and thus contributing to a more dynamic creation of employment in the private sector (Perry et al., 2007).

Lower education is strongly and linearly associated with higher rates of informality in most countries, an association that seems to be driven primarily by more educated workers joining the public sector (particularly in Egypt, Jordan, Morocco, and Syria). Informality rates among workers who completed primary and/or basic education (accounting for at least 50 percent of all the employed in most countries in the region) are generally much higher than among those workers who completed secondary and/or tertiary education. Consistent with the transitions depicted in Figure 6, differences in informality rates by age and education are mainly due to the lifecycle movement of older and more educated workers from informal employment to public sector employment. In countries where the bulk of formal jobs are in the public sector (such as Yemen and Iraq), differences in informality rates across education levels in the private sector are negligible (Figure 7).

Informality is more prevalent among workers in small firms. In the private sector, informal workers are mostly employed in small firms, with a distribution that is particularly skewed towards firms with fewer than five workers and which are most likely engaged in low productivity activities (Figure 8). Controlling for other observable characteristics, workers in medium size (10 to 50 workers) and large size (more than 50 workers) firms are, respectively, 16 to 21 and 17 to 53 percent less likely to work without social security coverage than workers in small size (5 to 9 workers) firms.

The relationship between gender and informality is quite complex. It should be noted that despite positive improvement in female employment rates in the last de-

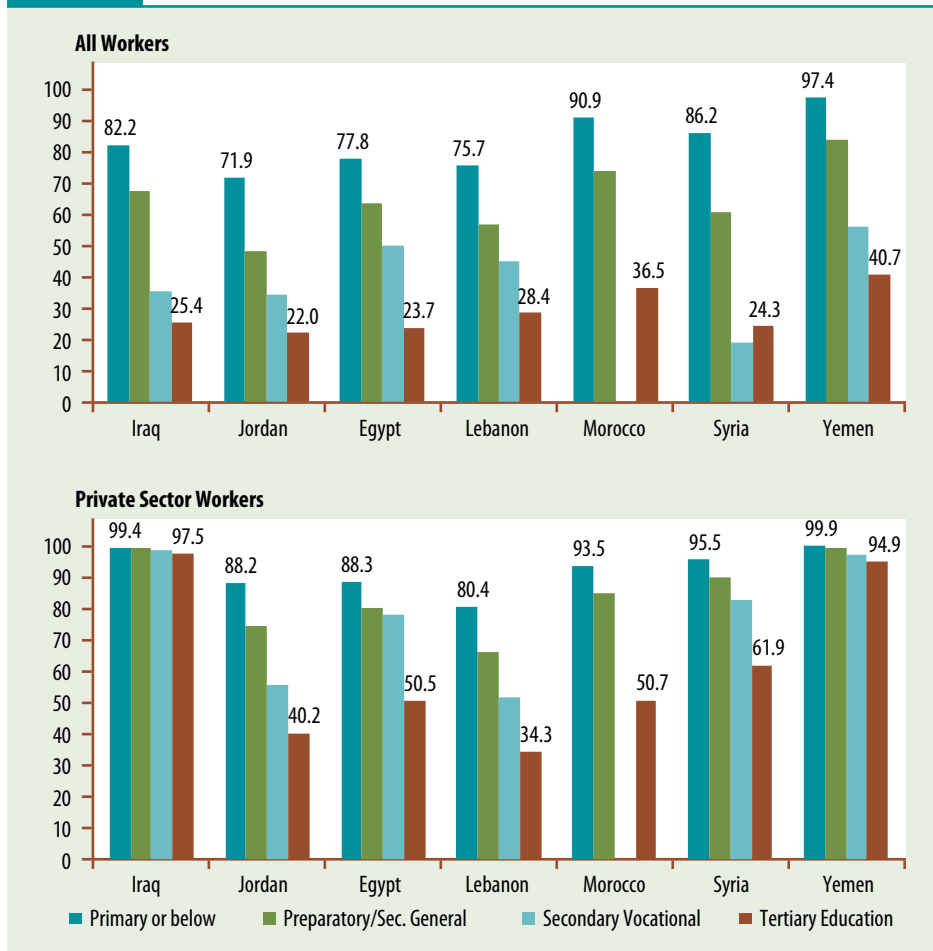
Figure 6. Employment Status by Age for Selected Countries, Urban Areas Only



Source: Angel-Urdinola and Tanabe 2011.

cade, labor force participation among women in the MENA region remains the lowest in the world, and among women who participate, unemployment is quite high, especially among the most educated. In countries like Yemen and Morocco, where agricultural employment constitutes an important share of overall employment, being a woman—other things being equal—is associated with a higher probability

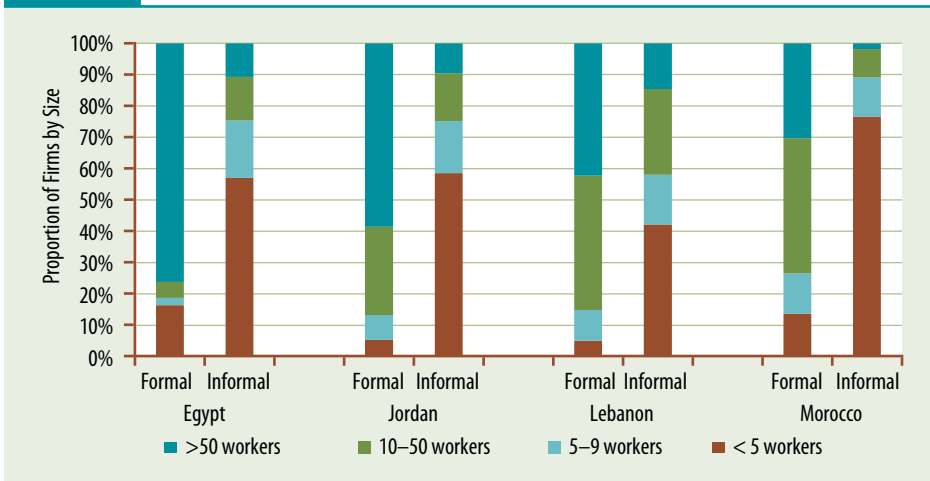
Figure 7. Informality Rates by Highest Educational Level Completed



Source: Angel-Urdinola and Tanabe 2011.

of working in the informal sector, since women are often employed in unpaid/ subsistence agriculture. When public employment constitutes a significant share of overall employment, as in Egypt, Iraq, and Syria, being a woman is associated with a lower probability of working in the informal sector, as women who participate in the labor force (generally those with higher levels of education) in these countries self-select into public sector jobs, which have working hours, benefits, and overall safety characteristics that are perceived as more desirable.

Figure 8. Informality and Firm Size



Source: Lebanon Labor Force Survey 2010, Morocco Youth Survey 2010, Egypt Labor Market Panel Survey (ELMPS) 2006.

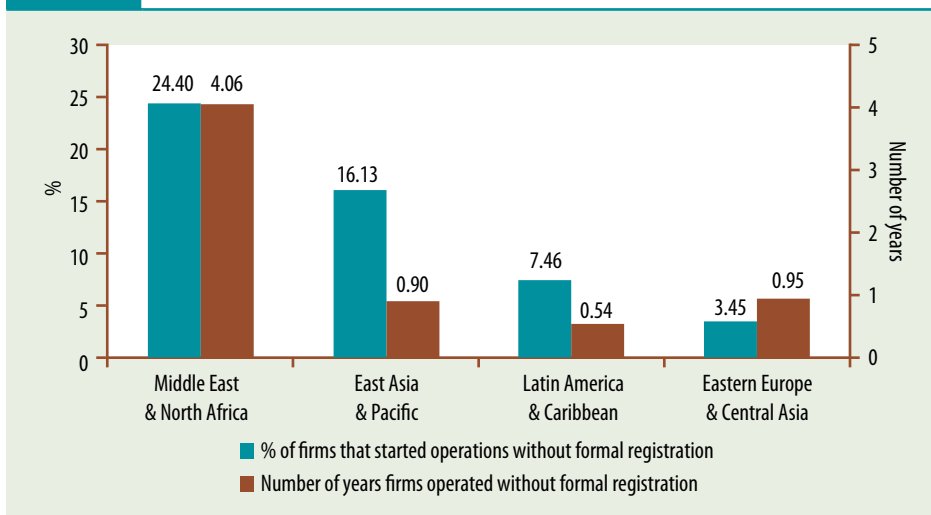
Note: In Morocco, 10-50 workers actually incorporates 10-100 workers and >50 captures firms with 100+ employees only.

Informality among Firms

Firms can operate informally along various margins. For wage workers, working informally is the result of factors that go beyond individual skills and attitudes and relates to labor demand features such as the types and availability of jobs and workers' relative bargaining power vis-à-vis the hiring firm. Hence, understanding why firms operate informally is an important dimension of informal employment. In particular, small firms might not register their activity to avoid paying taxes and/or to avoid paying social security contributions for their workers (in full or in part). Registered firms (usually larger firms) might only partially report their sales and underreport workers and/or workers' wages to avoid paying taxes and/or social security contributions.

Informality is prevalent among firms in MENA. In the region, many firms never formalize and even those that formally register still operate informally for a significant amount of time. Among existing formal firms, MENA has the highest share of firms starting up in the informal sector (25 percent compared to less than 10 percent in the LAC and ECA regions). Also, firms in the region have, on average, a longer operating period without formalization than other developing regions (four years versus less than one year in the LAC and ECA regions; see Figure 9). Small enterprises, which account for a large share of all private sector jobs, are mostly unregistered and often employ workers informally. Among larger registered firms (with 10 or more employees), about one-fifth of sales and workers are not reported. While a great deal of heterogeneity exists in the region, high taxes are consistently identified by entrepreneurs as the top constraint to formalization, together with the cost of registration, bureaucratic complexity, and administrative requirements. In many countries, including Algeria, Djibouti, Iraq, and West Bank and Gaza, there seems to be ample room for simplification of business entry regulations and procedures.

Figure 9. Unregistered Firms, by Region

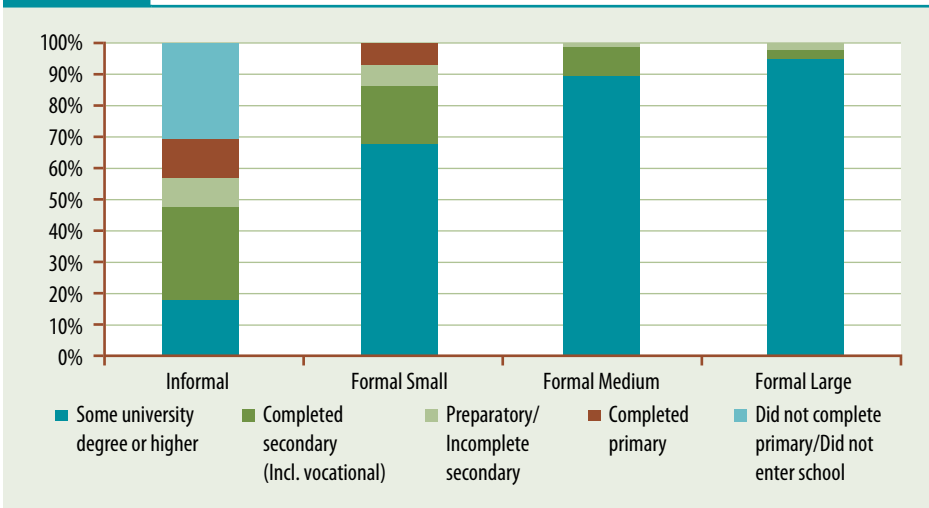


Source: World Development Indicators Dataset.

A strong association emerges between informality and low productivity among firms. Firm informality is often measured as the share of workers and sales that are underreported for social security and tax purposes, respectively. According to this definition, firm size, low productivity, and a manager’s education seem to be key determinants of informality. While the available data do not allow identification of a causal relationship between firm informality and the aforementioned determinants, these patterns are observed consistently in other regions. For instance, firm size has a significant association with informality and productivity: in Morocco, data suggest that labor productivity in smaller firms (9 employees or less) is one-half the productivity of firms with more than 100 employees. In addition to affecting productivity, firm size is strongly associated with underreporting wages to the social security administration. Specifically, among otherwise similar firms (e.g., similar sector, product, years in operation, etc.) doubling firm size is associated with a significant reduction in worker underreporting (e.g., by 10 percent in Yemen and by 35 percent in Jordan). The education level of managers and workers is also a strong predictor of underreporting workers to social security and/or tax authorities.

A large education gap exists between managers of informal and formal firms. Consistent with patterns in other countries, informal micro-firms in MENA typically have managers and a workforce with lower levels of education. For instance, among small firms in Egypt, the share of managers who have completed secondary school or have attained university education is about 45 percent in informal firms versus 85 percent in formal firms (see Figure 10). Workers in informal firms also tend to be less educated. Indeed, insufficient skills and education of the working

Figure 10. Highest Level of Education of Managers in Formal and Informal Manufacturing Firms in Egypt



Source: World Bank 2010.

force are perceived as serious constraints to employment and output growth in informal firms. Data from matched employer-employees surveys for small informal firms show that informal salaried workers are younger, more likely to work longer hours, and earn a relatively lower hourly wage than formal workers.

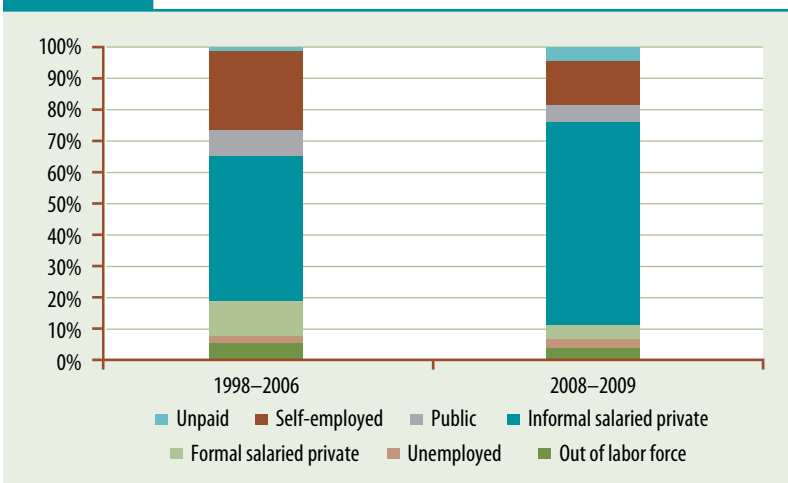
Informality in MENA: Exclusion or Choice?

Workers face low mobility across informal and formal jobs.

In instances where the data allowed for analysis, mobility from informal to formal jobs was found to be extremely limited. For example, between 2008 and 2009, an informal worker in Egypt had a 4 percent chance of moving to a private sector formal job and a 5 percent chance of moving to a public sector job (see Figure 11). The implied average job duration of informal salaried work is about 3 years in Egypt and is reported to be about 4 ½ years in Lebanon and Syria, both longer than the duration observed in countries such as Mexico, where workers move out of informal salaried jobs within 2 years (see Maloney, 1999).

Returns to skills differ substantially across informal and formal jobs. Informal workers earn lower salaries than formal workers with

Figure 11. Transitions of Originally Informal Salaried Private Sector Males

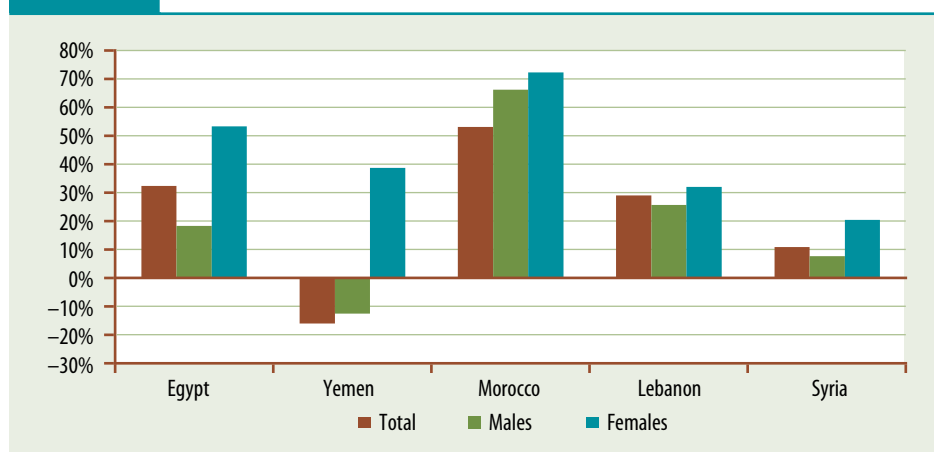


Source: Egypt 1998–2006 and 2008–2009 panels.

similar skills: the estimated premium associated with formal jobs varies from 10 percent for all workers (15 to 65 years of age) in Syria to more than 50 percent among Moroccan youth (15 to 34 years of age). The formality wage gap persists even when differences in individual characteristics (e.g., age, education, measured ability) and firm type are explicitly accounted for (see Figure 12). Most measures of job quality, including amount of annual leave and other benefits, as well as access to training, suggest poorer working conditions in informal jobs. This is also reflected in direct and indirect measures of job satisfaction. For example, Moroccan youth working in informal jobs reported being significantly less satisfied than youth working in formal jobs. In Egypt and Lebanon, informal workers are uniformly more likely than formal workers to want to change jobs or to be searching for a new job.

Informal workers are more likely than formal workers to work for family members or friends. In the absence of well-developed public and private formal labor intermediation systems, social networks matter for finding jobs. More than 70 percent of workers in Lebanon and Syria reported having found jobs predominantly through personal connections. This is even more common in the informal sector. Such a strong reliance on personal social networks (which are often formed within homogenous socio-economic strata) is likely to limit the size of the talent pool from which firms can select their workforce. There is also evidence that networks matter inter-generationally for finding employment. All else being equal, the chance of a worker holding a formal job in Morocco increases significantly if his/her father also has a formal job.

Figure 12. Estimated Formality Premium by Gender in Different Countries



Source: Angel-Urdinola and Tanabe 2010, and Alloush et al., 2011.

Note: Data for Morocco is for youth only.

Low mobility across informal and formal jobs, persistent wage gaps, and low self-reported satisfaction in informal jobs all suggest the presence of labor market segmentations.³ These patterns dispel the notion that informal jobs in MENA primarily reduce asymmetric information for new entrants to the labor market. Instead, they support the view that segmentations and important margins of exclusion exist along the formal and informal sectors, implying that relevant labor market outcomes (including unemployment rates and earnings) are not arbitrated across the two sectors. In some countries, such as Egypt, these differences are predominantly driven by the public/private sector employment divide.

³ A labor market is considered segmented if it consists of various sub-groups with little or no crossover capability.

Barriers to Coverage and Policy Options

The observed patterns indicate that economies in the MENA region generate a limited number of good jobs, with a large and growing informal sector characterized by overall worse working conditions and lower productivity than in the formal private sector. A complex set of institutional barriers and distorted incentives account for this disequilibrium. As a result, promoting a more inclusive growth process, with the creation of decent jobs and reduced vulnerabilities, will require a set of coordinated policies spanning the business environment, labor market regulations, civil service reform, pension system design, and skills upgrading interventions. Importantly, the observed high prevalence of informality indicates a need to rethink policy making. A vast majority of economic agents operate outside the realm of regulation and until recently in many countries, those outsiders (including the unemployed, youth, women, and informal workers), may not have been adequately represented in the social dialogue and consensus-building process around reform.

Five key distinct and complementary policy options, each linked to the drivers of informality in the MENA region, are identified: (1) designing reforms that foster competition; (2) realigning incentives in the public sector; (3) moving towards labor regulations that promote labor mobility and provide income support to workers in periods of employment transition; (4) enhancing the productivity of informal workers through training and skills upgrading; and (5) reforming existing social insurance systems and introducing new instruments for coverage extension.

(1) Designing reforms that foster competition

While MENA countries have moved progressively away from state-led growth, their private sectors, with few exceptions, still suffer

from limited dynamism and stagnating private investments. Even if private sector reforms have accelerated in recent years (as measured by *Doing Business* indicators), policy gaps still remain. In particular, high taxes and compliance costs are consistently seen as binding constraints to firms' growth and formalization. Importantly, policy uncertainty and discretion in implementing the law constrain investment and reinforce the role of existing firms, who have a vested interest in protecting their rents and limiting competition (see World Bank, 2009). In such an environment, the costs of joining the formal economy are often prohibitively high for small enterprises that opt to operate "below the radar" and consequently face limited opportunities to grow, exploit economies of scale, or connect to larger markets and access know-how.

Informality appears to be intertwined with the development process and can be largely explained as the private sector's response to restrictive regulation. It should be noted that informality is preferable to a fully formal economy where firms or workers are unable to comply with or are able to circumvent regulations. Policies solely based on strict enforcement of regulations are likely to increase formalization in the short term, but are also likely to increase unemployment and could eventually reduce growth. Instead, formalization would be better achieved as the result of a development process whereby growth becomes more inclusive, incentives to create more good jobs are fostered, and rents are more evenly distributed among the outsiders (informal workers and the unemployed). This process can begin by improving the regulatory framework for businesses, including simplifying regulations, decreasing barriers to entry (e.g., business registration and high corporate taxes), and consistently enforcing regulations to induce firms to compete fairly.

Reforms to entry regulations have been shown to have positive, albeit moderate, effects on formalization. Possible reforms options include: (i) reducing the costs of registration, and the number of procedures and minimum capital requirements; (ii) providing information on procedures and benefits of being formal, and training entrepreneurs (on filling forms, etc.); and (iii) facilitating registration by establishing one-stop shops for registration. While there is no evidence on the likely impact of these reforms in the MENA region, there are relevant international data. For example, in Mexico, simplifying the process of business registration had a moderate impact on formalization of existing firms, but formalization was substantially increased by creation of new businesses by former wage earners. Thus, it might be difficult to promote formalization for a large number of existing informal firms without a change in the associated benefits or without reducing other compliance costs such as taxation.

Small firms in Egypt and Morocco identify high taxation burden most often as a constraint to formalization. High taxes imply high costs of regulatory compliance in the formal sector. Lowering the corporate tax rate can impact tax revenue

through three main channels: (i) existing formal firms may invest more and earn more income on which they pay taxes; (ii) existing informal firms may be induced to formalize and start paying taxes; and (iii) new firms may be induced to operate formally. Evidence from other regions suggests that the net effect on tax revenue is likely to depend on whether a reduction in the tax rate is accompanied by additional enforcement and a reduction in exceptions. More frequent inspections are associated with lower underreporting of workers and sales. Formal firms that report tax and labor regulations to be severe or very severe obstacles to their business are consistently more likely to underreport their workforce and their sales. This has been found consistently in cross-country regression analyses and longitudinal data analyses from Egypt.

In many MENA countries, investment climate reforms have accelerated in recent years. However, consistent implementation of reforms matters greatly for their success. According to recent evidence (see World Bank, 2009), as a consequence of recent investment climate-related reforms, private investment in the MENA region increased by only 2 percent of GDP, compared to between 5 and 10 percent in Asia, Eastern Europe, and Latin America. The same report estimates that the number of registered businesses per 1,000 people in MENA is less than one-third of that reported in Eastern Europe and Central Asia, while the average business in MENA is ten years older than that found in East Asia or Eastern Europe (suggesting slower firm entry and exit). Close to 60 percent of business managers surveyed did not think that the rules and regulations were applied consistently and predictably, while policy uncertainty, unfair competition, and corruption were identified as major concerns for investors. Reforms are unlikely to produce the expected results without a credible commitment to more transparency and fairness in the relationship between businesses and the government. Discretionary enforcement of regulation acts as a strong deterrent to small entrepreneurs who start their businesses informally but are then forced to stay small to escape controls. Staying small may, in turn, make it prohibitively costly to formalize over time.

(2) Realigning incentives in the public sector

In some countries, the public sector continues to employ a large share of workers. For example, in Egypt, Iraq, and Syria, up to one of every three workers is employed by the public sector. Public sector jobs often offer higher wages than private sector jobs, as well as more job security and generous social security coverage (see Bodor et al., 2008). Such advantageous conditions are, not surprisingly, very attractive to workers. In a recent survey, 70 percent of youth in Egypt indicated that “it is best to work in the public sector.” In Syria, only a quarter of those officially in the queue for public employment accepted a recent offer of training and private sector placement, since registering in social security rosters would imply removal from

the public sector queue. Many of these workers then enter into informal employment as a means of supporting themselves while waiting for a public sector job. The generosity of public sector employment conditions (including pay, benefits, and job security) thus contributes to higher informality and important segmentations, making the need for civil service reform even more pressing. Moreover, the prospect of obtaining stable and remunerative employment in the public sector distorts skills formation, as a number of workers acquire education (especially in humanities) that is not necessarily in line with private sector demands.

Reforming the civil service is a key priority. In the short run, eliminating institutionalized queuing for public sector employment can reduce the segmentation between public and private employment and foster labor mobility. Queuing for public sector jobs contributes decisively to unemployment amongst graduates in the region and fosters informality. Moreover, wage scales in the public sector currently reward education level and tenure, but not performance. In several MENA countries, placement depends on connections and is virtually irreversible, as dismissing a civil servant is a difficult and complex process. Linking the public sector wage scale to competence and performance and easing the rigidity of civil service contracts may reduce the gap between public and private sector employment, thus limiting the incentive to work informally while queuing.

(3) Moving towards labor regulations that promote labor mobility and provide support to workers in periods of employment transition

Labor market regulation is perceived as an important constraint by more than one-third of employers in MENA, the highest share among all regions in the developing world. Employment protection legislation (EPL) includes a wide array of regulatory items, such as minimum wage, hiring and firing regulations, and provisions for fixed-term contracts. In MENA, legislated minimum wages are generally low, are not well enforced, and do not constrain employment outcomes significantly. However, in some countries, such as Tunisia, a centralized and rigid wage setting process may significantly contribute to informality and higher unemployment. Moreover, in some countries in the region, firing regulations are extremely restrictive, requiring notification and approval of a third party for a single worker's dismissal. In parallel, severance pay is often generous (54 weeks of salary in Egypt, and 43 weeks in Yemen and West Bank and Gaza). Such strict EPL reinforces segmentations between insiders (workers with formal, protected jobs) and outsiders (the unemployed, and informal or fixed term workers), as many firms circumvent regulations and resort to employing informal workers to fulfill their business needs.

MENA countries might improve compliance and employment outcomes by easing some labor legislation provisions. Although certain provisions in labor leg-

isolation in some MENA countries might be rigid in theory, in reality they are widely evaded. It is unlikely, however, that merely improving enforcement will result in less informality. A shift towards a richer and more flexible set of labor contracts (including more fixed-term contracts and fewer open-ended contracts) would provide opportunities for young workers and new entrants to join the formal sector through flexible working arrangements with social insurance coverage. Policy reforms that ease regulations and make them more realistic to comply with should be supplemented with social protection system reforms that better protect the income position of workers and their employment transitions.⁴ For example, recent experience shows that moderately strict EPL, when combined with a well-designed system of unemployment benefits and a strong emphasis on active labor market programs, can help create a dynamic labor market while also providing adequate employment security to workers (OECD, 2008). Adequate safety nets could also play an important role in protecting workers from sudden job loss, helping workers transition between jobs, and preventing more people from slipping into poverty. The newly legislated unemployment insurance schemes in Jordan and Egypt provide an example of reforms that should be considered by other countries in the MENA region.

Keeping the cost of labor at a realistic level via affordable social security contributions and relaxing wage rigidities are likely to reduce informality. In general, institutionalized minimum wages in the MENA region are neither high (with the exception of Morocco) nor binding. Yet centralized wage setting mechanisms, as in the case of Tunisia, contribute to informality by setting artificially high wage floors for certain occupations and skill levels. In addition to keeping minimum wages at low levels that can be realistically enforced, wage setting mechanisms in the MENA region should be anchored to changes in productivity. In countries where minimum wages are high (whether economy-wide or sector-specific), and where it is not politically feasible to reduce them, governments could consider reducing the minimum wage for youth to improve transitions of new labor market entrants into formal employment, while maintaining higher minimum wages to protect well-established workers. Similarly, labor taxes in MENA are not high by international standards, with the exception of Morocco and Egypt. The wedge between the employer's labor cost and the worker's take-home pay (i.e., the tax wedge) could be further reduced through social insurance reforms that lower the social security contribution rates (as already legislated in Egypt) or by shifting a portion of the labor taxes towards other general revenue sources, such as consumption or property taxes.

⁴ The International Labor Organization (ILO), European Union (EU), and Organization for Economic Cooperation and Development (OECD) have embraced the concept of “flexicurity,” combining flexible regulation, safety nets (such as unemployment insurance), and active social policies. One component of flexicurity policies is flexible and reliable contractual arrangements (from the perspective of the employer and the employee, of “insiders” and “outsiders”) through modern labor laws, collective agreements, and work organization.

Engaging in a more inclusive social dialogue is key to sustaining these reforms.

There are important political economy aspects to labor market reform. In particular, the traditional tripartite structure that convenes government actors, trade unions, and employer representatives is likely to favor the status quo of protective regulation for employed, unionized workers. Including representation from outsiders would likely shift the dialogue towards facilitating entry into labor markets, improving mobility, and promoting a more equitable distribution of returns across less favored segments of the population.

(4) Enhancing the productivity of informal workers through training and skills upgrading

The low productivity dimension of informality is especially notable in ME-

NA's poorer countries and rural areas, where workers with limited literacy and education are engaged in micro-entrepreneurship and low-yield agricultural work. Effectively increasing productivity in the informal sector, particularly in rural areas, is a complex undertaking that requires creating opportunities that promote human capital and connect people to markets. Well designed programs aimed at increasing productivity in the informal sector through training and skills upgrading are a potentially important intervention to promote inclusive growth in the long term. Privately and publicly provided training programs intended to increase workers' employability are abundant in the region. However, these programs tend to be delivered through in-class trainings targeted to urban, unemployed workers, and rarely reach informal workers (overwhelmingly the working poor), especially in rural areas. With limited access to these types of training opportunities, many informal workers are unable to enhance their skills and thus remain in low paying, low productivity jobs.

Emerging evidence from skills upgrading interventions sheds light on several success factors for informal, rural employment.

How training is delivered matters. For example, programs such as the Barefoot College in India and the Agriculture and Fishing Fund in Yemen suggest that the very modalities with which training is delivered (hands-on, community-based, combining learning with earnings) are key factors for success. Training might be most effective if provided with placement services such as job search assistance and soft skills training. Low levels of literacy, scarce information, inflexible program schedules, travelling restrictions, and language barriers all limit access to and usefulness of traditional, class-based training programs for informal workers, especially in rural areas (World Bank, 2011, forthcoming).

Facilitating the setup of training cooperatives might allow small firms to overcome the high fixed costs of structuring and delivering on-the-job training.

Since informal workers are overwhelmingly employed in small enterprises or hold

less stable jobs in larger companies, they are less likely to receive on-the-job training than formal workers. Providing incentives to firms (e.g., through training cooperatives) and workers (e.g., by providing vouchers) to engage in training could promote skills upgrading. To make these interventions more effective, re-orienting and tailoring the delivery and design of training towards the particular needs of informal workers is necessary. Second-chance programs, traditional apprenticeships, and training specifically designed for the self-employed and micro-entrepreneurs are examples of interventions likely to be effective in the MENA region.

(5) Reforming existing social insurance systems and introducing new instruments for coverage extension

Coverage extension through social insurance systems is an important yet complex undertaking. In MENA, expansion of social insurance schemes, particularly pensions, beyond the civil service has been achieved in all countries, but it has happened in a fragmented manner, and coverage remains limited. For example, in many countries, including Djibouti, Iraq, Morocco, Syria, and West Bank and Gaza, no legal coverage instruments are available for self-employed and agricultural workers. No pension schemes exist for agricultural workers in Algeria, Iran, Iraq, Libya, West Bank and Gaza, and Yemen. Although the existing pension systems in the MENA region have limited coverage, they are quite generous. Internal rate of return computations indicate returns of between 6 and 17 percent, significantly higher than alternative investment instruments. Workers with information about these returns indicate that they want to participate in the pension system, suggesting that lack of participation in social security might be largely driven by constraints to accessing the system (i.e., exclusion). Given the generosity of existing pension systems, policy makers might be reluctant to extend coverage at these favorable conditions beyond the current (limited) set of beneficiaries, to avoid amplifying the implicit pension debt. This justifies sequencing coverage extension, where reforms aimed at improving the sustainability of current systems will need to precede coverage extension. Consequently, coverage extension can take different forms, including: extending provisions of current mandatory systems; improving the design of existing social insurance schemes to promote coverage; or extending coverage beyond existing mandatory social insurance systems and traditional professions through new instruments. The latter, depending on country parameters and social preferences, could be based on providing universal or targeted benefits (i.e., adopting a noncontributory and/or a contributory approach).

There are important links between coverage outcomes and the design of social insurance schemes in the MENA region, particularly for pensions. With the exception of the recently approved social insurance reforms in Egypt, all countries in the region have defined benefit (DB) pension systems with design elements that are not in line with international best practices. A number of these features contribute

to the low participation (coverage) rates and include: limited legal coverage; short minimum vesting periods which promote gaming of the system; generous early retirement provisions which distort incentives to participation; and the use of average wages in the last few years of service as a basis for calculating benefit amounts, which makes these schemes more expensive. Addressing these issues through reforms to ensure adequate, affordable, and sustainable benefits appears to be an important precondition for effective coverage extension to a large and increasing share of the population. Moving towards a defined contribution (DC) system is likely to achieve some of these objectives. Moreover, DC systems are more useful for providing a platform to integrate different risk management instruments to cover risks such as disability, unemployment, and work injury, in addition to those associated with old age.

Adequate coverage extension in MENA is not likely to be achieved if efforts do not go beyond providing traditional social insurance and do not specifically target informal workers and those outside the labor force. Though this notion might be considered controversial, access to social insurance coverage could be designed to be unconditional on a formal employment relationship for some workers, particularly for the self-employed or those with irregular earnings and working patterns. Moreover, some workers might have too limited a savings capacity to contribute meaningfully to social security. Governments that opt to extend social insurance coverage beyond the existing mandatory social insurance system by targeting groups of informal workers are faced with a set of decisions related to strategy, design, and implementation. Key decisions pertaining to coverage extension strategies should be informed by: an assessment of the relative appropriateness of contributory or non-contributory programs (in the light of existing country conditions); fiscal sustainability; and an evaluation of universal versus targeted subsidies. Matching Defined Contribution (MDCs) schemes are one promising option for extending coverage. These schemes are voluntary defined contribution savings mechanisms offering old-age or other social insurance benefits, where the government or employer provides incentives to enroll by matching individual contributions at a given rate and threshold. Piloting MDCs targeted to informal workers with limited but positive savings capacity could provide policy makers with important insights on effective levers to increase coverage. In the short run, non-contributory schemes (such as social pensions) are still likely to play an important supplemental role. Middle-income countries like Lebanon, Syria, and Jordan, where poverty-based targeting systems are emerging, might consider targeted contributory interventions. In poorer countries like Djibouti and Yemen, means-tested non-contributory strategies may be more appropriate, since contributory schemes are not yet feasible given current country conditions.

Going beyond the traditional assumptions of agent rationality is important for promoting voluntary participation of informal workers in social insurance schemes, especially where contributions are required. Many of the observed be-

haviors in experimental settings contradict the standard economic models' predictions based on the assumption of agent rationality. In particular, behaviors such as procrastination and loss aversion could deter voluntary participation in savings schemes. Therefore, program features such as auto-enrollment, default options, and auto-escalation of savings could induce participation. Addressing the particular needs of informal workers in the design of programs could also mean allowing for flexible contribution schedules, amounts, and withdrawal conditions. Moreover, implementation arrangements that aim at minimizing transaction costs can also increase participation in these programs. Finally, complementary financial literacy and general interventions to raise awareness of the benefits of social insurance schemes should be considered.

References

- Alloush, M., C. Chartouni, R. Gatti, and J. Silva. (2011). "Informality and Exclusion: Evidence from Lebanon and Syria." Mimeo. Washington, DC: World Bank.
- Angel-Urdinola, D. and K. Tanabe. (2011). "Micro-Determinants of Informal Employment in the Middle East and North Africa Region." Mimeo. Washington, DC: World Bank.
- Bodor, A., D. Robalino, and M. Rutkowski. (2008). "How Mandatory Pensions Affect Labor Supply Decisions and Human Capital Accumulations? Options to Bridge the Gap between Economic Theory and Policy Analysis." Washington, DC: World Bank.
- De Soto, H. (1989). *The Other Path: The Invisible Revolution in the Third World*. New York, NY: HarperCollins.
- Elbadawi, I. and N. Loayza. (2008). "Informality, Employment and Economic Development in the Arab World." *Journal of Development and Economic Policies*. Arab Planning Institute, Vol. 10(2).
- International Finance Corporation and World Bank. *Doing Business*. <http://www.doingbusiness.org/>
- Loayza, N. and T. Wada. (2010). "Informal Labor in the Middle East and North Africa: Basic Measures and Determinants." Mimeo. Washington, DC: World Bank.
- Maloney, W.F. (1999). "Does Informality Imply Segmentation in Urban Labor Markets? Evidence from Sectoral Transitions in Mexico." *The World Bank Economic Review* Vol. 13(2): 275--302.
- OECD (2008). *Employment Outlook*. Paris: OECD.

- Perry, G., W. Maloney, O. Arias, P. Fajnzylber, A. Mason, and J. Saavedra-Chanduvi. (2007). *Informality: Exit and Exclusion*. Washington, DC: World Bank.
- Rodman, S. (2007). *Good Jobs, Bad Jobs, and Economic Performance: A View from the Middle East and North Africa Region, Employment and Shared Growth*. Pierella Paci and Pieter Serneels eds. Washington, DC: World Bank.
- World Bank. (2009). *From Privilege to Competition: Unlocking Private-Led Growth in Middle East and North Africa*. Washington, DC: World Bank.
- World Bank. (2010). “Egypt Investment Climate Assessment 2009: Accelerating Private Enterprise-Led Growth.” Washington, DC: World Bank.
- World Bank. (2011, forthcoming). “Challenges to Enterprise Performance in the Face of the Financial Crisis-Eastern European and Central Asia.” Washington, DC: World Bank.

