

MIDDLE EAST AND NORTH AFRICA
DEVELOPMENT REPORT

OVERVIEW

Informality and Inclusive Growth in the Middle East and North Africa



Gladys Lopez-Acevedo, Marco Ranzani,
Nistha Sinha, and Adam Elsheikhi



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Foreword

Over the past two decades, the economic performance of the Middle East and North Africa (MENA) has been subpar relative to low- and middle-income countries. Between 2000 and 2019, gross domestic product per capita increased by 1.7 percent per year on average, compared to growth rates about two times as high in the East Asia and Pacific and South Asia Regions. The MENA Region is also facing various challenges—subpar labor market outcomes, growth setbacks, and deteriorating fiscal and current account deficits in the aftermath of the COVID-19 (coronavirus) pandemic and in the wake of high inflation and supply chain disruptions triggered by the Russian Federation–Ukraine war. For too long, the private sector in MENA has primarily created informal jobs without offering social protection benefits, leading to the public sector becoming the main source of formal employment. In short, creating more formal job opportunities in the private sector has become increasingly important and is key to transition to a more socially inclusive growth path.

Although informal employment keeps many from living in abject poverty, it is associated with negative outcomes, such as limited safety net coverage, reduced risk pooling, limited redistribution, low productivity, and inequitable growth.

A key purpose of this report is to understand the characteristics and incentive structures that drive informal employment in the MENA Region, with a focus on the Arab Republic of Egypt, Morocco, and Tunisia. The report aims to help MENA policy makers foster more socially inclusive growth by (1) designing better social protection systems to protect workers and their families against contingencies as well as vulnerability or poverty, (2) improving the functioning and effectiveness of the welfare state by means of more effective risk pooling and higher tax revenues to help reduce inequality, and (3) incentivizing firms to grow and thereby raise overall productivity and economic growth in the long run.

The report adopts a framework that focuses on the legal, regulatory, and institutional contexts affecting incentives and disincentives that economic agents face to operate (in)formally. This “environment”

generates a set of incentives determined by laws, institutions, and policies that affects the decisions of economic agents and can be considered to be composed of three broad realms: Realm 1, entrepreneur-worker relations; Realm 2, taxes and transfers; and Realm 3, market conditions. Employment relationships are often informal due to incentives in this direction generated by a lack of, or distorted, legal and regulatory frameworks, whereby it is convenient for firms to hire workers informally. Taxes and transfer policies play a significant role in driving informality: firms may reduce their tax burden and have more flexibility in managing their workforce when operating at a small scale and partially informally; workers might in certain contexts benefit from social assistance while working informally without paying taxes on their income. In addition, market conditions—including limited competition, little private sector dynamism, difficult access to credit and enforcement of credit, and commercial contracts—contribute to widespread informality in the MENA Region.

To take on informality and achieve more socially inclusive economic growth, the MENA Region needs a new approach. This report calls for progressive and consistent actions to transition from a suboptimal equilibrium characterized by high informality, little coverage against risks, low productivity, and subpar growth. A shift is needed to a more inclusive social protection system, where the principles of universality with respect to the relevant population and equality of benefits replace the existing segmentation of social protection schemes and implicit unequal coverage of workers and families. Moreover, the source of financing would change. The risks common to all citizens would be funded from general taxes, risks common to all workers would be funded from workers' earnings, and risks specific to workers employed in firms would be funded from firms' contributions and be proportional to workers' wages.

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Overview

INTRODUCTION

The long-standing informality debate in the Middle East and North Africa (MENA) has taken on new urgency as the region looks for a pathway to more socially inclusive growth that is less reliant on fossil fuels. This is occurring against a backdrop of subpar labor market outcomes, further growth setbacks, and deteriorating fiscal and current account deficits in the aftermath of the COVID-19 (coronavirus) pandemic—and in the wake of high inflation and supply chain disruptions triggered by the Russian Federation–Ukraine war.

It is well recognized that a key pathway to making MENA's growth more inclusive lies in stronger job creation in the private sector (Assaad 2014; World Bank 2014). But this sector has not only underperformed in this area; it has also largely created jobs that do not provide social protection benefits: at 68 percent, MENA features one of the highest rates of informal employment after Sub-Saharan Africa and Asia and the Pacific (figure O.1). At the same time, the public sector has remained the dominant source of formal employment.

A focus on understanding informal employment in the region is timely. Governments are increasingly seeking to move away from reliance on universal subsidies and job creation in the public sector—elements that have been the cornerstone of the social contract. The high level of informality matters greatly for several reasons:

- A large share of workers (and thus households) does not participate in social insurance, which hinders the efficiency and inequality-reducing power of social protection systems via limited coverage, reduced risk pooling, and limited redistribution.

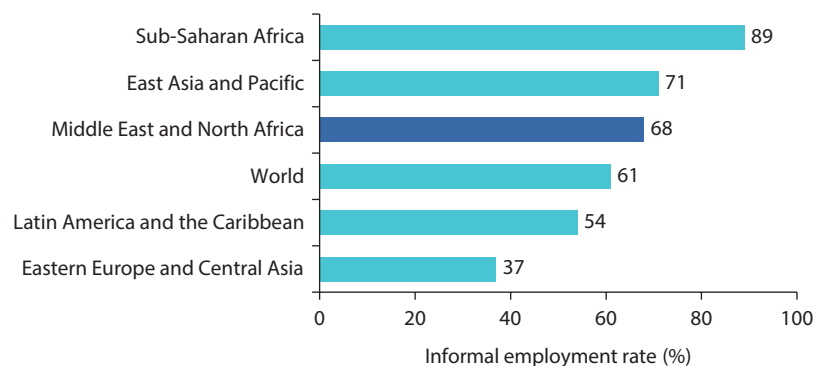
- Informal employment tends to be associated with small firms—and the concentration of resources in such firms can dampen productivity and economic growth.
- Informality limits domestic revenue mobilization, which diminishes the fiscal space to provide high-quality public goods and services.
- Informality represents deeper structural challenges in the economy, as it locks countries in a low-level equilibrium, which results in subpar and inequitable growth.

What do we know about the causes and correlates of informality in MENA? Some studies find that policy changes that reduce the costs of formality or increase labor market flexibility boost formal employment and vice versa (Angel-Urdinolo, Gadir Barry, and Guennouni 2016; Souag and Assaad 2017; Wahba and Assaad 2017). Others find that institutional labor reforms may not equally translate into positive outcomes for the informal sector due to segmented labor markets, leaving the informal sector no incentives to formalize (Boughzala 2017). Some studies point to the limited dynamism in the private sector and stagnating private investment as causes of informality in MENA (World Bank 2014, 2021a; World Bank, EBRD, and EIB 2022). Together, these findings suggest that there is no single cause of informality, and the size of the informal sector likely depends on a combination of factors.

This report aims to better explain the characteristics and incentive structure that have led to the prevalence of informal employment in three MENA countries (that is, the Arab Republic of Egypt, Morocco,

FIGURE O.1

Informal Employment Rates, by Region, 2019



Source: Based on data from ILO 2019.

and Tunisia, collectively referred to as “pilot countries” hereafter). It breaks new ground by adopting a comprehensive perspective to focus on features of, and interrelationships between, various aspects of a country’s institutional landscape—such as contributory and noncontributory social insurance, labor regulations, taxes, and market conditions—to make sense of the complex incentive structure that workers and firms face when deciding whether to work formally or informally. The report groups these issues in three broad realms: Realm 1, entrepreneur-worker relations; Realm 2, taxes and transfers; and Realm 3, market conditions.

The hope is to enable MENA countries to:

- Design better social protection systems to protect workers and their families against contingencies such as illness, longevity, job loss, disability, and work accidents, as well as vulnerability or poverty.
- Improve the functioning and effectiveness of the welfare state with more effective risk pooling and higher tax revenues to help reduce inequality.
- Incentivize firms to grow and thereby raise overall productivity and economic growth in the long run.

The report is based on an in-depth institutional analysis of the three broad realms in the pilot countries, which, as of 2021, collectively accounted for about 38 percent of MENA’s population and 39 percent of MENA’s gross domestic product (GDP).¹

Four key messages emerge from the report:

- At 68 percent in MENA, informality matters as it: (1) hinders social protection systems in terms of coverage, risk pooling, and redistribution; (2) dampens productivity and economic growth; (3) diminishes tax revenues; and (4) can lower the quantity and quality of the provision of public goods and services.
- The current design of social protection systems offers suboptimal coverage to workers and their families, delivers little redistribution, and often provides inadequate protection against risks, particularly risks associated with longevity and health. Combined with the minimum wage and collective agreements; lengthy, costly, and complicated dismissal procedures; and weak enforcement of labor regulations, this encourages informality and hampers productivity growth.
- The existence of special tax regimes, loopholes, and exemptions hurts firm expansion, productivity growth, and formal job creation, which

are all compounded by a lack of tax enforcement. In addition, enterprise registration offers few benefits to firms in terms of enforcement of commercial and credit contracts, providing little incentive to register and operate formally.

- Addressing informality and achieving higher and more inclusive growth would require a policy shift leading to a social protection and tax system in which all citizens have access to basic health services and enjoy at least a minimum income in old age, and there are no special tax regimes, while promoting the creation and growth of businesses with high productivity.

MENA'S TRACK RECORD: A NEED FOR MORE SOCIALLY INCLUSIVE GROWTH

Over the past two decades, the economic performance of the MENA Region—that is, the low- and middle-income countries but not the high-income ones—has been subpar compared to peers in a similar income category.² Between 2000 and 2019, their GDP per capita increased on average by 1.7 percent per year, while other developing regions, such as East Asia and Pacific and South Asia, experienced growth rates about two times as high. As a result, MENA has lost ground, and income gaps with other developing regions, such as East Asia and Pacific and South Asia, have widened.

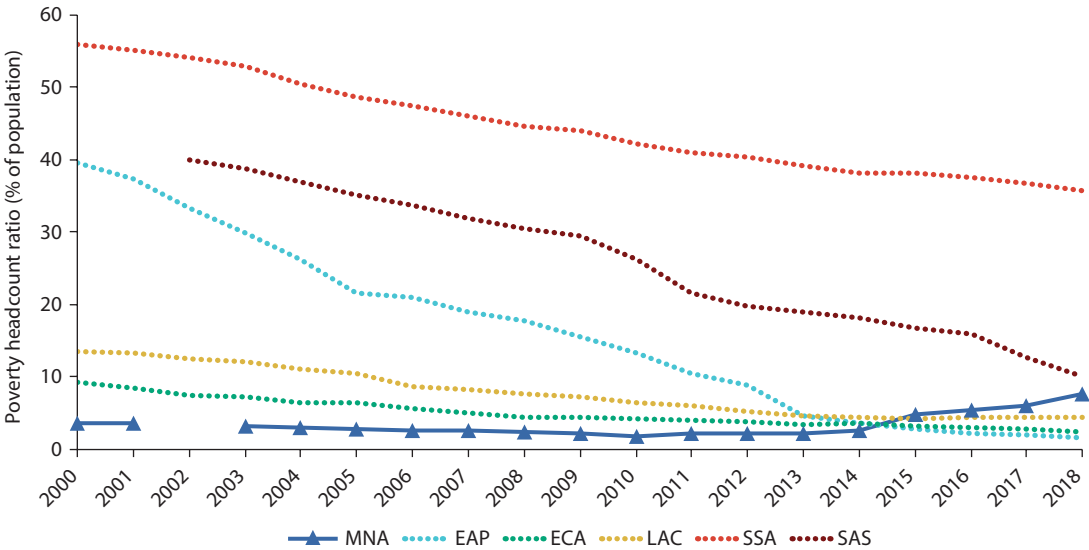
The modest economic growth not only generated few jobs compared to the size of the working-age population but also few jobs of good quality. Labor market outcomes also remain unsatisfactory across the board. In 2019, MENA stood out for the lowest employment-to-population ratio, at 38.2 percent; the lowest female labor force participation rate, at 19.5 percent; the highest youth unemployment rate, at 27.9 percent; and the largest share of youth “not in education, employment, or training,” at 26.9 percent in North Africa and 34.2 percent in the Arab states (World Development Indicators and ILOSTAT).

Further, there has been little improvement in living standards. Although the international measure for extreme poverty (those living on less than US\$2.15 income per day, 2017 purchasing power parity) remained lower in MENA than in other regions between 2000 and 2014, it grew by 56 percent between 2015 and 2018—from 4.8 percent to 7.5 percent—making MENA the only region where poverty has been increasing in recent years. This compares with 2.4 percent in Europe and Central Asia, 4.3 percent in Latin America and the Caribbean, and 35.7 percent in Sub-Saharan Africa in 2018 (figure O.2).

In the pilot countries, the results are mixed. In Morocco, the poverty headcount rate, measured against the national poverty line, declined considerably, thanks to “pro-poor” growth, coupled with investments in education, health, and other social services, whereas transfers and subsidies were largely regressive (World Bank 2018). In Tunisia, the acceleration of the rate of poverty reduction between 2010 and 2015 was associated with more public transfers (World Bank 2022a). However, progress has been limited in Egypt, where the lower poverty headcount achieved between 2012 and 2015 was undone between 2015 and 2017.

Faced with declining life satisfaction, citizens in MENA countries are once again questioning the ability of governments to deliver on the “social contract” that emerged post independence: a quid pro quo in which the government would provide jobs in the public sector, free education and health care, and subsidized food and fuel, in return for citizens keeping quiet and tolerating some degree of repression and elite capture in the private sector (Ianchovichina and Devarajan 2021). According to Arab Barometer data, citizens in the pilot countries are becoming increasingly dissatisfied with their country’s economic situation. In Morocco and Tunisia, the share of respondents describing their country’s economic situation as “bad” or “very bad” rose from 49.0

FIGURE O.2
Poverty Level, by Region, 2000–18



Source: Based on data from the World Development Indicators, World Bank.
Note: The poverty headcount ratio is calculated based on US\$2.15 per day, 2017 purchasing power parity. EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MNA = Middle East and North Africa; SAS = South Asia; SSA = Sub-Saharan Africa.

and 70.6 percent in 2010, respectively, to 56 and 90.7 percent in 2018. In Egypt, by contrast, the share of negative responses fell from 75.4 to 44.1 percent over the same period.

Recently, some governments in the region have started to acknowledge the need for a new development model and a new social contract. Here, it is important to note that this report's review period leaves out pertinent reforms introduced after 2019 in Egypt—including the new social insurance law that extends protection to irregular employees (temporary and seasonal workers), who were previously exempted. Similarly, since 2020, Morocco has gradually extended specific components, namely, health insurance, of contributory social insurance to certain categories of own-account workers.

HOW DOES THIS REPORT MEASURE INFORMALITY?

Informality arises from a nexus of factors, and thus it is not surprising that—despite its prevalence in the developing world—it does not have a universal definition. In some cases, it is viewed in terms of the shadow economy, unaccounted-for proportions of GDP, or even illegal economic activity. In others, it is seen as a lack of compliance among firms in terms of registration or tax obligations or other applicable regulations, lack of social security coverage of workers, or lack of written contracts.

Importantly, informality assumes different meanings according to the interlocutor. A minister of finance and a businessperson might be more concerned about informality in terms of the amount of taxes to be paid; a minister of labor or a union leader might think about the lack of social insurance and noncompliance with job stability and minimum wage regulations among workers; and the average citizen might think of a street vendor not complying with health and safety standards or not issuing a receipt of purchase.

In this report, informality refers to informal employment—defined as workers, salaried or nonsalaried, not covered by contributory social insurance (see box O.1). This means that informal workers are not insured against risks (such as illness, work accidents and disability, loss of life, longevity, and loss of employment). In principle, firms are defined as informal if they employ all their workers informally, while they are considered formal if they employ at least one worker formally.

Formality and informality may best be seen as states of employment: workers might start working informally and then contribute from a certain point of their working life onward; or they might continuously alternate periods of informality and formality as they contribute (perhaps, for example, only a few months in a year). In addition, the same

BOX O.1**Slight Variations in How Informality Is Defined for the Three Realms of the Institutional Landscape for Informal Employment**

Throughout this report, informality refers to informal employment—defined as workers, salaried or nonsalaried, not covered by contributory social insurance. The one exception is for the in-depth analyses of tax systems (Realm 2) and market conditions (Realm 3), where firms are defined according to their registration status. This adjustment reflects the absence of representative enterprise surveys that match firms and workers.

The two definitions largely overlap because (1) unregistered firms cannot hire formal workers, and (2) registered firms are formal under the first definition, as they very likely hire at a minimum one worker formally.

In addition, for market conditions, the first definition is applied implicitly, given that:

- Registered firms can hire formal workers and compared to unregistered firms, registered firms are more likely to be caught and sanctioned for hiring informal workers.
- Strong contract enforcement encourages firms to register with official authorities to benefit from the regulatory environment (including secure and low-cost transactions and credit contracts).
- Contestability drives the natural selection of firms and increases the integrity and benefits of the regulatory environment, encouraging firm registration and growth.

worker could hold both formal and informal jobs. Such fluidity in labor markets implies that a full understanding of the incentives and disincentives built into institutions, laws, regulations, and policies might be complex.

An in-depth analysis of the pilot countries shows that informal employment need not violate the law and that legal provisions contribute to shaping the extent of informality observed. That is why this report argues for the need to go beyond enforcement as a solution to tackling informality and to consider the role of workers' and firms' incentives that result from how laws, regulations, and institutions are designed.

In the pilot countries, the legal framework, which differs significantly among them, consists of the constitution and labor and social security codes. It establishes rights and responsibilities for employers and workers, including for social insurance (table O.1):

- In Tunisia, almost every worker must contribute to social insurance, except unpaid family workers, which means that almost all informal employment is illegal.
- In Morocco, only private and public sector wage and salaried workers must contribute, which means that for most categories of workers (like employers, own-account workers, and contributing family workers), informal employment is legal.
- In Egypt, only private sector wage and salaried workers in regular employment and public sector workers must contribute, which means that for some categories of workers (like wage and salaried workers in irregular employment, own-account workers, and contributing family workers), informal employment is legal.

The legal framework—together with firms' and workers' compliance with it, the composition of employment, and the degree of enforcement—impacts the size and composition of informal employment. Among the pilot countries, the overall rate of informal employment ranges from 43.9 percent in Tunisia to 62.5 percent in Egypt and 77.3 percent in Morocco (figure O.3). One reason informality varies by country is because some countries exclude by law specific categories of workers from contributory social insurance, implicitly allowing legal informal employment. Among workers who must contribute to social insurance, as defined in table O.1, about 54 percent do not do so in Tunisia, compared to about 65 percent in Morocco and Egypt.

The problem is that limiting the number of workers who must contribute to social insurance *de facto* imposes a constraint on the extent of risk pooling that the contributory pillar can achieve, as well as on the amount of revenues that the system can potentially raise.

Moreover, the viability of contributory social insurance systems, including their ability to protect workers, is reduced by job transitions, with the same worker switching between informal and formal jobs over their lifecycle. This decreases the appeal of contributory social insurance, as workers do not know for how long they will be formally employed, or if they will be able to benefit from their social security contributions—such as through benefits in the distant future, like an old-age pension. In Morocco, in 2019, only half of registered private salaried workers paid contributions for the entire year, whereas the rest contributed for a fraction of the year, thus operating semi-informally. In Egypt, from 2012 to 2018, about 16 percent of (illegal) informal salaried workers became formal and 24 percent of formal salaried workers became (illegal) informal salaried workers.

TABLE O.1

Informal Employment, by Type of Work, Arab Republic of Egypt, Morocco, and Tunisia, 2018 and 2019

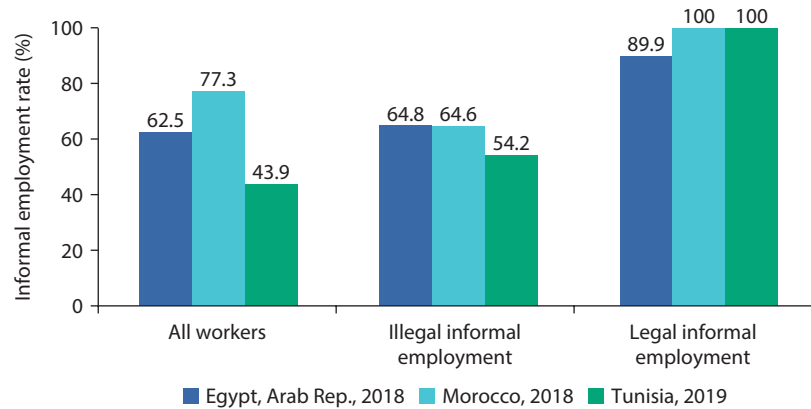
	Egypt, Arab Rep. (2018)					Morocco (2018)				Tunisia (2019)			
	Public sector workers	Private sector employees (regular)	Private sector employees (irregular)	Own-account workers / employers	Contributing family workers	Public sector workers	Private sector employees	Own-account workers / employers	Contributing family workers	Public sector workers	Private sector employees	Own-account workers / employers	Contributing family workers
Retirement pension	Green	Red	Red	Red	Red	Green	Red	Red	Red	Green	Green	Green	Red
Health insurance	Green	Red	Red	Red	Red	Green	Red	Red	Red	Green	Green	Green	Red
Family allowance	Red	Red	Red	Red	Red	Green	Red	Red	Red	Green	Green	Green	Red
Unemployment allowance	Green	Red	Red	Red	Red	Green	Red	Red	Red	Green	Green	Green	Red
Sickness/maternity benefit	Green	Red	Red	Red	Red	Green	Red	Red	Red	Green	Green	Green	Red
Work accident insurance	Green	Red	Red	Red	Red	Green	Red	Red	Red	Green	Green	Green	Red

Source: Original table for this publication.

Note: Green cells indicate that workers are covered by law against a specific risk and thus informal employment is illegal; red cells indicate that workers are not covered by law against a specific risk and informal employment is legal.

FIGURE O.3

Informal Employment Rates, by Sector, Arab Republic of Egypt, Morocco, and Tunisia, 2018 and 2019



Sources: Calculations based on Labor Force Surveys in the Arab Republic of Egypt (2018); Morocco (2018); and Tunisia (2019).

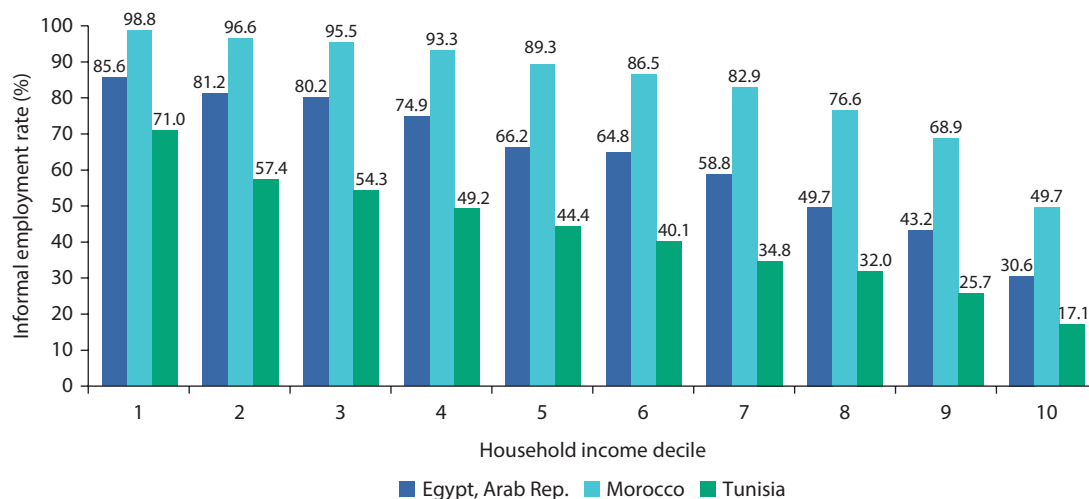
Note: The percentages are for the most recent year available. The groups of bars refer to informal employment rates among all workers and illegal and legal informal employment rates among private sector workers, respectively.

The evidence of informal-formal transitions implies that for some workers, informality is not only an outcome of exclusion but also a choice. This is further confirmed by its pervasiveness across income levels: in Egypt, Morocco, and Tunisia, 31, 50, and 17 percent of workers, respectively, among households in the highest welfare deciles, are informally employed, representing more than 5 percent of the countries' entire populations (figure O.4). The same is true for the presence of informality across education levels: in Egypt, Morocco, and Tunisia, 31, 31, and 14 percent of informal workers, respectively, have a university degree. In addition, the wage distributions of formal and informal wage workers partially overlap, which means that some informal workers earn more than some formal ones.

Informality is mostly concentrated in small firms, which represent the largest section of the production fabric in the pilot countries. In Tunisia, about 97 percent of firms employ fewer than 10 workers and contribute almost 65 percent to total employment. In Morocco, small firms with fewer than 10 workers contribute around 90 percent of informal wage employment and 30 percent of formal wage employment. In Egypt, about 53 percent of total employment is concentrated in micro firms with fewer than five workers.

FIGURE O.4

Informality Rates, by Income Decile Levels, Arab Republic of Egypt, Morocco, and Tunisia



Sources: Based on data from CAPMAS 2018 for the Arab Republic of Egypt; HCP 2015 for Morocco; NIS 2015 for Tunisia.

Note: Due to data limitations in the case of the Arab Republic of Egypt, it was not possible to use deciles of per capita household expenditures—alternatively, wealth deciles were constructed based on a factor analysis approach using household ownership and durable assets and housing conditions.

FRAMEWORK FOR THE REPORT

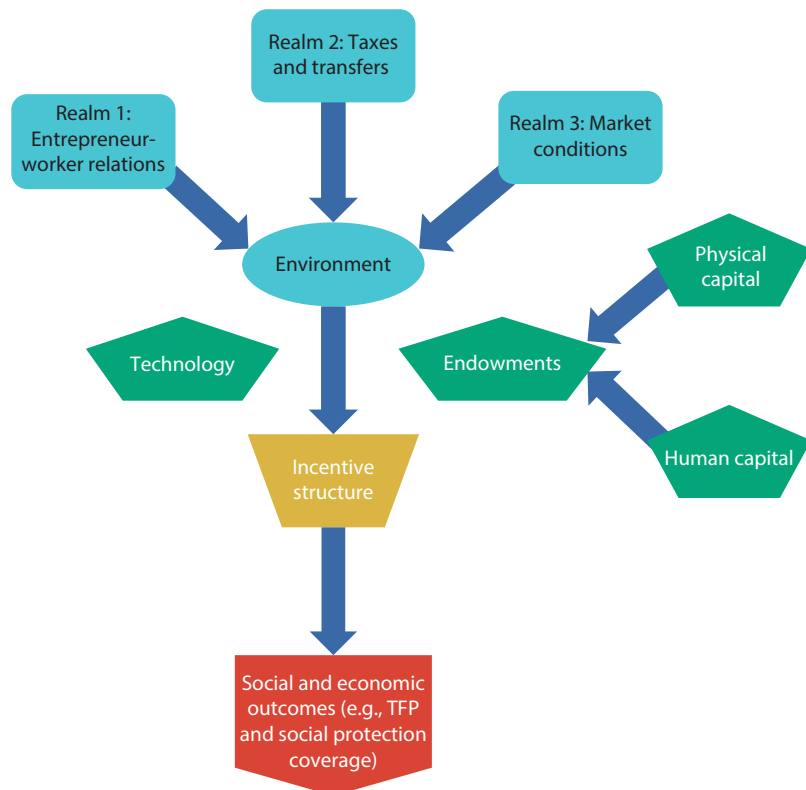
This report adopts the framework put forward by Levy and Cruces (2021) to shed light on the legal, regulatory, and institutional context affecting the incentives and disincentives that economic agents—primarily workers and firms—face to operate (in)formally in selected MENA economies. A cornerstone of the framework is that informality is endogenous to the legal, regulatory, and institutional context in which firms and workers operate and make decisions. The size of the informal sector is not given and grows larger or shrinks depending on a country’s environment. In other words, it does not represent a constraint but rather an outcome of the institutional context that economic agents face.

The framework focuses on the legal, regulatory, and institutional context affecting incentives and disincentives that economic agents (primarily workers, firms, and banks) face to operate (in)formally. This “environment”—what economic agents consider the “rules of the game”—influences these decisions, based on a set of incentives

determined by laws, institutions, and policies, as well as by the functioning of institutions that enforce and determine the extent of the rule of law function. It is composed of three broad realms: Realm 1, entrepreneur-worker relations; Realm 2, taxes and transfers; and Realm 3, market conditions (figure O.5). Unlike approaches that view the drivers of informality through a single lens, this approach takes a comprehensive perspective to focus on features of, and interrelationships between, each broad realm of the environment to make sense of the complex incentive structure that different groups of workers and firms face when making economic decisions. Together with technology and countries' endowments of physical and human capital, this determines social and economic outcomes, including social protection coverage, distribution of income,

FIGURE O.5

The Environment and Social and Economic Outcomes in a Country



Source: Original figure for this publication.

Note: TFP = total factor productivity.

poverty and inequality, productivity (total factor productivity), and economic growth.

In the context of this report, the environment creates an incentive structure that influences actors' decisions to operate informally or formally. For example, the design of social insurance systems affects employers' and workers' preferences to operate formally because of factors such as contribution rates, risk coverage, and the quality of services provided. Similarly, if the tax burden associated with operating formally (fully or partially) is high and enforcement is weak, economic agents may opt for hiding under the radar and operate informally.

Informality can increase for various other reasons: (1) if it is costly for firms to register their business or resolve commercial disputes, (2) if it is cumbersome or risky to obtain credit because of high collateral requirements or uncertainties linked to protection of borrowers' and lenders' rights, or (3) if markets are uncontestable due to corruption and unfair competition. Whatever the reason, if firms and workers perceive few benefits from formalization, or these benefits are low compared to informal alternatives, informality will remain high.

Although the report applies both quantitative and qualitative methods to understand why workers and firms are informal, data limitations are severe and constitute a significant caveat. In the pilot countries, the report gauges how informality is influenced by the design of the social protection system and labor regulations, the tax system, and market conditions. It uses household survey data, tax and social security administrative data, secondary sources from international organizations and academics, and, for Morocco, interviews with workers and employers. On the investigative nature of the work, there were significant challenges in accessing data in areas like wage distributions, contribution densities, number of taxpayers, and firms (especially those operating in the informal sector). Thus, some of the results should be taken with an element of caution. Future analysis will help to shed light on areas that are not fully explored in this report due to important data gaps.

REALM 1: INFORMALITY AND ENTREPRENEUR-WORKER RELATIONS

The design and implementation of contributory social insurance provides suboptimal coverage to workers and their families. This occurs for several reasons. First, informality does not necessarily mean poverty or vulnerability. In the pilot countries, the share of informal workers who are neither poor nor vulnerable ranges from 63 percent in Egypt, to 70 percent in Tunisia, to over 90 percent in Morocco. Even so, informal

workers and their families are not covered against longevity and health risks unless they can afford private insurance, meaning that they might become poor or vulnerable in old age or in case of a health shock. Informal workers are also left without protection in case of work accidents that might lead to temporary or permanent disability and in case of job loss, as well as without entitlement to sickness, maternity, or annual leave.

Second, many workers who should contribute to social insurance do not. This defeats the purpose of social insurance and limits the extent of risk pooling—thus delivering suboptimal coverage even to formal workers compared to a scenario where every employer and worker who is required to pay contributions does so.

Third, the exclusion of specific categories of workers by design further limits the efficacy of the contributory system. In Egypt and Morocco, employers and own-account workers are not required to contribute to social insurance (as of the latest available year used in the analysis, 2018 or 2019). However, these countries have recently started to extend social insurance coverage to specific categories of self-employed workers, using a system that works similarly to the one currently in place for private sector employees for health insurance and a retirement pension.³

Contributory social insurance delivers little redistribution, given strong incentives for high earners to be formal but few incentives for low earners. The labor markets in the pilot countries feature an important public/private wage employment divide, with the public sector providing on average better monetary and nonmonetary benefits and job security. Contributory social insurance makes the situation worse by providing higher-quality social insurance benefits at a lower cost to public sector workers (such as family allowances at no cost to workers and access to better health insurance). In the private sector, workers with short formal careers are likely to be taxed, as they do not contribute continuously to social insurance, making it less likely for them to meet the eligibility requirements. Further, the probability of working formally for long periods of time is likely to be higher on average among high-wage workers, which defeats the redistribution component of the system.

Pension systems do not provide adequate protection against the longevity risk to private sector workers with short formal careers. Pension systems are designed as pay-as-you-go and feature important discontinuities that can play in favor of informal employment. In the pilot countries, the pension systems base benefits on the number of years of contributions. Workers who do not meet the minimum number of years of contributions are entitled to a lump sum that corresponds to the contributions the

workers paid, but it excludes the contributions paid by their employers. In other words, such workers are taxed by contributory social insurance, with the amount of the tax corresponding to the discounted value of contributions paid by employers.

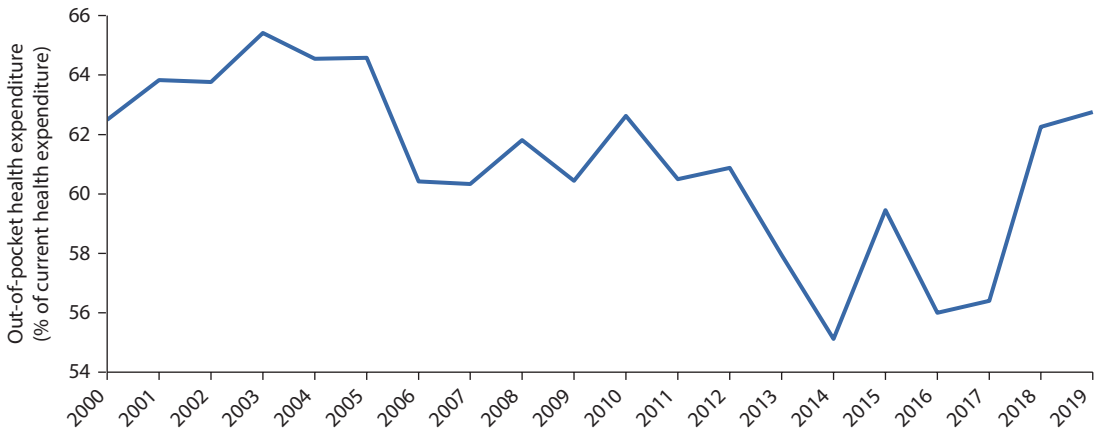
This feature exposes such workers to longevity risk, as no right to an annuity is accrued. It also exposes them to health risk, as the elderly without entitlement to a pension benefit are left without health insurance. On the one hand, the pension systems in Egypt, Tunisia, and Morocco redistribute from informal and low-wage workers who do not accumulate the minimum number of years of contributions to formal and high-wage workers. Moreover, for workers who meet the eligibility requirements, the system is more than actuarially fair, as it provides retirees a pension that is higher than what they paid for and provides little incentive to contribute beyond the minimum number of years required by the law. On the other hand, in countries like Tunisia, which lack wage ceilings for contributions and a cap for benefits, there is an element of redistribution from high- to low-wage workers.

Contributory health insurance does not deliver good coverage to workers in the private sector, thereby exposing households to hefty out-of-pocket health expenditures. Although specific features of contributory health insurance vary across the pilot countries, in practice, access to health care services depends on workers' income level, despite all formal employees being covered in principle. Long waiting lines, the low quality of services provided, and regional imbalances push workers to opt for private providers. However, workers are only refunded a percentage of the legal tariff, which is typically lower than the market price that families actually paid. Contributory health insurance is an option that only high-wage workers can afford, and it comes at the cost of high catastrophic health expenditures for the rest.

In Egypt, it is common for employers in the upper segment of the labor market to opt out of the system, to provide workers better service quality, although this defeats the purpose of insurance risk aggregation across the private sector. Such opting out helps explain the large (and growing) share of out-of-pocket health expenditure in Egypt—which has remained high, despite fluctuations, at about 63 percent since 2000 (figure O.6).

Noncontributory social insurance provides partial and erratic coverage. Informal workers who belong to poor or vulnerable households typically have access to noncontributory social insurance, which provides free or subsidized health insurance—but it does not provide a retirement pension benefit or protection against disability, death, accidents at work, or job loss.

FIGURE 0.6

Out-of-Pocket Health Expenditures, Arab Republic of Egypt, 2000–19

Source: Based on World Bank data.

In Morocco and Tunisia, poor and vulnerable workers who are employed informally receive free or subsidized health coverage, which grants them access to public health care facilities. In Egypt, every uninsured person has access to public hospitals and health care facilities at a subsidized rate. There are also cash transfer programs (Le Programme National d'Aide aux Familles Nécessiteuses [PNAFN] in Tunisia, Tayssir and Project DAAM in Morocco, and Takaful and Karama in Egypt) that provide income support to help the poor make ends meet.⁴ Although these programs can be helpful if they are designed as a temporary support to help poor families invest in the human capital of their children to break the intergenerational transmission of poverty, they do not provide insurance and protection against contingencies.

Noncontributory social insurance might act as a subsidy to informal employment, particularly for low-wage workers. In Tunisia, the incentives for private sector wage workers to comply with contributory social insurance are weak. Being formal and paying social security contributions would imply the loss of both free or subsidized health care and cash transfers. Insurance provided for other risks, particularly a retirement pension, might give little value for money. However, in Egypt and Morocco, the noncontributory pillar does not seem to have direct effects on the incentives to work formally. Even so, in a context of constant supply of health care and inadequate resources, free or subsidized health care might reduce the value of contributory health insurance for low earners—who must use the same public channels as formal workers and are less likely to be able to afford to opt for private health care.

Most social protection expenditures are absorbed by contributory social insurance, particularly for public sector workers, and little is captured by social assistance. In the pilot countries, expenditures on contributory social insurance for salaried workers account for the largest share of social program outlays—with Egypt, Tunisia, and Morocco spending 10.9, 11.7, and 6.6 percent of GDP, respectively. This compares to the averages of 6.1 percent of GDP for lower-middle-income countries, 10.3 percent for upper-middle-income countries, and 17 percent for high-income countries.⁵

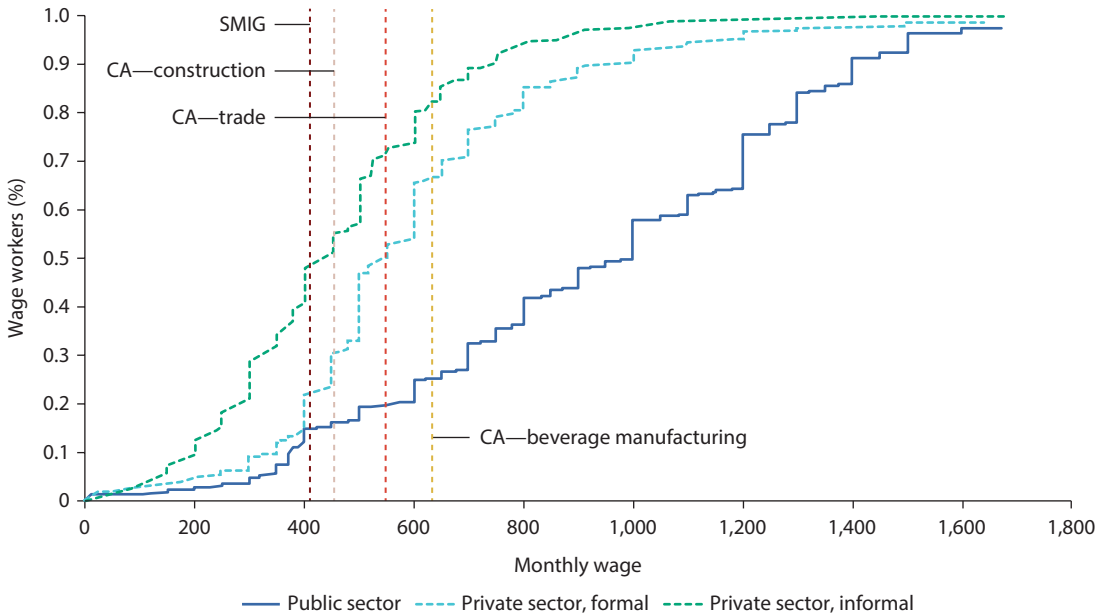
Moreover, universal consumption subsidies, aimed at providing households specific consumption items below market price, absorb a considerable amount of public resources. In Egypt, Morocco, and Tunisia, they represented 5.6, 1.30, and 3.91 percent of GDP, respectively, in 2019. However, universal consumption subsidies provide more advantages to the middle class and the most affluent households, as such households consume more of the items typically subsidized (such as gasoline, electricity, and gas), thereby adversely impacting income inequality.

Minimum wages might be set at levels too high for workers with low levels of productivity—as is occurring in Tunisia. The minimum wage in Tunisia is about 79 percent of the median wage (the same as in Egypt), and in Morocco, it is about 51 percent of the average wage.⁶ In Tunisia, collective agreements impose higher minimum wage levels for specific sectors and establish the extent of wage increases, which might not always be well suited to the economic and financial conditions of all firms operating in specific sectors (figure O.7). This might further push employers to hire at least some of their workforce informally, as they cannot shift back the cost of labor in the form of a lower wage to workers. Moreover, Tunisia's wage floor is high by international standards—in developing and emerging economies, the average is about 67 percent of the median wage. In Egypt, although the minimum-to-median-wage ratio is comparable to other developing countries, private sector workers were unable to benefit until 2022.

Firing costs and dismissal procedures might further hinder formality, as firms need flexibility to adjust the workforce in case of shocks. In Egypt and Morocco, dismissal costs (excluding damages) start at about 8 and 4 percent of workers' wages, respectively, and increase with seniority. In Tunisia, based on the labor code, the cost of dismissal (excluding damages) is 5 percent of accumulated wages, while it is 6.25 percent if a sectoral agreement is in place, and both decline with seniority. However, uncertainty about the length of dismissal procedures might push firms to hire part of their workforce informally. Often, strict firing regulations are created as a substitute for limited, or lack of, unemployment insurance—but they are not a good substitute, as they protect formal workers while shifting the risk to informal workers.

FIGURE O.7

Minimum Monthly Wages, by Sector, Tunisia, 2019



Source: World Bank 2022a.

Note: The figure shows the cumulative distribution function of monthly wages of private (by formality status) and public sector wage workers in 2019. Monthly wages are expressed in TD (2019 prices). CA = collective agreement; SMIG = minimum monthly wage for nonagricultural workers, set at TD 403 in 2019.

Enforcement of labor laws and regulations is weak. Given low penalties and a low probability of getting caught due to limited resources available for labor inspections, the pilot countries cannot implement an adequate level of enforcement of labor laws and regulations, thus facilitating evasion of labor regulations and informal employment.

REALM 2: INFORMALITY AND THE TAX SYSTEM

Preferential tax treatment offered by “special regimes” attracts many small, unincorporated enterprises. Special regimes are often implemented with the intention of facilitating participation of self-employed and micro firms in contributory programs and bringing them within the purview of the tax authority. They provide preferential tax treatments to specific enterprises compared to those obtained under the corporate income tax regime. Such treatments are granted if firms meet certain requirements—such as single ownership or limited partnership, operating as an unincorporated business, and keeping annual sales below specified thresholds.

- In Tunisia, individual enterprises can file their tax returns under one of two special regimes and pay a flat rate or 3 percent on sales if their annual sales are below a specific threshold. Their tax burden compares favorably to those of enterprises in the personal income tax (PIT) and corporate income tax (CIT) regimes, which charge minimums of 26 and 25 percent, respectively, and they are also exempt from value-added tax (VAT). Here, an individual enterprise refers to a firm owned by a single person, that is, with only one shareholder, registered as a natural person regardless of the number of employees, and with no distinction and no separation between assets of the owner and assets of the enterprise.
- In Morocco, self-employed workers can apply for auto-entrepreneur status and benefit from preferential tax rates and VAT exemption, if their turnover is less than DH 500,000 (or DH 200,000 for those operating in the service sector, equivalent to about US\$55,617 and US\$22,247, respectively).
- In Egypt, commercial and industrial unincorporated enterprises structured as sole proprietorships and simple partnerships can file taxes under the PIT regime regardless of their size. The tax burden is significantly less than the CIT regime: the highest personal income tax rate is equal to the standard corporate income tax rate of 22.5 percent.

However, this comes at a cost as special tax regimes are inconducive to firm expansion, productivity growth, and formal job creation. The reasons why are many. First, special regimes do not generate incentives to expand the size of enterprises beyond the qualifying threshold, and firms will only do so if they expect sales to rise such that after-tax profits are higher than before, which is unlikely to occur for most micro and small firms. Second, the special regimes help micro and small enterprises that operate at low productivity levels to survive, which distorts the natural process of firm selection, trapping resources in unproductive firms rather than more productive ones. Third, operating at small scale reduces firms' likelihood of being caught by tax enforcement authorities and sanctioned, thereby encouraging fraudulent behavior and informality.

Special regimes interact with other taxes in pilot countries, such as the VAT, distorting market dynamics further and stifling productivity and formality. In Morocco and Tunisia, small firms and the self-employed under special regimes are exempt from paying the VAT, which encourages them to remain small and pay lower taxes. It also discourages interacting with other firms, as goods and services purchased from a firm under the special regime cannot be included in the calculation of the deductible VAT. As a result, firms and the self-employed under the special regime mostly trade with other informal firms or sell to final consumers—a situation

that prevents technical and technological knowledge transfer and inhibits economies of scale, growth, value chain development, and the creation of formal jobs.

The structure of the PIT regime can disincentivize formal employment of low-wage workers. In the pilot countries—especially in Tunisia—low-wage earners, particularly those earning an annual income around the minimum wage, have little incentive to pay income taxes. The marginal tax rate rises sharply from zero for workers earning a monthly income at or below the minimum, to 26 percent in Tunisia and to 10 percent in Egypt and Morocco. This might further discourage formal employment of low-wage workers, given the few incentives provided by contributory social insurance, the minimum wage, and dismissal regulations.

The lack of tax enforcement encourages tax evasion and informality, which raises the cost of formality. Tax enforcement is weak because of poor information exchange and communication between tax authorities and a lack of human and financial resources. As a result, tax evasion and underreporting are widespread. In Tunisia, tax fraud was estimated at US\$8.5 billion—or 20.4 percent of GDP—in 2019 (Bouzaiene 2021), while in Morocco, as much as US\$2.45 billion—or about 2 percent of GDP—was lost due to the tax practices of multinational corporations alone in the same period (Oxfam and Reuters 2021). As a result, a small number of taxable formal private and public wage workers and mostly large firms face a high tax burden compared to most economic actors in their respective countries. As of 2019, Tunisia’s and Morocco’s tax burdens were comparable to the Organisation for Economic Co-operation and Development (OECD) average despite having a narrower tax base, representing 25.1 and 21.4 percent of GDP, respectively, while it was slightly lower in Egypt, at 15.5 percent (IMF 2022). Still, weak enforcement coupled with a high tax burden increases the appeal of arbitrage, fraud, and evasion among workers and firms in the pilot countries, as the probability of getting caught is low and most other economic agents do not pay direct taxes. This situation produces a vicious circle of informality, tax evasion, subpar tax collection, limited redistributive power, and low quantity and quality in the provision of public goods and services, which encourages further informality.

REALM 3: INFORMALITY AND MARKET CONDITIONS

The process of registering a business is the first step an entrepreneur must take before starting an economic activity. The more complex, lengthy, and costly the procedures are, the less attractive and likely that micro and small firms will comply with the law and operate formally.

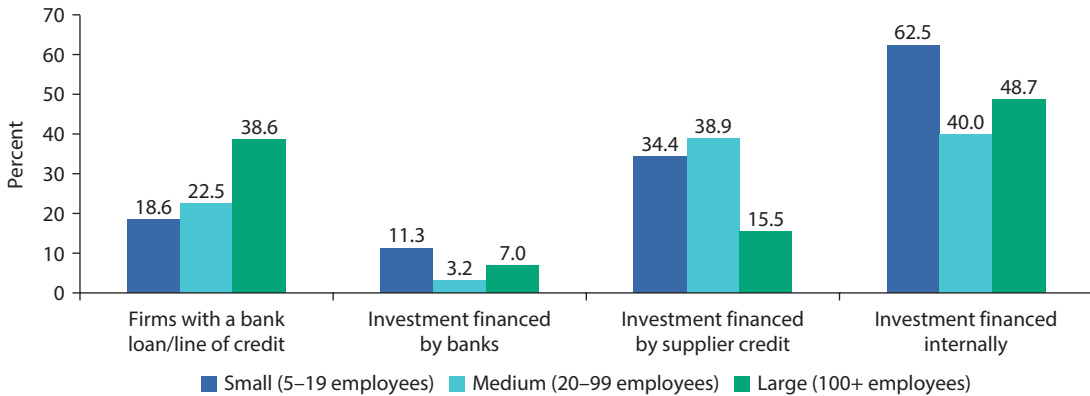
In Morocco and Tunisia, starting a business is a relatively fast and inexpensive process, taking an average of 6.4 and 9 days, respectively, while costing 3.6 and 2.9 percent of income per capita, performing similarly to the OECD average of 9.2 days and 3 percent of income per capita (World Bank 2021a). In Egypt, however, starting a business takes 12 days and registration costs are about 20.3 percent of income per capita, much higher than regional peers, which might dissuade firms from registering their businesses.

Enforcement of commercial and credit contracts remains challenging and can discourage formality and hamper firm growth. In the case of commercial contracts, strong enforcement directly affects the level of security and integrity of economic transactions. For firms, it corresponds to lower transaction costs, higher incentives to register with official authorities, and a greater likelihood of interacting with many firms beyond a small and trusted network of suppliers and customers. Such factors are associated with firm formality because not only are they growth-enhancing, but also the risk of getting caught and sanctioned for hiring informal workers increases with firm registration. In the pilot countries, however, resolving a commercial dispute is typically a costly and slow process. The biggest downfall is the low quality of judicial processes, reflecting inefficient court structures and proceedings, poor case management, and a lack of court automation and alternative dispute resolution.

On credit contracts, weak enforcement generates uncertainty and increases the legal costs to impound collateral in case registered firms fall into bankruptcy or default on their loans. This might lead banks to provide less credit or offer costly loans, which dissuades firms from registering with official authorities to benefit from credit contracts and often prompts them to rely on internal finance—a route that limits their growth prospects and ability to formalize by hiring formal workers. In the pilot countries, the rights of borrowers and lenders are weakly protected, as shown by their poor performance on an index that captures the strength of legal rights—with Egypt, Morocco, and Tunisia scoring 5, 2, and 3 (out of 12), respectively. This translates into difficulties in getting credit, which is particularly challenging for the smallest firms, which largely rely on internal sources of finance (figure O.8).

Restrictive regulations, a heavy state-owned enterprise (SOE) footprint, and cronyism hamper competition in product markets, causing unfair and non-contestable market structures and high market concentration. Product market competition is related to firms competing on an even field and speaks to the cost that firms face when starting operations in a market for specific goods or services and when they interact with existing firms. The presence of SOEs and monopolies in sectors where such market structures are not justified on economic grounds dissuades firms from registering

FIGURE O.8

Access to Credit, by Firm Size, Morocco, 2019–20

Source: Based on data from Enterprise Surveys, World Bank.

with official authorities (to hide under the radar) or even entering markets. As a result, firms stay small after entry, or are pushed out of markets, which depresses the number of formal firms, their size and level of productivity, and ultimately economic growth.

In the pilot countries, SOEs are widespread, with their presence extending to 41 sectors in Egypt, 23 sectors in Morocco, and 40 sectors in Tunisia, compared to an average 26 sectors in developing countries. The situation is made worse by cronyism and political connections that further undermine market contestability and fair competition.

GUIDING PRINCIPLES FOR MOVING TOWARD HIGHER, MORE SOCIALLY INCLUSIVE GROWTH

A Starting Point

As the pilot countries move away from regressive subsidies and reliance on the public sector to provide jobs, there is an opportunity to realize sustained and socially inclusive growth. That means a social protection and tax system in which all citizens have access to basic health services, are provided at least a minimum level of financial protection against health risks, and enjoy at least a minimum income in old age, while promoting the creation and growth of businesses with high productivity. Although there has been a welcome and needed recognition of the role that targeted income transfers can play in reducing poverty, these programs alone cannot provide the key ingredients needed for a growing and youthful workforce.

How can governments start to address informality to achieve higher and more socially inclusive growth? This report calls for progressive and consistent actions, starting with the premise that to date the interactions of the three institutional realms have led to a suboptimal equilibrium—notably, high informality, little coverage against risks, low productivity, and subpar growth in the region. Six policy principles emerge from the analysis of institutions in the realms of worker-entrepreneur relations, the taxation system, and market conditions that will shift individuals' incentives. The goals are (1) making the formal and informal dichotomy irrelevant as social protection policies will operate through the tax and transfer system (Realm 2) and not through entrepreneur-worker relations (Realm 1); (2) fostering universal protection, redistribution, and efficiency gains; and (3) shifting pilot countries onto a higher, more socially inclusive development trajectory. Table O.2 describes the six policy principles.

TABLE O.2

Policy Principles to Encourage Formal Employment

Policy principle	Realm(s)	Description	Impact of policy on informality
1. Policies should not be designed or evaluated in isolation.	Realms 1, 2, and 3	Policy makers must be mindful about the change in incentives offered to firms and workers to operate informally when introducing a new, or altering an existing, policy because it is the effect of the policy mix on individuals' behavior that matters for policy reforms.	By adopting a holistic view on the policy front, policy makers will be able to improve the effectiveness and predictability of policy interventions on workers' and firms' behavior, thereby minimizing unintended and often undesirable outcomes, including informality.
2. All the population exposed to a given risk should be covered by the same program.	Realm 1	When contributory social insurance schemes are not standardized across groups of workers, including noncontributory programs for the poor and vulnerable, it reduces the protective capacity of programs, can encourage informality, and creates opportunities to arbitrage the system. Providing coverage to all individuals exposed to the same risk with one single program can ensure more risk pooling, can increase efficacy and diversification of risk, as well as ensure that all individuals receive the same quality of service.	Following the report's definition of informality, universality with respect to the relevant population solves the informality problem, at least from a standpoint of protection against the fundamental risks of health and longevity.
3. The source of financing should vary with the type of risk covered.	Realm 1	Risks of different natures are best covered through different sources of financing: (1) risks common to all citizens should be funded from general taxes; (2) risks common to all workers should be funded from workers' earnings; and (3) risks specific to workers in firms (employees) should be funded from firms' contributions based on workers' wages.	

(continued)

TABLE O.2

Policy Principles to Encourage Formal Employment (continued)

Policy principle	Realm(s)	Description	Impact of policy on informality
4. Social protection for the poor via non-contributory programs should be targeted based on family income and not tied to the work formality of beneficiaries.	Realm 1	All the poor should receive income transfers, and eligibility must not be conditional on workers' formality status. This is to avoid informality and poverty traps and to support the vulnerable during the labor market adjustment period in response to proposed changes to health insurance and retirement benefits.	The fact that income transfers are conditional on income, and not formality status, creates an incentive for poor workers to search for a formal job. Moreover, poor workers may prefer a formal to an informal job if the former offers better working conditions.
5. The taxation structure should strengthen incentives for formal employment and, together with social protection, be progressive.	Realm 2	The number of tax regimes offered to economic agents must be minimized such that tax loopholes, special regimes, and exemptions are abolished. Tax schedules must exhibit sufficient progressivity to fund redistribution and create opportunity, not to discourage productivity, and to assure public services of high quality. In addition, enforcement and tax collection must increase in tandem.	Standardizing the tax system by abolishing exemptions or discounts encourages firm natural selection, productivity growth, and formal job creation. Coupled with increased enforcement, it also broadens the tax base and, in turn, tax revenues, which can be invested in funding the universality of health care and old-age transfers, and improve the quality of services provided, making formality more attractive.
6. Governments should ensure that market conditions are conducive to firms' entry, growth, and exit.	Realm 3	(i) The registration process for new enterprises should be further simplified with the aid of digital technologies. (ii) Measures should strengthen commercial contract enforcement, most notably by strengthening the quality of the judicial process in the pilot countries. (iii) Measures should strengthen credit contract enforcement, particularly the legal rights of borrowers and lenders. The pilot countries should implement measures to reduce the time and cost required to resolve an insolvency. (iv) Policies should address product market competition, price controls, the presence of state-owned enterprises, and cronyism. See World Bank (2022b).	By making the registration process simple in addition to improving the benefits of being registered—for example, by enhancing contract enforcement—more firms will register with the authorities. Since registered firms can benefit from commercial and credit contracts and cannot easily hide under the radar from their tax and social obligations, formal employment will increase.

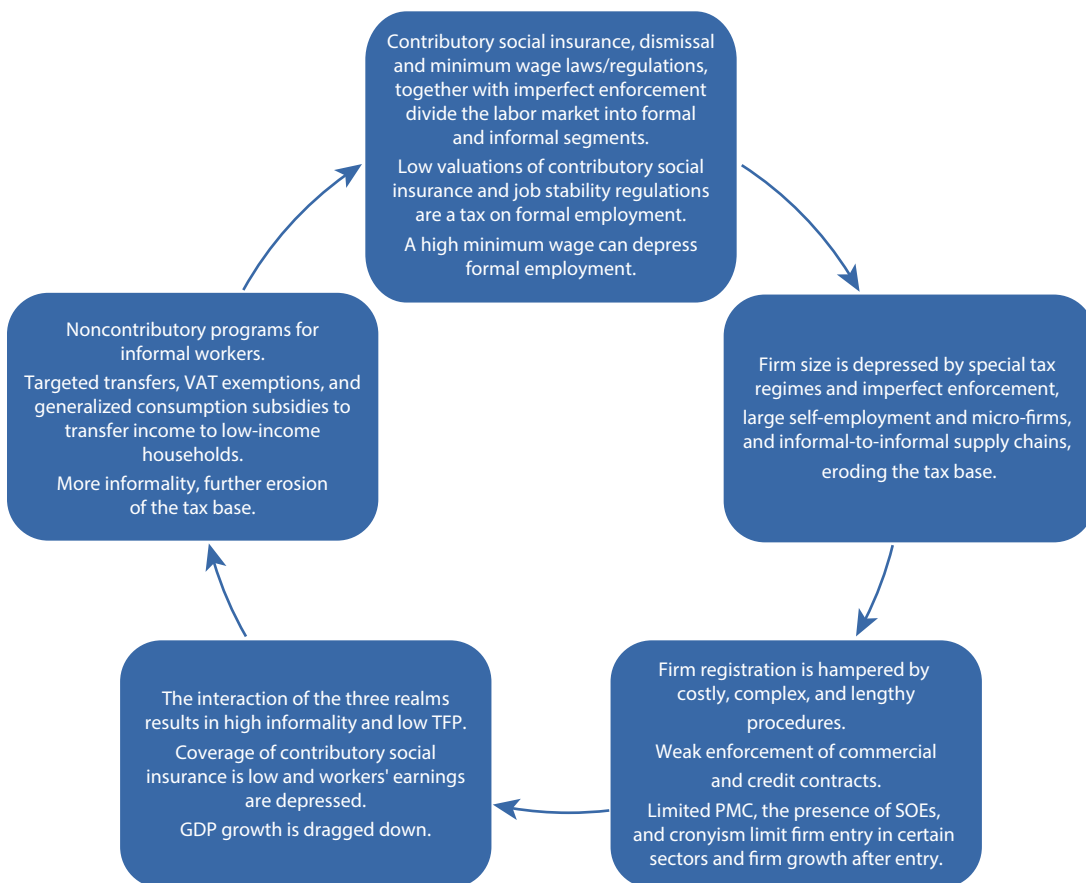
Source: Original table for this publication.

Policy Principle 1: Policies Should Not Be Designed or Evaluated in Isolation

Each policy lever in each of the three realms has direct effects on firms' and workers' incentives to operate formally or informally (figure O.9). Moreover, policies interact with each other, and it is the effect of the policy mix on economic agents' behavior that matters—and thus should be considered when evaluating policy reforms. Potential policy interactions could fall into the following areas:

FIGURE O.9

Interactions among Social Protection, Labor Regulation, Taxation, and Market Conditions, and Their Effects on Firms' and Workers' Formality Status



Source: Based on Levy and Cruces 2021.

Note: GDP = gross domestic product; PMC = product market competition; SOEs = state-owned enterprises; TFP = total factor productivity; VAT = value added tax.

Noncontributory social insurance. These programs, which deliver free or subsidized health coverage to poor and vulnerable workers—often combined with a cash transfer—might help reach population groups that would otherwise be left unprotected against health risk. Yet, the programs typically provide only partial social insurance coverage (in the pilot countries, only health risk is covered) and top up the income levels of the poor to boost current consumption. The problem is that they might unintentionally subsidize informal employment, particularly when (i) the quality of free or subsidized health care is adequate, and (ii) the income transfer is large enough to discourage poor informal workers from getting a formal job, which would mean losing this health care.

Job regulations. Policies that govern when firms can dismiss employees—such as advance notice requirements, specific reasons for dismissal, and workers’ compensation—may be insufficient to adequately protect workers. The policies can be adequate when they are combined with unemployment insurance that provides income replacement in case of job loss and active labor market policies aimed at retraining workers.

Taxation. Although indirect taxes, such as the VAT, are regressive in nature because poorer households spend a larger share of their income on consumption, the resulting tax revenues can be channeled into financing transfer programs to poorer households. This would ensure that the combined effect of the VAT and income transfers delivers the desired degree of progressivity.

Special tax regimes. These offer discounted tax rates to small, unincorporated businesses that register with the tax authorities. The problem is that they often interact with other taxes—such as when firms must consolidate income taxes and the VAT into a single payment, and thus may not be allowed to sell to firms that pay the VAT in the general regime. Paradoxically, while these regimes try to reduce inequality by subsidizing low-income entrepreneurs and helping the self-employed move into contributory programs, they hinder firm expansion, productivity growth, and formal job creation.

Business regulations. If procedures to register a business are costly, lengthy, and complex, and enforcement of commercial and credit contracts is weak, the incentives built into special tax regimes to comply with tax laws and register with tax authorities might not be obvious, given that the benefits are few.

Policy Principle 2: All the Population Exposed to a Given Risk Should Be Covered by the Same Program

Often, programs are created for small groups of workers, such as civil servants, and are gradually extended to other workers. In the pilot countries, at first, the system was expanded to include private sector employees, in some cases with different schemes depending on the sector of employment or income levels to encourage participation in the system. In a second step, which is currently underway in Egypt and Morocco, the system is being further expanded to include nonwage workers, particularly employers and own-account workers. Although the incremental approach was adopted with the best of intentions—to cover more workers with contributory social insurance—it has also generated an array of programs that not only provide different benefits but also benefits of different quality.

In addition, noncontributory social insurance provides poor and vulnerable informal workers protection against the health risk for free or at a subsidized rate. However, the presence of a multitude of programs to cover the same risk (such as health) poses numerous problems: less risk pooling and diversification, less efficacy of insurance, higher costs, and unequal benefits in terms of quality (depending on workers' employment status or sector of employment). By contrast, providing coverage to all individuals exposed to the same risk with one program can ensure more risk pooling, greater efficacy and diversification of risk, and the provision of the same quality of service for all individuals.

Policy Principle 3: The Source of Financing Should Vary with the Type of Risk Covered

Risks of differing natures are best covered through different sources of financing: (i) risks common to all citizens should be funded from general taxes, (ii) risks common to all workers should be funded from workers' earnings, and (iii) risks specific to workers in firms (employees) should be funded from firms' contributions based on workers' wages.

Given that all individuals are exposed to health and longevity risks, there is no rationale for financing these risks out of workers' contributions and leaving individuals with no formal job uncovered. The policy objective is to provide every individual access to health care when it is needed, since it is not known *ex ante* who will get sick or when. Similarly, in the case of longevity, the goal is to provide a minimum income in old age to every person. Thus, there is a need for both universal health insurance for individuals of all ages and a universal policy for the elderly.

Universal health insurance. Health services provided by one program for all would achieve a greater degree of risk pooling and ensure that the same quality of health care was provided, regardless of labor market status or informality status. Moreover, if health care services were to be financed via general tax revenues, it would ensure a higher extent of redistribution through health care. In this area, the most significant obstacle would be the fiscal cost.

In the pilot countries, many workers are not covered by contributory or noncontributory social insurance (40 percent in Egypt, 31.1 percent in Morocco, and 2.2 percent in Tunisia). Even among those who are covered, there is significant variation in the overall quality of services received. Back-of-the-envelope calculations using data on current health coverage and expenditures suggest that it would cost an additional 2.1 and 1.75 percent of GDP in Morocco

and Tunisia, respectively, to provide universal health insurance to the remaining uncovered population, as well as to switch individuals from noncontributory to contributory social insurance. The total cost of universal health insurance would be 3.45 percent of GDP in Morocco and 3.01 percent of GDP in Tunisia.

Universal policy for the elderly. All individuals face uncertainty about the duration of their life. Some might save for retirement when they work, others might have never worked, and others might not save enough. A policy to avoid old-age poverty would be a flat pension benefit, financed from general revenues, for all the elderly—independent of whether they worked and for how long. It would be a noncontributory universal pension. However, it is important to consider how this policy would interact with contributory pension benefits to strike the right balance between redistribution via noncontributory benefits and individual-level incentives to work and save for retirement via the contributory system.

Contributory pension policy for all workers. Contributory pensions are associated with workers employed in firms for a wage, which implies that some workers (such as own-account workers and contributory family workers) are excluded. The proposal for contributory pension insurance would require all workers (i) to contribute, irrespective of employment status; and (ii) to participate in the same system that pools the longevity risk of all workers once they retire. This would mean shifting the obligation to contribute from the firm to the worker. It could be combined with an obligation to pay PIT, although revenues from contributions for a pension benefit would be earmarked for workers' pension benefit and could not be used for other purposes (as in the case of PIT revenues).

The proposal would also align the incentives to contribute, as only workers would be responsible for contributing to health insurance and pension benefits—unlike now, where employers are required to pay contributions, partly on behalf of workers. For example, in Morocco and Tunisia, employers contribute 8.98 and 7.76 percent, respectively, of their employees' salaries for retirement pensions (table O.3). If workers assigned a positive value to the benefits provided, they would have incentives to contribute. Linking the obligation to save for retirement with PIT might provide an incentive at the margin to comply, as pension benefits would be proportional to income taxes. Further, transferring the obligation of contributing to the worker implies a reduction in employers' labor cost, which might partially or fully benefit workers as an increase in gross wages.

TABLE O.3

Contribution Rates for Private Sector Employees, by Type of Benefit, Morocco, 2018

Benefit	Cap on gross		Employer (%)	Employee (%)	Total (%)
	monthly wage (DH)				
Retirement pension	6,000		8.98	4.48	13.46
Health insurance ^a	—		4.11	2.26	6.37
Family allowance	—		6.40	—	6.40
Job loss allowance	6,000		0.38	0.19	0.57
Professional training	—		1.60	—	1.60
Work accident and disability insurance ^b	—		1.90	0.84	2.74
Illness and maternity, death	6,000		0.67	0.33	1.00
Total			21.77	7.77	29.54

Source: Original table for this publication.

Note: — = not applicable.

a. Companies that provided medical insurance before the introduction of Assurance Maladie Obligatoire (AMO) are exempt from health insurance contributions and pay a solidarity rate of 1.85 percent.

b. These benefits are provided by private insurance companies and are not administered by the Caisse Nationale de Sécurité Sociale (CNSS).

A big obstacle to implementing contributory pension insurance for all workers is enforcement, as pension benefits would be proportional to individual savings without cross subsidies or any additional costs to the state budget. In the pilot countries, many informal workers do not pay PIT, given that enforcement is weak and large shares of workers are not registered with the tax authority. But the analysis shows that the distributions of earnings of formal and informal wage workers largely overlap, meaning that there is space to tax informal workers. Moreover, the proposal would incentivize workers to contribute, as they would be solely responsible for paying for their contributions to health insurance and pension benefits. Therefore, if workers assigned a positive value to the benefits provided, they would have incentives to contribute to the system.

In sum, the proposals sketched here for insuring risks would entail a rebalancing of the source of financing of social insurance between contributions and taxes. The two largest components of contributory social insurance—health insurance and retirement pensions—would disappear, with the first being universal and funded via general tax revenues, and the second being levied on workers only and collected with PIT.

What about risks (like death and disability in the performance of work duties) that are faced only by workers? These would require a policy that covers all workers. Risks (like job loss and accidents at work) that are only associated with employment in a firm would concern only workers hired as employees by firms.

Policy Principle 4: Social Protection for the Poor via Noncontributory Programs Should Be Targeted Based on Family Income and Not Tied to the Work Formality of the Beneficiaries

Making social insurance more inclusive with the proposed changes to health insurance and retirement pension benefits would provide protection to the poor and vulnerable against fundamental risks, while also improving the conditions under which the poor and vulnerable participate in the labor market, thereby positively affecting their income and contributing to reduce poverty. However, systemic policy changes proceed slowly, and labor market adjustment might take time to display the full effects. Thus, the poor will need help via income transfers to support their current consumption levels.

More concretely, all the poor should receive income transfers, and eligibility should not be conditional on workers being employed informally. Moreover, the amount of the transfer should balance, on the one hand, the need to support current consumption and, on the other hand, the need to minimize an implicit tax on poor workers who lose the transfer when their earnings place them above the eligibility threshold. In combination with universal health insurance and contributions to the retirement pension benefit, fewer households will likely fall into poverty if negative shocks occur, as they will be covered against key contingencies. In addition, more productive jobs would be available in the economy, thus helping the poor to escape poverty on their own and reducing the likelihood of poverty traps.

Policy Principle 5: The Taxation Structure Should Strengthen Incentives for Formal Employment and, Together with Social Protection, Be Progressive

Special tax regimes for firms come with specific requirements in terms of sales, legal entity, and type of ownership. They provide preferential tax treatments relative to standard corporate tax rates, which average about 20 percent in the pilot countries. The special tax regimes also impose constraints on capital diversification, access to credit, and economies of scale. Plus, VAT exemptions that accompany these regimes imply that firms cannot sell to firms under the standard corporate tax regime and thus end up being trapped in operations with a small network of firms, informal or under the special tax regimes, or selling only to final consumers, which disallows technological transfer from larger to smaller firms.

Thus, eliminating these regimes and exemptions can help boost tax revenues while also removing barriers to firms' growth. Some firms would be forced to exit the market, as the higher tax burden under the CIT regime would require higher sales to maintain positive posttax profits. Therefore, the process of firm selection would gradually contribute to raising total factor productivity, as more productive formal firms would prosper and grow, entry of firms with very low productivity levels would be discouraged, and firms with low productivity would exit the market. The latter would have economic and social implications for employers and workers employed in those firms. However, if the key assumption for special tax regimes is that many such small firms are owned by low-income families, the proposals illustrated above to modify contributory social insurance would increase redistribution and coverage and question the need for inefficient special tax regimes as a redistributive tool.

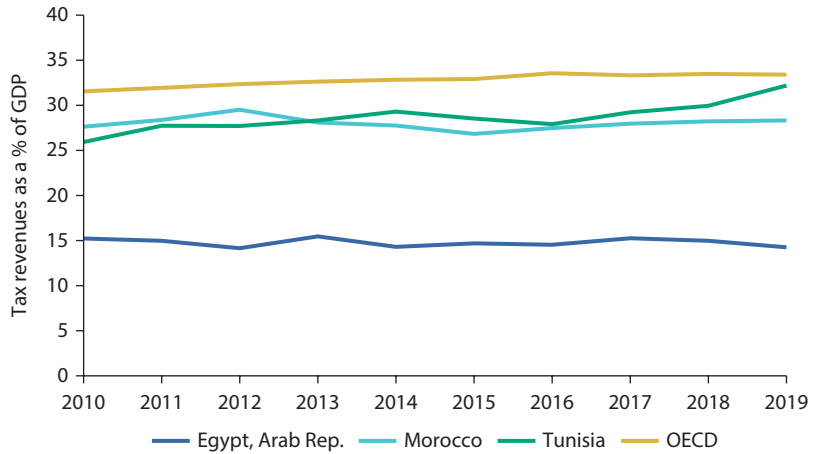
Overall, the tax-to-GDP ratios in the pilot countries range from about 15 percent in Egypt in 2018 to 32 percent in Tunisia in 2019 (figure O.10), which are below the OECD average (33.4 percent in 2019). These figures point to the possibility of raising more revenues, for example, to fund universal health insurance and improve its quality. In addition, resources can be obtained from current allocations to universal consumption subsidies. The pilot countries allocate between 1.3 and 5.6 percent of GDP to universal consumption subsidies on food, transportation, and energy. The largest share of subsidies is typically spent on energy: in Egypt, energy subsidies were valued at about 0.3 percent of GDP in 2020; in Morocco, 0.8 percent of GDP; and in Tunisia, 2.1 percent of GDP.

Although the pilot countries have been gradually decreasing the amount spent on energy subsidies, some of these subsidies still exist and redistribute resources inefficiently, with middle- and high-income households receiving higher subsidies in per capita terms than low-income households. In Morocco, households in the top decile received over twice the amount in per capita terms than those in the bottom decile for the liquefied petroleum gas subsidy in 2013/14; in Tunisia, households in the fifth quintile received 25 percent of the per capita energy subsidy benefits, compared to 15 percent for households in the first quintile in 2014/15 (Cuesta, El-Lahga, and Ibarra 2015).

On the composition of taxes, there are important differences between the pilot countries and the OECD. First, the pilot countries typically collect more indirect taxes and less income taxes than the OECD. For example, about 56 percent of Morocco's tax revenue comes from indirect taxes (like the VAT and other consumption taxes) (figure O.11),

FIGURE O.10

Tax Revenues as a Percentage of GDP, Arab Republic of Egypt, 2010–19

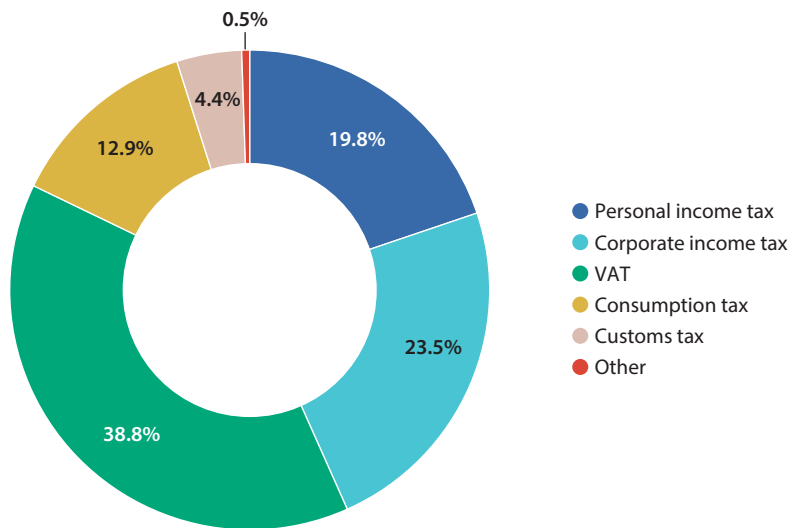


Source: Based on data from the OECD tax database.

Note: GDP = gross domestic product; OECD = Organisation for Economic Co-operation and Development.

FIGURE O.11

Share of Tax Revenues, Morocco, 2018



Source: Original figure for this publication.

Note: The figure shows the composition of tax revenue. Direct taxes are levied on taxpayers' income and profits; however, indirect taxes are charged on goods and services. Whereas the VAT, consumption tax, and customs tax are examples of indirect taxes, the personal income tax and corporate income tax are examples of direct taxes. VAT = value added tax.

which is significantly higher than the OECD average (about 31 percent in 2019). Similarly, the CIT represents 30.6, 21.0, and 13.3 percent in Egypt, Morocco, and Tunisia, respectively, far above the 10.7 percent in the OECD. By contrast, the PIT accounts for smaller shares of tax revenues in Egypt (10.6 percent) and Morocco (17.7 percent) than in Tunisia (30.8 percent) and the OECD (41.4 percent). While property taxes contribute negligible tax revenue shares in Egypt and Tunisia (0.7 and 1.3 percent, respectively), they represent 6.7 percent in Morocco, which is nevertheless far less than the average in OECD countries (11.6 percent).

Thus, additional revenues could come from higher property taxes (especially in Egypt and Tunisia), new taxes levied on environmentally unfriendly activities, or better tax enforcement. The last would require far more financial and human resources than are currently allocated—along with the use of digital technologies to identify individuals and firms evading taxes and for better communication across entities to reduce tax evasion.

Policy Principle 6: Governments Should Ensure That Market Conditions Are Conducive to Firms' Entry, Growth, and Exit

Market conditions are key for the creation and growth of new and high-productivity firms—and making improvements here could be a first step toward higher and more socially inclusive growth. Firms' decisions to formalize depend on incentives stemming from the complexity and costs of business registration procedures, and the degree of enforcement of commercial and credit contracts.²

First, the registration process of a new enterprise should be further simplified, and the costs associated with the process can be reduced by implementing the use of digital technologies. While in the pilot countries starting a business has been made easier in recent years with the introduction of one-stop shops, there is still room for improvement, particularly in Egypt, where costs remain high.

Second, on contract enforcement, two policy avenues should be explored to increase the level of security and integrity of formal firms' economic transactions:

- *Commercial contract enforcement.* Measures to strengthen the quality of the judicial process are at the forefront of much needed policy intervention in the pilot countries. A commonality across the countries is that dealing with disputes is an inefficient process, which is long in duration and expensive. Improvements can be realized by devoting

additional resources to establishing more efficient court structures and management of proceedings, with the support of court automation, which is currently nonexistent.

- *Credit contract enforcement.* Measures to strengthen the legal rights of both borrowers and lenders are required, as this is a weak area in the three pilot countries (World Bank 2021b). Insolvency laws and performance represent another dimension of doing business that requires attention: pilot countries should implement measures to reduce the time and cost required to resolve an insolvency, which currently lag aspirational leaders, such as the OECD.

Taken together, these policies would increase the benefits of registering for firms, encouraging them to go beyond a trusted network of suppliers and clients; absorb skills, techniques, and technologies from interacting with more and larger firms; and increase their external credit take-up—thereby spurring productivity, firm expansion, and formal job creation.

ROAD MAP

The policy principles put forward in this report are aimed at indicating a way forward to achieve higher and more socially inclusive growth. Importantly, the specific policy changes may differ across countries and can create winners and losers. Therefore, broad and deep reforms will likely face opposition from various groups and setbacks in many contexts. For this reason, it is key that governments identify a clear vision of where they are headed and set a path to get there before embarking on a complex set of reforms. Governments should design a clear map of intertemporally consistent reforms that contribute to the desired social protection system, as a better understanding of the desired outcome can help build the necessary coalitions to support the reform agenda.

Providing a road map can help groups representing various interests to grasp what the proposed policy changes intend to bring for them, which may spur sentiments of inclusion and trust that were beforehand fragile but are fundamental to cohesive societies. Although some parts of the reform process might penalize some groups, the overall redesign of the system will be more acceptable and should produce a net societal gain as the proposed policy principles offer a route to fiscally sustainable and socially inclusive growth.

Identifying a country-tailored way forward is a challenging task, as countries differ in terms of initial conditions, administrative capacity, and political context, and thus is beyond the scope of this report.

Nevertheless, a road map can help governments navigate the reform process along the lines of the principles sketched in this report. The policy proposals identified would entail a shift toward a more inclusive social protection system, where the principles of universality with respect to the relevant population and equality of benefits substitute the existing segmentation of social protection schemes and implicit unequal coverage of workers and families. Moreover, the source of financing would change. Risks common to all citizens would be funded from general taxes, risks common to all workers would be funded from workers' earnings, and risks specific to workers employed in firms would be funded from firms' contributions and proportional to workers' wages. A road map for countries to move toward realizing the vision and goals outlined in this report would contain the following five sequential key elements:

1. *Coordinated reform.* To oversee the compatibility of the policy changes in the overall policy mix with government objectives, each country sets up a cross-ministerial implementation group to ensure a holistic and coordinated approach in the policy arena.
2. *Tailored, gradual, and incentive-compatible social protection reform.* Countries introduce gradual reforms to the social protection system, particularly the health and retirement components, complemented by a noncontributory universal pension and a poverty-targeted cash transfer program.
 - As a first step, health coverage should be extended to all citizens, regardless of their employment status, and the pension system may move toward providing benefits to every worker conditional on paying contributions, which should take place together with payment of income taxes, as suggested by policy principles 2 and 3.
 - Only workers, not their employers, would be responsible for paying contributions for pension benefits, and such payments would finance individual accounts as opposed to being used to cross-subsidize the pension benefits of current retirees or other workers. Vesting periods in number of years of contributions would be eliminated, except for the minimum retirement age. Thus, every worker who pays income taxes and therefore contributes to the pension system would be entitled to an actuarially fair benefit. This could also increase compliance, since workers, employees, and the self-employed would know that their pension benefit will be proportional to their income taxes.
3. *Expanded tax base to ensure that general revenues are available to fund universal health insurance.* These measures include reducing or eliminating tax expenditures; introducing new taxes and/or raising rates for

existing taxes on certain activities, such as those that damage the environment and taxes on property; and removing universal consumption subsidies, particularly on energy products.

4. *Improved service delivery quality.* Countries increase the quality of public services in parallel with element 3. This would incentivize workers to pay income taxes, curb resentments, and build trust, potentially to increase the income tax in the future, including its progressivity, to expand the fiscal base, increase investment, protect the vulnerable, and reduce inequality. Therefore, the road map calls for improving the supply of health care with more human resources and more infrastructure.
5. *Private sector reforms.* Countries prioritize a range of measures that affect firms.
 - o Special tax regimes would be gradually abolished, and economic units registered as firms would be required to pay standard corporate income tax rates regardless of size, sector of activity, or other conditions. This change would be disruptive in the short term but, together with the new social protection system, it will contribute to raising the productivity of firms and the economy, and thereby translate into higher income levels and higher growth in the long term. Overall tax revenues will also increase because, first, more firms will pay taxes under the standard corporate regime and, second, thanks to the elimination of the VAT exemption that often comes with special tax regimes and possibly the elimination of the VAT exemption of certain consumption goods. Abolishing special tax regimes may also have a positive or at least neutral distributional impact. A recent study finds that eliminating VAT exemptions does not have regressive effects since in contexts with high informality, a significant share of the poor's consumption takes place in establishments that elude the VAT (Bachas, Gadenne, and Jensen 2020).
 - o In parallel, job stability regulations could be made more flexible and minimum wages less binding as the introduction of unemployment insurance and job loss compensation can support workers in transitioning between jobs, and workers would be covered against health risk even after losing their job. Moreover, in the medium term, the proposed changes would support higher productivity and economic growth that would lead to increases in wages.
 - o To increase the dynamism of the private sector and improve market conditions, countries must simplify the registration process and improve the benefits available to registered firms. Benefits can be improved by strengthening the enforcement of commercial and

credit contracts, thereby incentivizing firms to register because they will be able to access credit on better terms, enter more and larger markets since their transactions would be secure and backed by strong commercial contracts, benefit from technical and technological transfers due to interacting with larger firms, and face reduced risk as their business assets would be separate from their household. Other institutions will also benefit, including government and banks, as a larger pool of registered firms translates into higher tax revenues and more diversified credit markets. Given that registered firms are more likely to hire formal workers than informal ones, this policy intervention alone is likely to have a positive impact on formal employment.

NOTES

1. GDP and population figures are from the World Development Indicators database, World Bank.
2. Statistics are derived from the World Development Indicators database and Feenstra, Inklaar, and Timmer (2015).
3. A notable exception is the taxable base, which in the case of own-account workers and employers is typically a measure of business income, with brackets defined in some cases as a multiple of the minimum wage.
4. In Morocco, in addition to targeting based on poverty rates at the municipality level, the transfers are conditional on having children in school (Tayssir) or restricted to widows with children (DAAM).
5. Social protection expenditure as a proportion of GDP is calculated as the sum of expenditure data from ILOSTAT and the World Health Organization data portal (2020). Specifically, GDP contributions from “total expenditure on social protection (excluding health)” and “domestic general government health expenditure” have been added together.
6. Due to data limitations, Morocco’s Kaitz index has been computed as the minimum wage as a proportion of the national mean wage.
7. Policies on product market competition, price controls, the presence of SOEs, and cronyism are not discussed here, as there is a broad literature covering these topics (see World Bank 2022b).

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More information about the Bank’s environmental philosophy can be found at <http://www.worldbank.org/corporateresponsibility>.



The long-standing informality debate in the Middle East and North Africa (MENA) Region has taken on a new urgency as it looks for a pathway to more socially inclusive growth that is less reliant on fossil fuels. This is occurring against a backdrop of subpar labor market outcomes, further growth setbacks, and deteriorating fiscal and current account deficits in the aftermath of the COVID-19 pandemic—and in the wake of high inflation and supply chain disruptions triggered by the Russian Federation–Ukraine war.

Informality and Inclusive Growth in the Middle East and North Africa aims to better understand the characteristics and incentive structure that have led to the prevalence of informal employment in three MENA countries—the Arab Republic of Egypt, Morocco, and Tunisia. The report breaks new ground by adopting a comprehensive perspective to focus on the features of, and interrelationships among, different aspects of these countries' institutional landscapes to make sense of the complex incentive structure that workers and firms face when deciding between formal and informal options. Specifically, the report groups these issues in three broad realms: (1) entrepreneur-worker relations, (2) taxes and transfers, and (3) market conditions.

"This report is an extremely welcome addition to the literature on MENA labor markets. By analyzing the incentive structure and institutional factors that have led to the prevalence of informal employment in Egypt, Morocco, and Tunisia, it points the way to policy actions that can be taken to reduce informality and increase social protection for workers. It is a must-read for anyone who cares about greater economic inclusion in MENA."

Ragui Assaad, Professor, Hubert H. Humphrey School of Public Affairs, University of Minnesota

"A compelling account of the implications of informality in the workforce and how economies of MENA can design appropriate policy responses. This timely report comes amid multiple social reforms in MENA and is a must-read for policy practitioners and economists in the region."

Karim El Aynaoui, Executive President, Policy Center for the New South

"This report is particularly timely given the negative impact the COVID-19 pandemic and subsequent crises have had on living standards and poverty rates around the world and especially in MENA countries. While the focus on boosting growth and achieving the Sustainable Development Goals has revolved around financing, the report sheds new light on the benefits that tackling informality through institutional, regulatory, and policy changes could present to achieving these goals."

Mahmoud Mohieldin, Executive Director, International Monetary Fund