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Addressing Informality in Egypt[1]

A significant share of a typical developing economy is informal, and Egypt is no exception.[2] On average, about 60% of the developing country's labor force, and about 60-80% of micro, small, and medium enterprises (MSMEs) are informal (ILO 2012, IFC 2014). The latest estimates for Egypt suggest that more than 60 percent of the firms and more than 70 percent of workers in the private sector are informal (see Annex Table 1 and 2). Lack of formal private sector growth has caused an increase in informal employment. Net job growth in the formal private sector was 0.1 percent between 2013 and 2016, while informal employment increased from 31 to 76 percent between 1998 and 2016. The distinction between informal work inside and outside establishments is particularly important, as characteristics of informal jobs are more accentuated for the latter group (see Table 2). This reflects the role of casual labor (especially in construction and services), which in turn relates to the pattern of growth being tilted towards non-traded sectors.

Informality has many dire consequences. Informal jobs are often bad jobs - unproductive, poorly paid, risky, and unprotected. Informal firms perform poorly than their formal counterparts in terms of firm productivity, growth, and job creation. Nearly 50 percent of the overall productivity gap between countries, such as Portugal, Turkey, and the United States, is viewed because of informality (Farrell 2004). Using World Bank Enterprise Survey Data (WBES), La Porta and Shleifer (2008) find that formal firms have substantially higher productivity levels than informal firms, while Ayyagari et al. (2013) have demonstrated zero growth of employment of informal businesses over its life-cycle compared to a two- to four-fold increase of jobs in the formal sector in India. Informality also impedes tax administration. While many informal firms would be below standard income thresholds, the administration of VAT is more difficult with high informality and can lead to perverse distributional outcomes (e.g., the inability of firms to claim VAT refunds). If firms that have characteristics similar to the firms operating in the formal sector (such as similar in terms of size, owners' attributes, and so on), operating in the informal sector to avoid taxes and other relevant government regulations, then it also creates an unlevel playing field between formal and informal firms.

Why does informality exist? There are at least three different paradigms that explain informality. The dualist paradigm views that the informal sector is the residual component of an economy. It exists as a subsistence economy as the formal economy is incapable of providing enough jobs. The structuralist

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[2] While definition of informality varies, typically informal economy is consist of informal enterprises and informal employment. Unregistered firms with the registration office, municipality, or tax authority where businesses are required to register are referred to as informal firms, while workers without any contract and unregistered with relevant authorities (e.g., Social Security, Ministry of Labor, etc.) are viewed as informal workers. A related concept to informality is shadow economy that Includes all market-based legal production of goods and services that are deliberately concealed from public authorities to avoid taxes and other legal obligations, which is not the focus of this note.

paradigm views that informal and formal sectors are interdependent; the informal sector is part of, but subordinate to the formal sector and provides cheap labor, inputs and products to the formal firms and contributes to the economy's flexibility and competitiveness. Finally, the de Soto (1989) paradigm views that informal firm owners would like to be formal, but costly regulations and bureaucracy prevent them from doing so, causing a productivity loss for these firms. De Soto paradigm has been one of the most influential in advancing regulatory reform agenda across countries.

Many governments embarked on regulatory reforms to formalize firms; yet the majority of the informal firms tend to remain informal. In a number of informality surveys conducted by the World Bank in different countries, informal firms tend to highlight costly and complicated regulatory processes as significant barriers to formalization. Consequently, making it easier to register a business formally has received enormous attention from policymakers around the world including Egypt. Egypt's recently enacted Single Person Company Law is also in the same spirit of the OHADA entreprenant reform to encourage MSEs' formalization.

It would be important to evaluate to what extent Egypt's regulatory reforms have contributed to formalization. The rigorous evidence in a wide range of countries suggests almost zero effect of these formalization reforms. Benhassine et al.'s (2018) findings on OHADA entreprenant reform in Benin, shows that despite some encouragement to formalize, the majority of the informal firms remains informal. Also, formalization does not seem to bring any measurable benefits or firm performance improvements in the short term. A number of rigorous evaluations in Sri Lanka, Bangladesh, and Brazil find no effect on formalization through simplifying business entry (Andrade et al. 2013, de Mel et al. 2013, and de Giorgi and Rahman 2013). In other countries, where there are some effects, those effects are highly transient and unsustainable.[3]

This, in turn, implies formalization is not for all. The formalization agenda needs to appreciate the diversity within the informal sector as there could be multiple reasons behind informality beyond a complicated regulatory regime as discussed above. Not all informal firms are necessarily highly aspirational entrepreneurs who remain in the informal sector because of the regulatory maze, as the de Soto paradigm would suggest. In line with the dualistic paradigm, many businesses could be informal for survival/ subsistence needs in the absence of job opportunities. Hence, the regulatory simplification will not necessarily induce the bulk of the informal sector to formalize. Rather than informality being a cause of low productivity, less productive firms could simply remain informal.[4] In this context, business entry reforms may help only the high-potential informal firms to formalize.[5] And in between these two

[3] For a critical review of this literature, see Bruhn and McKenzie, 2014 and Rahman 2014.

[4] For instance, De Mel et al. (2010) find that between one-quarter and one-third of the self-employed appear to share characteristics that give them the potential to be owners of somewhat larger firms, while the remaining two-thirds to three-quarters look much more like wage earners.

[5] For instance, categorizing informal business owners into those who share characteristics with formal business owners and those who have characteristics similar to wage earners, Bruhn (2013) finds that as a result of Mexico's business entry reform, the wage earner types are less likely to formalize but more likely to become wage workers, while informal business owners with the characteristics of formal business owners are more likely to formalize (but

categories, there could be a group of "constrained entrepreneurs" who are not viable to operate in the formal sector because of either different supply-side constraints (e.g., lack of skills, working capital), or demand-side constraints (such as, lack of demand for their goods and services or lack of access to markets), or a combination of both supply and demand side constraints. For them, targeted policy response will be needed to address the pertinent constraints to unleash their growth potential, initially in the informal sector and to enable them to graduate to the formal sector through the regulatory simplification agenda.

Consequently, the business environment for informal activities also need attention. This has a bearing on both poverty alleviation and the overall competitiveness of the country. While increasing formality may be the ultimate policy objective, informality is unlikely to disappear any time soon. By providing 70 percent of all employment in the country, the informal sector fulfills important economic functions, particularly to the poor and most vulnerable in the society. Not only does the sector offers jobs and economic opportunities, but it also provides goods and services to many, often in ways uniquely adapted to the needs of the poor. A better business environment for informal enterprises is thus important from a welfare perspective. It would create a larger pool of financially sound informal enterprises, many of which may transition into the formal sector as a consequence of growth, and as evidenced in today's developed world. A better business environment for informal enterprises would stimulate competition and innovation in the informal and formal sector and, because so many people are directly or indirectly involved in the informal sector, a better functioning informal sector is also electorally important. Creating a secure and predictable business environment for informal enterprises should, therefore, be an integral element of the formalization agenda.[6]

On the other hand, a more targeted and effective regulatory enforcement could bring larger informal firms to the formal sector. While there may be public policy rationale for formalization to widen the tax base, the revenue implications of formalizing the entire informal sector are unclear given that the majority of these informal firms are likely to be micro in nature. Given the government's limited enforcement capacity, a more targeted enforcement mechanism to bring larger and profitable informal firms may be more prudent as rigorous evidence from Brazil and Bangladesh suggests (see De Andrade et al. 2013 and De Giorgi et al. 2018). These larger and more successful informal firms are more likely to be the ones

only in municipalities with high pre-reform constraints to formal entrepreneurship). The effects are relatively small, and most informal business owners remain informal even after the reform.

[6] More research is needed to document the constraints different types of informal enterprises face, but public acknowledgment of the importance of the informal sector and a zero tolerance towards any harassment of informal entrepreneurs would send an important signal. Such support to the informal sector could be accompanied by measures like obligatory IDs on uniforms of public officials and "lignes verts" where harassment can be reported. Zoning where informal enterprises can set up undisturbed, and possibly even have access to electricity, water and waste management might be considered (fees could be charged, just as fees are charged to sellers on markets). Zoning would make informal sector firms less formal, and could be a first step in the transition towards formal. Broadly published tax exemption rules for formal and informal enterprises with turnover below a certain threshold (tax collection is not efficient when proceeds are small), could be considered. Harassment can also be prevented if inspectors, as part of their job, collect phone numbers of clients, and a call center interviews a random selection of clients for how they have been treated. In Punjab this has been tried this for services like drivers' licenses, and it could be expanded to the collection of tax, market fees or health inspections.

competing with formal firms for customers. Therefore, ensuring that such firms also become formal may reduce unfair competition that prevents more efficient formal firms from growing faster.

Combining formalization agenda with financial inclusion may also be a more effective approach to tackle informality, particularly for (cash) constrained entrepreneur category. A rigorous field experiment from Malawi finds that when business registration (but not tax registration) is combined with an information session on the bank account, that leads to a significant increase in formalization and also an increase in monthly profit of the businesses (Campos et al. 2018). Building on this evidence and with the advancement of the Fintech agenda, financial inclusion may be an important pathway towards formalization, particularly for Egypt, where the level of financial inclusion is very low.[7] Digital financial services – including those accessed through mobile phones and the internet – can greatly increase financial inclusion and thus encourage formalization as argued by Klapper et al. (2019; see Annex 2 for more details).

Overall, addressing informality in Egypt needs a broader perspective on MSEs' growth agenda beyond formalization. So that formalization decision for the firms come as a natural consequence of growth. The overall MSE growth agenda is also a critical route to promote jobs as MSEs constitute the largest segment of the private sector in Egypt and across the developing world. Policies that help firms overcome the obstacles they face in innovating, growing, and creating more jobs are more promising than traditional active labor market policies. Raising awareness of formal firms and providing legal assistance on labor laws also seem effective to promote formal jobs. Bertrand and Crépon (2016) find that teaching South African firms about labor laws and providing legal support to help them deal with these laws spurred new employment generation.

A critical review of active labor market policies (AMLPs) across the world suggests that traditional AMLPs, such as vocational training, wage subsidies, job search assistance, and moving assistance are much less effective than policymakers typically assume (McKenzie 2017)**.** The most promising interventions on the labor supply side appear to be ones that help workers access different labor markets, overcoming sectoral and, especially, spatial mismatches. Campos et al. (2016) show that in Uganda, women who cross-over into male-dominated industries make three times as much as women who remain in female-dominated industries. This is particularly relevant for Egypt because of poor connectivity issues. Formal private sector jobs are overwhelmingly concentrated in metropolitan areas. Women who do not live very close to the metropolitan are highly likely to be excluded from formal jobs (World Bank 2014).

In supporting the overall MSE growth agenda, a range of supply-side interventions have been implemented in different countries, including Egypt. Egypt's Women Entrepreneurship project is a case in point that aims to enhance women entrepreneurs' access to finance and non-financial services. Rigorous evaluation of grants (e.g., de Mel et al., 2008; Fafchamps et al., 2014), business training (summarized in McKenzie and Woodruff, 2014), formalization assistance (summarized in Bruhn and

[7] The share of population over 15 years of age with an account at a financial institution is 33 percent in Egypt compared to the MENA average of 48 percent (Findex 2017).

McKenzie, 2014), wage subsidies and subsidized apprentices (de Mel et al., 2019; Hardy and McCasland, 2018), and access to bank accounts (Dupas and Robinson, 2013) are informative. These studies imply that these supply-side interventions have helped alleviate constraints on input markets, and in some cases, have allowed microenterprise owners to grow their incomes. However, they have rarely resulted in sustained high growth and firms adding employees, and the effects have often been particularly limited for female-owned firms. In most of these interventions, the effect on formalization has not been tested.

A key reason for the limited impact of many supply-side interventions is that firms may lack sufficient demand for their products to expand. Demand may be particularly likely to be a constraint for micro and small firms whose business is limited to consumers in their local markets. A notable example is Atkin et al. (2017), who helped connect rug producers in Egypt to foreign markets and found this resulted in quality and profit improvements. A second example comes from Hardy and Kagy (2018), who provide orders to garment firms in Ghana, and find that a lack of demand is particularly an issue for female-run firms. These existing demand interventions intervened to boost demand by directly linking firms to specific clients (and even more directly by being the client). A scaleable solution requires giving small firms the tools they need to expand their customer base by themselves. Teaching firms to market better offers this possibility, with Anderson et al. (2018) finding that marketing training helped South African firms expand.

There are, of course, synergies possible between supply-side and demand-side interventions. Some of the emerging evidence suggests that a lack of demand might be the binding constraint for many firms, and so interventions to help firms expand their customer base can be beneficial. But as firms grow to meet their new customer base, they will be better able to do so if they have good business practices and access to working capital. So, in places where there have been no supply-side interventions, demand-only interventions may not work as well, as firms may not be able to respond to the increased demand. But in many places, including Egypt, there has been a much longer history of government and NGO programs to extend access to credit and to provide different forms of business training. In these cases, demand may be the binding constraint for many firms to grow and thus become viable to operate in the formal sector.

Building on the literature, WB is currently undertaking an innovative pilot in Egypt on MSE growth and formalization. The objective of this intervention is to help approximately 850 MSEs (both informal and formal) to use digital advertisement to expand access to market and rigorously evaluate if the use of digital advertising enables MSEs to access broader markets, and does doing so, in turn, spur higher growth and formalization of informal MSEs. WB has been collaborating with MSMEDA and Alexandria Business Association for this activity.

Thus, for Egypt to address the informality agenda, the priority next steps could be the following:

- **Develop an action plan that cater to different segment of the informal sector:** Building on the above discussion, this approach needs to be broader than just the regulatory reform agenda. The overarching theme should be promoting MSE growth. Thus,
    - **For potential high-growth firms,** the action plan should focus on:

public procurement (learning from experience in Brazil, Ghana, etc.) to enhance access to domestic market and upgrade firm capability

securing export orders (learning from Egypt's own experience with the rug producers) to facilitate access to international markets
simplified business entry and SME tax regime and a drive towards cash-less economy to foster business growth

- **For cash-constrained MSEs**, the action plan should focus on promoting financial inclusion through:

Implementing regulatory framework for innovative financial solutions (e.g., digital finance, trade finance, suppliers' credit, learning from Malawi, Benin, Kenya, Tanzania)
Developing non-bank financial services (by widening the definition of microfinance in the Microfinance Law, improve the Law on Leasing and Factoring)

- **For subsistence entrepreneurs** (who are informal for survival) the action plan should focus on promoting job opportunities by:

removing physical and socio-cultural barriers to access labor markets across geography and sectors (learning from Ethiopia, Uganda, South Africa…), providing universal health insurance and improving workers' conditions.

- **Evaluate Egypt's existing programs:** It is also important to take stock of a wide range of government and NGO run programs on entrepreneurship and AMLPs and see which programs tend to support which driver(s) and where are the gaps.

- **Implement the action plan, learn, and act on evidence**: In areas, where there is already sufficient rigorous evidence available in Egypt and elsewhere, put in place an effective monitoring system to ensure that programs are meeting the development objectives (and if not, why not) of MSE growth and formalization. For more innovative interventions, advance with pilot(s) and rigorously evaluate. Drop or adjust the interventions that do not seem to be cost-effective and scale up the most cost-effective ones.

Annex I

Table 1: Incidence of Informal Firms

Selected Indicators for Informality - Establishments Census 2017 (% of establishments in the sector)	Private Sector		Public Sector	
	No	Yes	No	Yes
Keeps regular accounting books[1/]	76.8%	23.2%	28.9%	71.1%
Commercial Registry[2/]	60.9%	39.1%	31.2%	68.8%
Industrial Registry[3/]	88.8%	11.2%	68.3%	31.7%
Insurance Number [4/]	71.0%	29.0%	30.8%	69.2%

1/ Does the establishment keep regular accounting books?

2/ Does the establishment have a commercial register?

3/ Does the establishment have an industrial register?

4/ Does the establishment have an insurance number?

Table 2: Incidence of Informal Employment

Selected Indicators for Informality - Labour Force Bulletin (July - September - 2019)							
Work Quality Indicators for Employees (15 Years & above) According to Sector and Gender (%)							
				Private			
	Gender	Government	Public	Inside Establishments	Outside Establishment	Other	Total
Percent of participants with Social insurance	Male	97.7	93.0	34.0	10.9	68.5	40.7
	Female	97.3	87.9	36.0	0.0	78.6	72.2
	Total	97.6	92.4	34.3	10.7	70.1	45.1
Percent of participants with health insurance	Male	97.0	91.5	24.8	2.3	63.0	33.8
	Female	97.0	86.9	29.4	0.0	78.6	70.0
	Total	97.0	91.0	25.4	2.3	65.1	38.9
Percent of employed who have work contract	Male	99.2	96.4	27.4	1.3	67.5	35.0
	Female	99.6	96.7	33.7	0.0	60.7	73.1
	Total	99.3	96.4	28.2	1.3	66.7	40.3
Percent of employed who have permanent work	Male	98.6	95.4	78.9	26.8	90.7	63.4
	Female	99.3	95.8	77.6	34.8	78.6	88.5
	Total	98.8	95.5	78.7	27.0	88.9	66.9

Annex II

Informality and Digital Financial Services

There is evidence that access to digital financial services (DFS) can help reduce informality, as mentioned earlier (Klapper et al., 2019). Research has shown that DFS can make it easier for informal firms to register and operate as a formal business, while also creating synergies between individual reform efforts. For example, companies that use a digital payroll system can easily make pension contributions when online platforms are available. Digital financial transactions also make it easier for governments to enforce laws and regulations, including tax collection. A relatively less investigated area within DFS and informality is whether better access to formal financial services can also serve as an incentive for firms to formalize. Governments have used subsidies and other tax inducements to encourage both businesses and consumers to adopt DFS. For example, in Uruguay, the government has subsidized the adoption of point-of-sale terminals for small businesses while reducing tax withholding requirements for firms and lowering value-added taxes for consumers. In South Korea, wage earners can claim tax deductions for purchases made using digital payments when they file their year-end income taxes. Early research suggests the reforms have helped increase the number of formal financial transactions. Informally operating firms might also be encouraged to register to receive these financial incentives and meet customer demands for electronic payment receipts.

Merchants in Egypt prefer to receive cash payments from customers and make cash payments to their employees and their suppliers. According to World Bank Group (2016), only 18 percent of retail payments by consumers at micro, small and medium-sized merchants are estimated to be done electronically. In addition, this same study also identifies that approximately one-third of wage earners working at micro, small and medium-sized merchants in Egypt are paid their wages in cash rather than into a bank account electronically, reducing incentives for them using electronic means for their payments for goods at retail goods and stores. At the same time, it is estimated that in Egypt, only about one in three small merchants make electronic payments to their suppliers.

The World Bank, as part of the Financial Inclusion Global Initiative (FIGI) Program, has been working with the Central Bank of Egypt (CBE) to develop an assessment and a pilot to improve electronic payments acceptance by (small) merchants. FIGI Program, as part of the FCI Global Engagements, has an international working group specifically on *Electronic Payments Acceptance*, with central banks and private sector from around the world as members. The working group has developed a specific methodology for assessments and pilots, which is now under preparation in Egypt, jointly with the CBE. This workstream aims to use a combination of relevant incentives and regulatory and infrastructure reforms to facilitate wider acceptance of electronic payments by merchants. With the help of the reforms on regulatory and infrastructure aspects, the workstream aims to catalyze new innovative business models and product development for the delivery of digital payment services to merchants. With the help of incentives targeted towards merchants and customers, the planned pilots aim to reach to an understanding of what would work in Egypt to ensure wide acceptance of digital payments in the retail

sector, as well as usage of digital payments by merchants for payroll and supplier payments. Contributing to the formalization of merchants is one expected outcome of this work among a number of others.

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