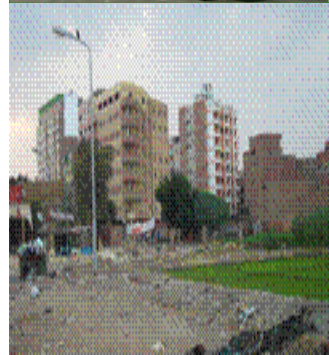
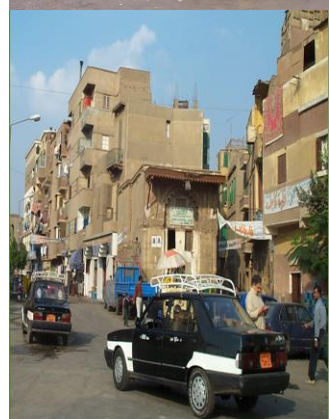
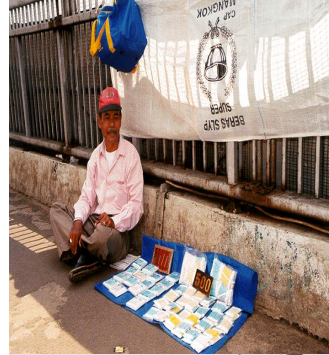


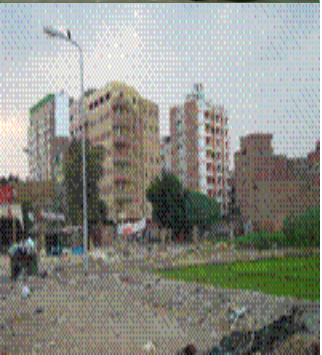


# POTENTIAL WINNERS AND LOSERS FROM FORMALIZATION IN EGYPT

Ahmed Galal

January 18, 2004

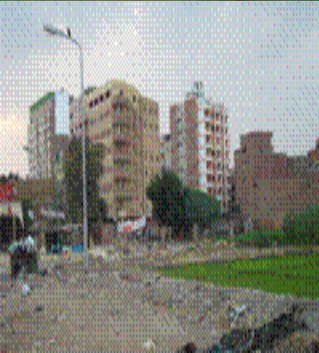




# Introduction

- **The arguments for “leaving the informal sector alone” are not convincing**
- **However, policymakers will only be persuaded to act, if and only if:**
  1. The benefits from formalization are large enough to the justify effort
  2. The benefits accrue to groups they care about, and
  3. They have at hand an implementable reform package.
- This presentation deals with these questions

# OUTLINE OF The PRESENTATION



## Introduction

- I. What makes “entrepreneurs” and “policymakers” decide to formalize?
- II. Why do we observe informality in Egypt?
- III. Who are the likely winners and losers if Egypt adopts the proposed reforms?

## Concluding Remarks

# I. What makes “entrepreneurs” and “policymakers” decide to formalize?

## Entrepreneurs

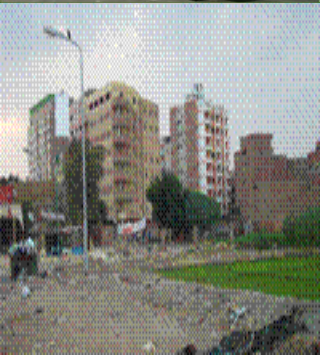
- Will formalize if the NPV of the firms will be greater in the formal sector than the corresponding values under continued informality
- They will stay in the informal sector if:
  - i. The costs of entry, operation and exit in the formal sector are greater than the costs of informality
  - ii. The expected benefits in the formal sector are low, and
  - iii. Extralegal practices enable them to survive in the informal sector, even sub-optimally.

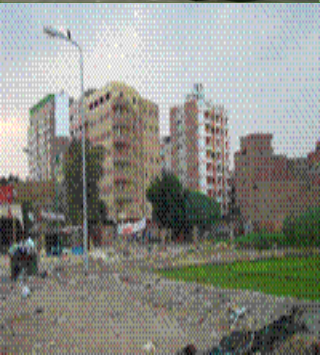
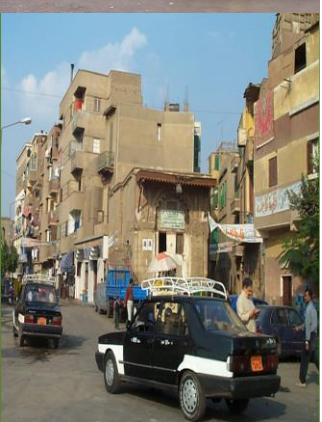


# I. What makes “entrepreneurs” and “policymakers” decide to formalize?

## Policymakers

- Will promote formalization if the net benefits to entrepreneurs, workers, consumers and government are positive.
- These benefits will be larger where:
  - i. The size of the informal sector is large, and
  - ii. The potential benefits from reform are substantial.

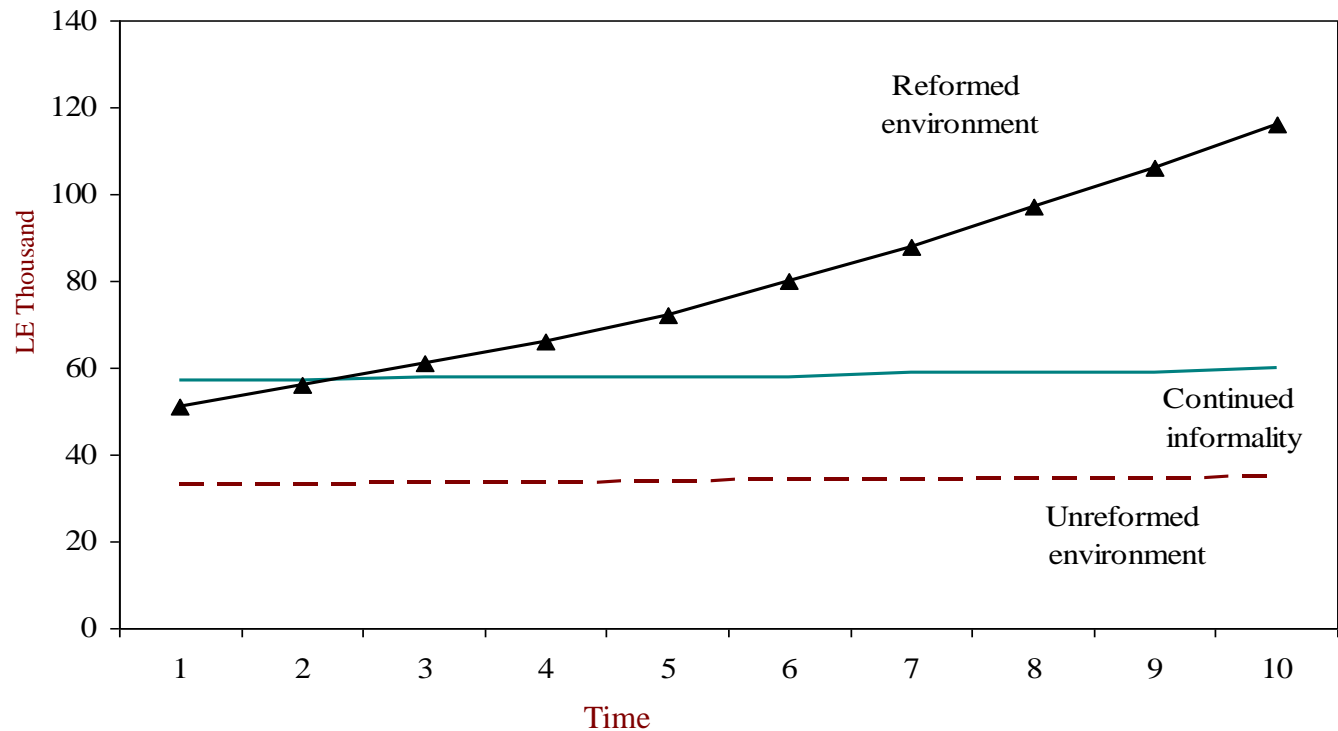




## II. Why do we observe informality?

Fundamentally because it is more profitable for entrepreneurs to stay informal.

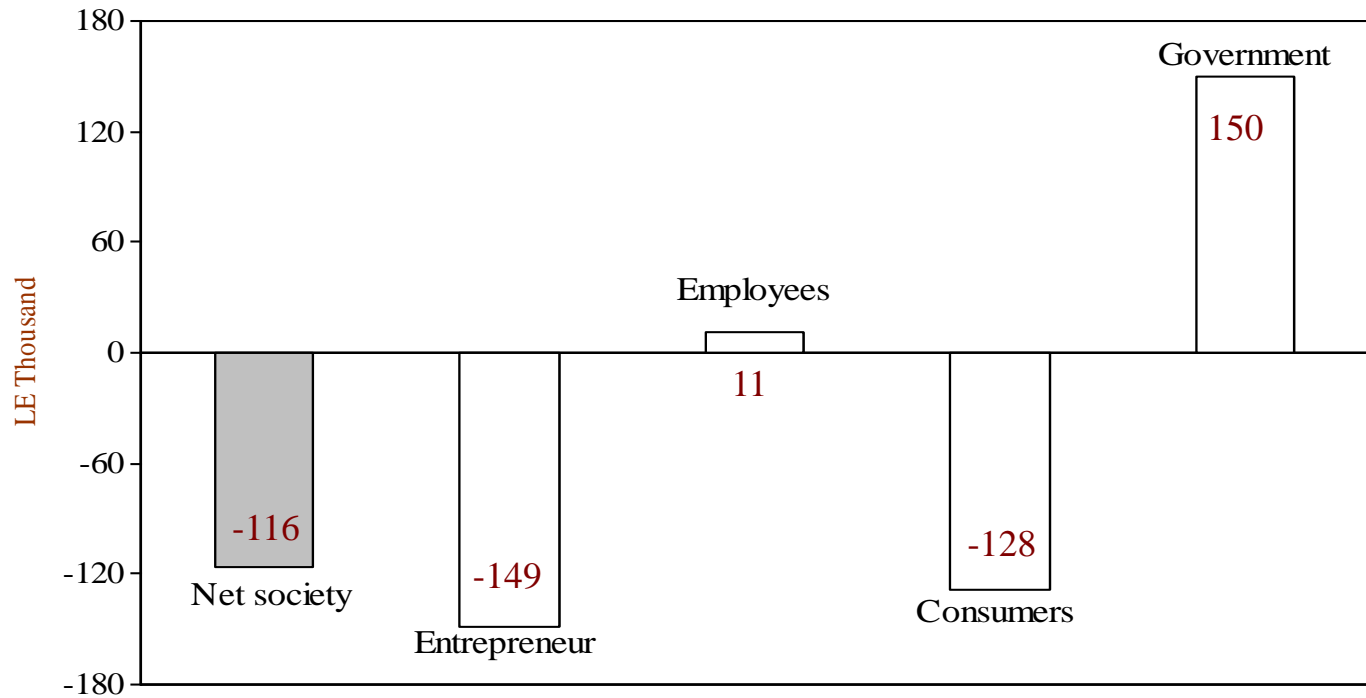
After tax profit of a typical firm under alternative scenarios



## II. Why do we observe informality?

Also, because formalization is not worth it for policymakers.

Winners & losers from formalization of a typical firm without reform

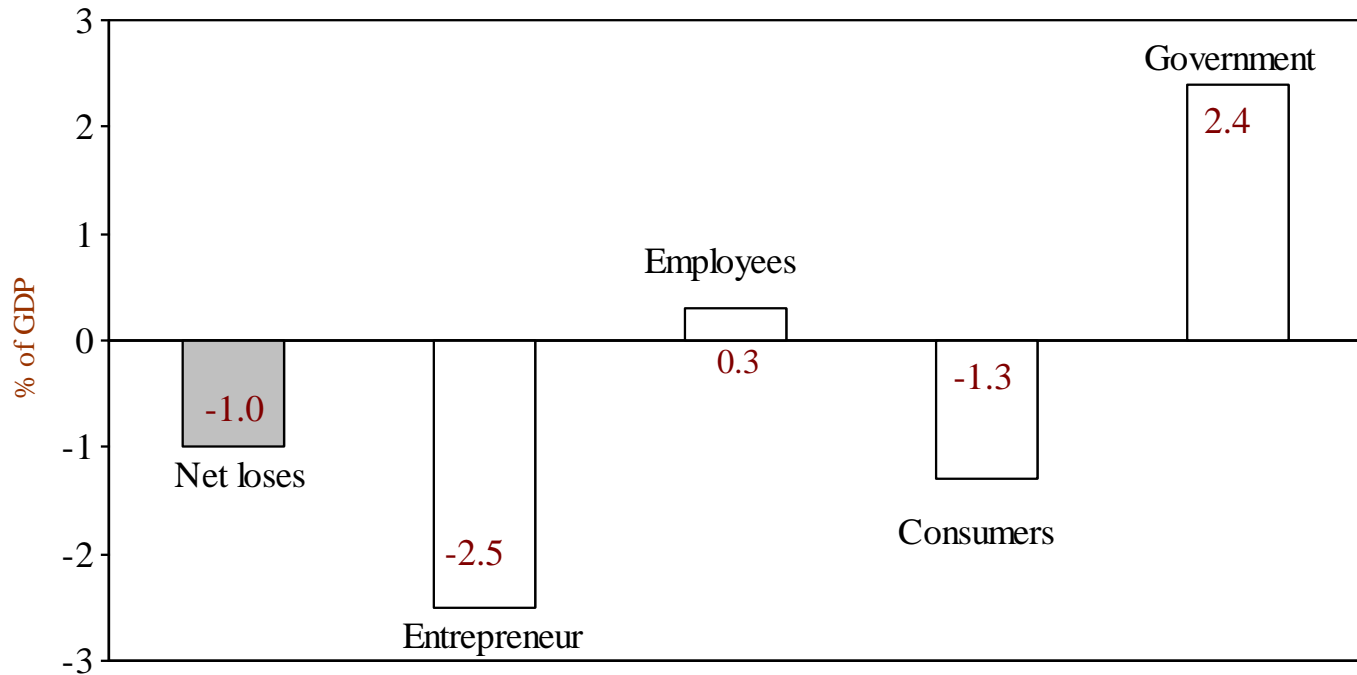


The benefits to government and employees are less than the losses to the entrepreneur and consumers.

## II. Why do we observe informality?

Because the losses to the economy from formalization without reform can also be large.

Winners and losers from formalization of the informal sector without reform

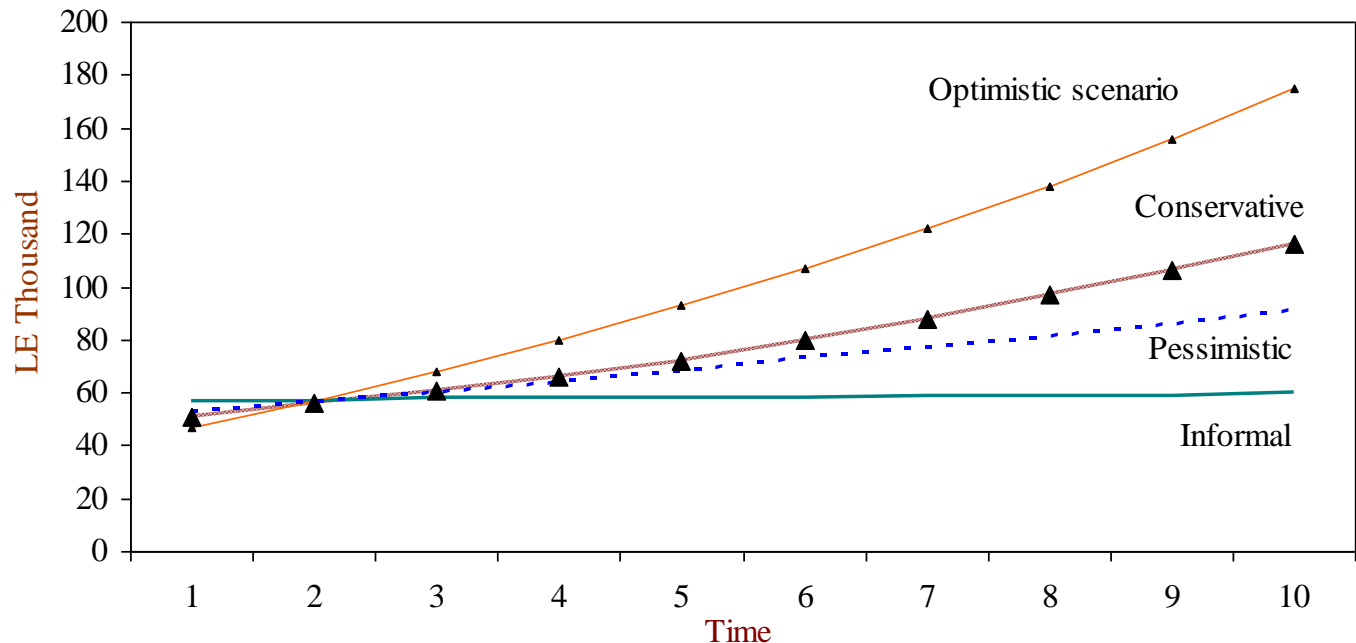




# III. Who are the likely winners and losers if Egypt adopts the proposed reforms?

The formalizing firm will be a winner, thus will take the initiative to formalize.

After tax profit of a typical firm under alternative assumptions

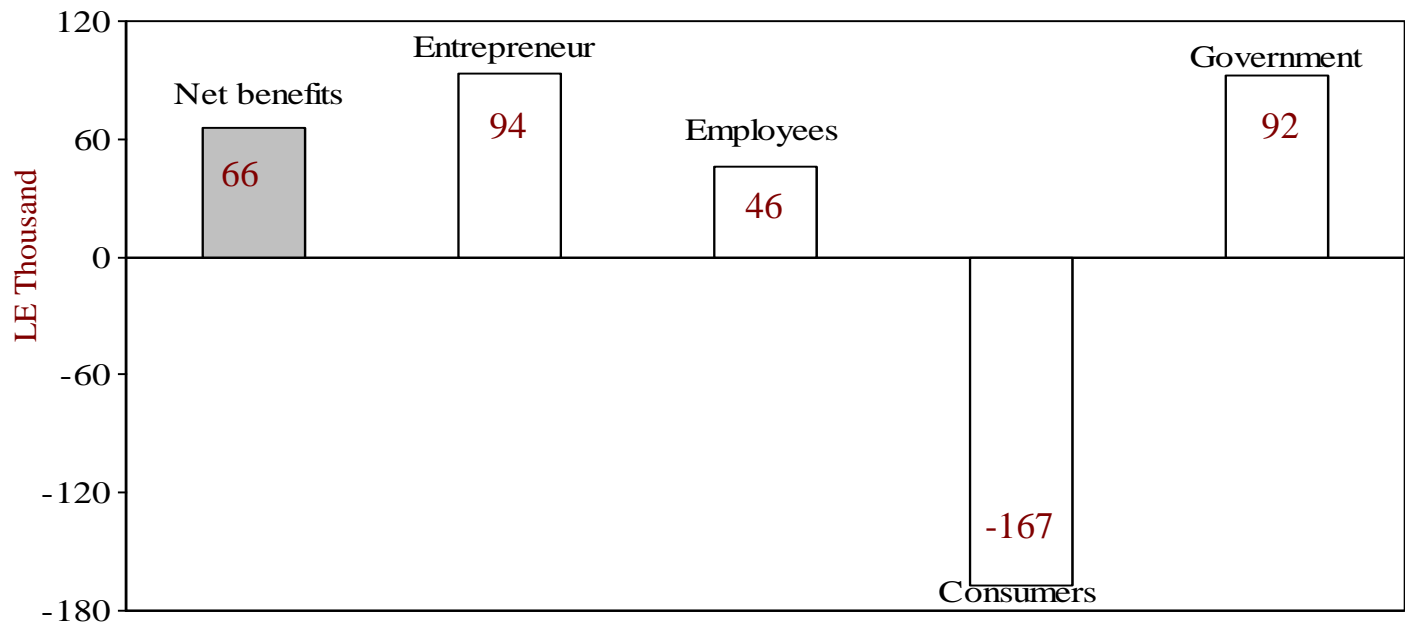


Reforms involve dramatic simplification of entry, operation and exit procedures and effective enforcement of contracts.

# III. Who are the likely winners and losers if Egypt adopts the proposed reforms?

Society will also benefit, so will most economic agents.

Winners and losers from formalization of a typical firm with reform

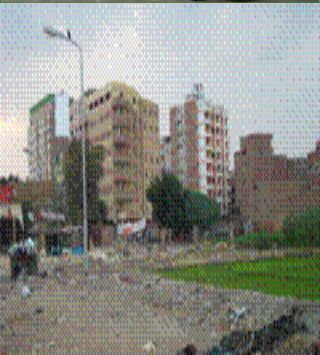
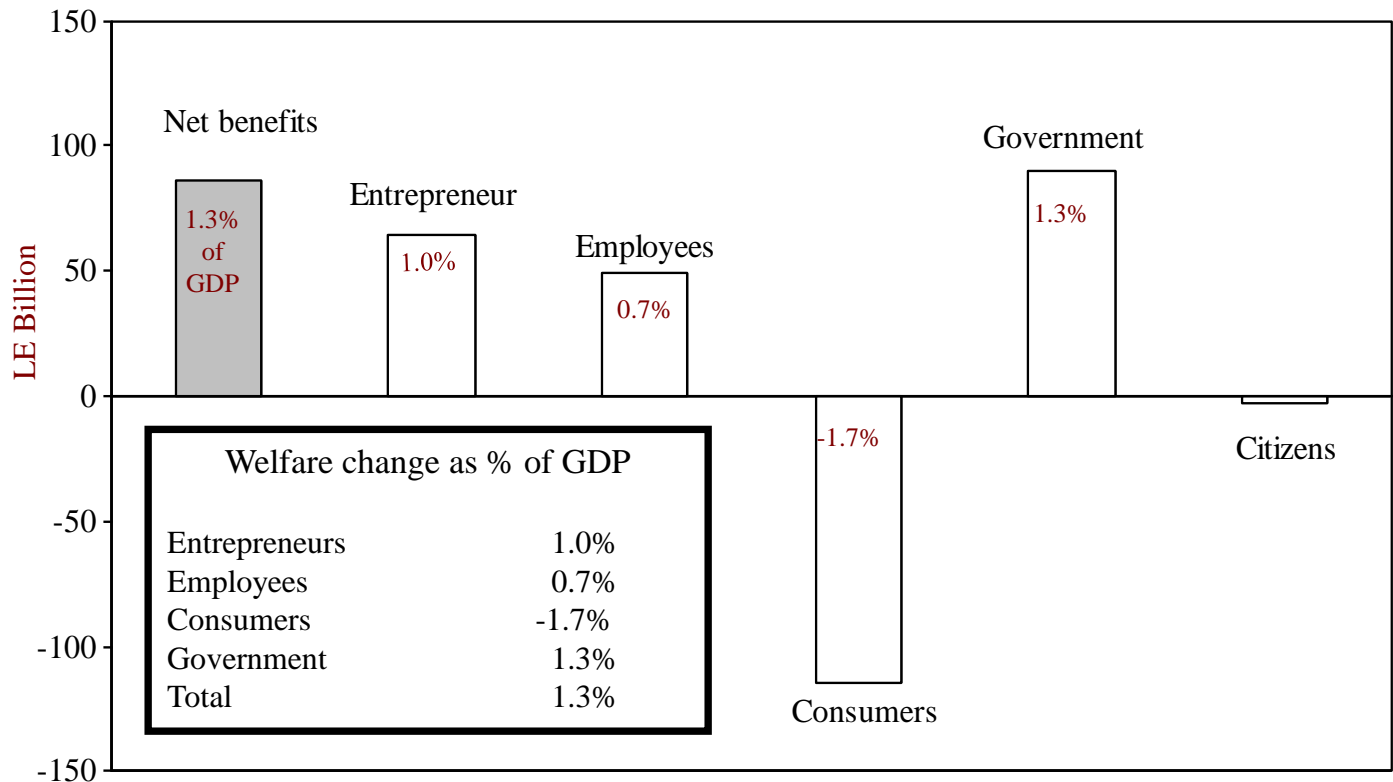


- Entrepreneurs benefit from expansion and productivity despite payment of taxes.
- Workers benefit in higher wages, social insurance and job stability.
- Government collects VA and income tax.
- Consumers enjoy better quality of products but pay higher prices.

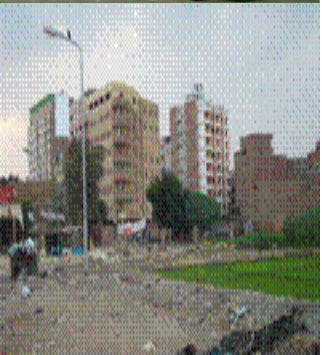
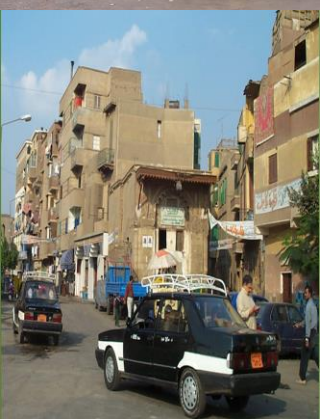
# III. Who are the likely winners and losers if Egypt adopts the proposed reforms?

For the economy, the net benefits and their distribution are positive and large.

Winners and losers from formalization of the informal sector with reform



# Concluding Remarks



- The case for “leaving the informal sector alone” is a lost opportunity for the economy, big time
- In contrast, formalization could boost GDP by 1.3% annually and benefit marginalized entrepreneurs, unprotected workers and government budget.
- What remains to be done is simply to take “ACTION”.