

The Case for Formalization of Business in Egypt

Policy Viewpoint reflects the stance of ECES on key policy issues in Egypt.

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Should Egypt integrate the informal sector into mainstream economic activity? Will such action be beneficial to the individuals involved and society at large? If so, what would it take to achieve this objective? These are the questions addressed in this edition of *Policy Viewpoint*.

The answers to these questions have been a subject of debate for some time in Egypt. Opponents of formalization argue that it would force entrepreneurs to move from a low-cost mode of operation most suited to small and micro-enterprises to a restrictive and costly formal environment, deprive the economy of an absorber of shocks in times of difficulty, and negatively affect those who cannot afford to be unemployed. Moreover, some believe that formalization is merely an effort to raise funds for the Treasury with little benefit to anyone else.

These arguments are unfounded however, as will be shown below. The case for formalization into a reformed environment is compelling because it would lead to better protection of property rights, thereby enabling entrepreneurs to secure inputs at lower costs, have access to infrastructure services and credit, take advantage of expanded markets, and avoid uncertainty and unofficial payments. It would allow them to expand their business, reorganize internally, and benefit from specialization and division of labor. For society, it would foster private initiative and the development of a market economy, while benefiting an otherwise marginalized

and underprivileged class of entrepreneurs and workers. It would also make more revenues available to the Treasury, which could be used to reduce the budget deficit or to increase government spending on social projects. In short, formalization would benefit both individuals and society by boosting economic growth and improving income distribution. The political benefits emanating from social cohesion and shared prosperity are difficult to measure, but are arguably large.

The remainder of this *Policy Viewpoint* discusses the magnitude of business informality in Egypt, its causes and remedies, and estimates the welfare impact of formalization if the government were to adopt recommended reforms. The final section offers some concluding remarks.

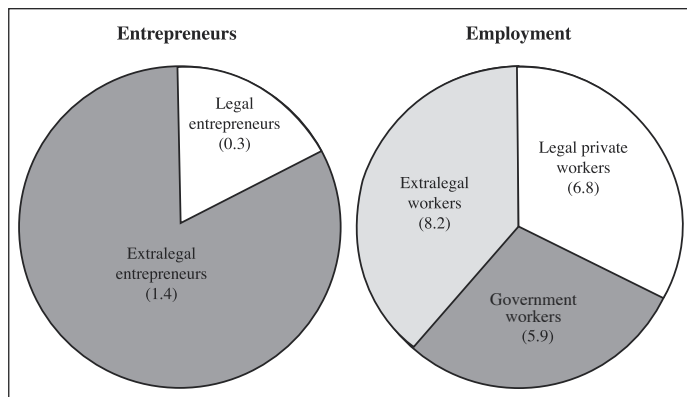
Extent of Business Informality in Egypt

From a legal perspective, firms are considered part of the formal sector if they possess an operating license and if they abide by all established legal procedures, for example, regarding labor and taxation. In reality, some firms may acquire an operating license, but fail to adhere to all legal requirements in conducting their business. Conversely, some firms may not possess an operating license, but end up following some legal practices in order to survive (e.g., paying taxes). In both instances, these firms are only partially legal. As such, a full account of informality should include extralegal entities as well as extralegal practices.

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The problem is that the above definition is seldom followed by statistical agencies in compiling information about the informal sector. Egypt is no exception. The operative definition in Egypt is that firms are considered informal if they do not have an operating license, or if they are not registered in the commercial registry. This means that reported statistics tend to understate the extent of informality in Egypt. But even so, the numbers are staggering: some 1.4 million entrepreneurs—82 percent of all entrepreneurs in Egypt—worked in the informal sector in 1996. The sector employed 8.2 million workers—more than employment in the formal private sector (6.8 million) or the government (5.9 million) (Figure 1). The characteristics of the informal sector in Egypt were found to be similar to those observed elsewhere. More than 90 percent of extralegal firms in Egypt were run as sole proprietorships, employing fewer than five workers and operating mostly in the service sector. The average life cycle of the firm was about 10 years, and the production techniques employed tended to be labor-intensive.

Figure 1. Extralegal Entrepreneurs and Workers in Egypt (in millions)



Source: ILD/ECES (2004).

No accurate information is available about the contribution of the informal sector to GDP in Egypt. However, international estimates of the contribution of the sector to GDP in developing countries range between 30-70 percent. If we assume conservatively that the sector accounts for one-third of the Egyptian economy, this is by no means a negligible percentage. Its magnitude raises a question as to why so many entrepreneurs prefer to stay in the shadows, and what could be done to make it attractive

for them to join the formal sector.

Informality in Egypt: Causes and Remedies

Economic rationality suggests that entrepreneurs in the informal sector must have found it more rewarding to stay informal rather than join the legal sector. They must have concluded that the net benefits from entering the formal sector, operating under the formal rules of the game, and exiting markets if necessary are less than the net benefits of staying informal. In other words, they are willing to forgo the benefits of better protection of property rights and to bear the cost of extra-legality (e.g., in the form of bribes and costly finance) rather than endure a restrictive business environment. To convince them to become formal, it is therefore necessary to adopt sufficient reforms to tilt the balance of net benefits in favor of joining the legal sector.

The above explanation is supported by the findings of the extensive field study carried out by a team from the Institute of Liberty and Democracy and ECES (2004) over a period of two years, involving in-depth interviews with entrepreneurs, lawyers, accountants and policymakers. This study found that entrepreneurs in the informal sector face many problems with local authorities, and have limited access to finance, infrastructure, technology and markets. However, they perceive the constraints of the formal sector to be even more costly and binding at their scale of operation. These results are not surprising, but their merit lies in the details that are fully documented in the study itself.

On the basis of the findings, the study team developed a comprehensive reform package to make formalization an attractive option for firms. Broadly speaking, the recommended measures include simplifying the rules and procedures regarding entry, operation, expansion, and exit of firms; creating an independent organization to carry out the formalization process and consolidating all relevant laws into a single law. More concretely, the recommendations include:

- Facilitating entry and exit by establishing new public registries that adopt timely and simplified mechanisms;
- Reducing operation costs by establishing a simplified tax regime for formalized businesses, besides simplifying

labor and social security procedures;

- Promoting business expansion by proposing measures to facilitate contract enforcement via a simplified and inexpensive system of pledges, establishing a system for certifying signatures, and creating a special court system for the resolution of disputes and a center of conciliation and arbitration; and
- Reducing transaction costs by creating a business information system for formalized businesses.

If the government were to adopt the above recommendations, the reforms are expected to reduce the cost of establishing and operating businesses by 90 percent, the cost of mortgages by 91 percent, and the cost of enforcing pledges by 77 percent. Will these benefits be high enough to persuade entrepreneurs to move to the formal sector? Furthermore, who are the likely winners and losers in the process?

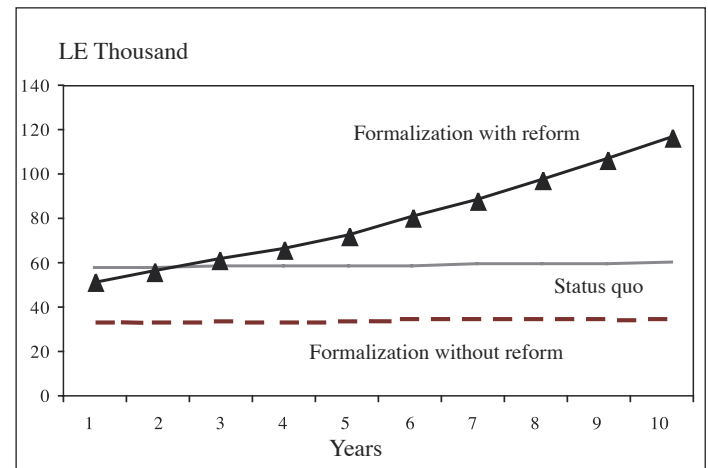
Potential Winners and Losers from Formalization in Egypt

Estimating the potential gains from formalization is demanding. It requires detailed firm-level information about the costs and benefits associated with entry, operation and exit in the informal sector and similar information about operation in the formal sector, with and without reform. This kind of information is not readily available. Compiling it takes careful investigation of the rules and regulations governing the life cycle of a firm, and, more importantly, an exploration of how these rules are enforced. The study undertaken by ILD/ECES has done just that.

On the basis of collected information and the proposed reform package, it was possible to estimate the impact of formalization of a typical firm. The results are illustrated in Figure 2, which shows the after-tax profit of the firm under three scenarios. The first is continuing informality and no reform. The second involves the formalization of the firm into an unreformed business environment. Finally, the figure shows the more attractive scenario, which involves reforming the business environment along the lines recommended by the team and formalization into that new environment. Under the latter

scenario, formalization would increase the private value of the firm by 23 percent. This gain is equal to one and a half times per capita income, measured in 2002.

Figure 2. After-Tax Profit of a Typical Firm under Alternative Assumptions



Source: ILD/ECES (2004).

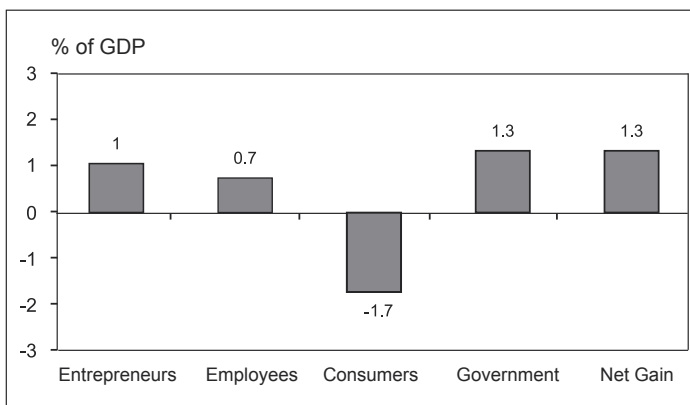
From society's perspective, entrepreneurs are only one group among many. The other main groups affected by formalization are workers, consumers and government. Accordingly, the decision to promote formalization should be derived from its impact on all of these actors. Formalization could, of course, positively impact certain groups and negatively impact others, just like other policy reforms. However, as long as the net benefits to society are positive, the decision to encourage formalization is socially desirable. Meanwhile, mechanisms could be found to make the winners compensate the losers.

To help policymakers make an informed decision regarding formalization, it was necessary to estimate its likely impact on the economy and to identify the potential winners and losers. The analysis was carried out by first assessing the likely impact of formalization of the typical firm on entrepreneurs, workers, consumers and the Treasury. The results were then aggregated for all firms. Under the assumption that the government adopts the recommended reforms, the results were very favorable. As shown in Figure 3, formalization would increase GDP by 1.3 percent every year. Entrepreneurs would gain 1.0 percent of GDP and workers 0.7 percent of GDP, thanks to productivity improvement and expansion. The Treasury

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would gain 1.3 percent of GDP, as firm profits increase. Consumers are the only group that is expected to be worse off—by 1.7 percent of GDP—because they would have to pay value-added taxes. In return, they would be assured better quality products because firms would be subject to inspection.

Figure 3. Winners and Losers from Formalization under a Reformed Environment



Source: ILD/ECES (2004).

Concluding Remarks

The case for leaving the informal sector alone is justified only if the government takes no action to reduce the cost of entry, operation, and exit and no steps are taken to expand opportunities for all entrepreneurs in Egypt. Maintaining the status quo would deprive the economy of huge potential benefits from formalization. A coherent set of reforms would benefit entrepreneurs, workers, and government. While consumers are likely to pay higher prices, they would be assured that the goods they consume are checked for quality. Economic growth would increase and poverty would decline.

The case for formalization may be even stronger than suggested. No attempt was made in the study to account for the positive externalities resulting from an improved business environment for medium-size and large firms, the possible benefits of a more developed financial system, or the benefits from greater respect for the law. Such indirect benefits are difficult to measure but cannot be ignored.

Finally, it is worth noting that partial reforms are not likely to be effective. All too often measures to promote small and medium-size enterprises or investment tend

to focus on relaxing one constraint or another, with disappointing results. What is needed in the case of formalization—and in other areas of reform as well—is a coherent set of reforms that persuade economic agents to change their behavior in the direction of socially-desirable outcomes.

This *Policy Viewpoint* was written by Ahmed Galal, Executive Director and Director of Research at the Egyptian Center for Economic Studies (ECES).

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