

# Signals and Policies Required for Informal Markets: Evidence from Egypt & China

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## Abstract

This paper is investigating the informal market in Egypt and China. First, it will go through the main concept of informal markets and the four main schools of thoughts, then the history of informal sector in Egypt and China since the 1970s' and the causes and effects of such phenomena. Also, it will go through the effect of informal sector on economic growth of a country and the characteristics of informal sector in any country. The paper suggests some solutions to overcome the problems of informal sector. The paper concluded that there are negative relation between informal sector and economic growth, and that developing countries often have bigger informal sector than developed countries and the poverty and unemployment play vital role in determining the size of the informal sector in an economy.

## Keywords

Informal Markets, Unemployment, Poverty, Economic Growth, Policies

## 1. Introduction

The informal sector exists in all economies all over the world, and it is classified as the part of the economy that is not taxed because it is not legally recognized or monitored by the government. The output of this sector is not included in the GDP of the country; also the employment in it is not calculated in the employment ratio. This sector always works in the shadow or from under the table because the majority of cases its activities are illegal. The informal activities have distinguished characteristics such as they are low productive, have high labor turnover, lack growth opportunities and poor conditions [9]. The informal sector is also commonly known as the grey economy or the shadow economy which all of its activities and operations are unseen.

There are many types of informalities in any economy; those types are summarized in informal enterprises, informal employment and informal activities. First the informal enterprises which are small or unregistered businesses that is privately owned and operated by one or more household. Those informal enterprises are engaged in non-agriculture activities and some or all of the goods/services they produce must be meant to be sold or [12]. Secondly, informal

unemployment is not governed by the government like any other type of informality in the economy, which makes the labors working in this sector not entitled to labor legislation of the country or even the social benefits and taxes. Informal employment is referred to jobs that have not contracts, registration or even social benefits and rights. The majority of informal employment is concentrated in micro-enterprises, employment by domestic households, self-employment and temporary employment by formal sector for instance part timers and seasonal employment. Thirdly, the informal activities are the activities that are done by workers with no formal agreement or papers. Those forms of activities take place in an economy as a result of the weak rule of law of the country [2].

In developing countries, the informal sector is an extremely large proportion of the economy, because it provides working opportunities to poor people which are a large percentage of the total population of a developing country. People in such countries start engaging themselves in jobs such as selling food in the street, riding people with their own cars or even repair and clean clothes for people in order to gain money to enable them to afford basic needs [4]. The main well known factors that lead to informal activities are the burdensome regulations, low institutional systems,

high economic inequality, ease of entering, lack of access to recourses, preferences of individuals and the lack of monitoring and enforcement of rules and laws by the government.

The informal sector brings advantages and disadvantages to people working in it, for instance one of the main advantages is that no taxes are paid, which decrease the cost for the entrepreneurs and increase the income for the informal employee, as there are no income taxes paid by them. Another lead point for the informal sector is that less legal and formal paper work is required, which decrease the time and effort needed to start up a business. On the other hand, there are some disadvantages too such as the absence of legal rights and the lack to access to finance from formal source because the businesses in informal sector are risky and the government could shut any shady business down any time. Egypt is one of the developing countries that suffer from the issue of informalities, throughout this paper the history of the informal sector in Egypt will be discussed while being compared to China which has very small informal sector, and how the Egyptian economy developed over the years, also it will go through the causes, effects and possible solutions of informalities.

## 2. Literature Review

The informal sector in all economies is known as the underground economy or the shadow economy, and it's a known fact and reality all over the world. It is believed that the shadow economies exist as a consequence of the government intervention in the economy, this intervention can be via taxation or regulations. Scholars show that the size of the shadow economies has been showing a positive trend over the years, he also believed that this growth is a result of high taxes imposed on people so they escape this problem by engaging in the informal economy, moreover the rigid regulations are one of the reasons of the growth. During the period of 1960s, people preferred to engage in the informal sector of the economy in order to avoid paying taxes imposed by the government. In the 1990s, the concept of globalization increased all over the world which could have increased job opportunities to people, yet the jobs provided by globalization were mostly not good jobs because the market became more competitive, which pushed the firms and producers to employ more informal workers to have advantage of lower costs than the competitors. In addition, the small and medium firms found it extremely hard to be able to compete with foreign firms, so they continued to compete locally with informal small firms [5].

The Dualist school of thought argued that the informal activities in the economy are an antonymous activity that has no connection to the rest of the formal economy. This thought stated that the poor people engage in the informal activities in the economy in order to gain money and it acts as a safety net in the periods of economic crisis and political crises. The characteristics of the informal activities in this school were the ease of entering the informal sector,

individual/family ownership of small businesses, extremely small scale operations, not regulated and labour intensive. It didn't focus on how to create a connection between the two economies, yet based on this theory the only solution for the informalities in an economy is the provision of more formal job opportunities by the government and a plan to help in the development of the informal businesses as they are a very profitable investment to the countries [5].

The structural school is another school of thought that its main ideas and concepts revolve around the capitalism nature of an economy. Based on this though the main reason behind informalities is capitalism as the trade and activities are controlled by the private sector. Unlike the dualist school, they viewed a strong relation and connection between the formal and informal economies as the capitalists needs the informal workers for development and the reduction of costs to increase their profits. Informalities were seen that it is strongly linked to formal firms, is increasing all over the world and heterogeneous. The Structural supported the idea that the government should reduce the imbalance between large firms and small firms by building relationships [5]. While the legal school of thought defined the informal sector as a group of small enterprises that want to operate with the least cost, effort and time in registration. They argued that a strict and strong legal system with regulation push people to operate informally and to be self-employed. This school support the idea that the government should decrease procedures to encourage the informal enterprises to become formal and benefit from their production [5].

Finally the Voluntarist school is similar to the legalist school as informal businesses seek to avoid taxes yet they don't blame the regulations and the government. They believe that people choose to operate informally after calculated the cost-benefit analysis of formality and informality. This theory didn't focus on the linkage between the informal businesses and the formal ones, yet it concluded that as informal businesses increase the competitiveness to the formal ones it become unfair for the formal business as they pay higher costs. The solution was stated that the informal enterprises should somehow become formal to increase government revenue by burdening them with taxes, and settle the debate of being unfair for the formal businesses.

As the number of people engaging into informal employment increase in an economy even though the economic growth is increasing, it is known as informalization of labour. This trend has been widely seen in developing countries all over the world for the past years. The informal labour can be working in agriculture, streets vendors, home production, or paid domestic work. The majority of informal workers are self-employed, and in developing countries the majority of those workers are females. Those who live under the poverty line don't have other option to gain money even if it's small amounts. The government has no control over the informal employment, thus the means of protection are absence for this segment of people. Informal workers are abused in terms of safety, working hours or even minimum

wage. Recently, Roberto Dell'Anno (2018) focuses on the importance of existence of an optimal rate of inequality that minimizes the informal economy. Income inequality in a country affects the presence of informal sector, as the gap between people increase the informal sector increase. Consequently as inequality increase the number of young people being self-employed increase, which increase the difficulty in accessing loans and the costs of starting formal business. As a result young adults are pushed to start informal businesses instead [6].

### 3. Informalities in Egypt and China

#### 3.1. History of Informalities in Egypt

The informal sector was firstly acknowledged during 1970s and they thought that it only exist in low-income and developing countries. The job opportunities of the informal sector in Egypt at this time was about 20% [15]. The informal sectors was mainly consist of tradition artisans and people whom trade small goods and services. Egypt used to suffer from extremely high level of unemployment during this time, till the President Mohamed Anwar EL Sadat applied the open door economic policy to Egypt. As the president applied this strategy the inflow of capital to Egypt has massively increased and the foreign currencies too, which boosted the economy of Egypt decreasing the level of unemployment and improving the economic position. As unemployment in the country decreases the role of the informal economy (informal employment) drops, so at that time Egypt didn't face a critical problem of informalities [10].

During the period of 1980s the Egyptian economy suffered from various macroeconomic imbalances, such as the high budget deficit, high balance of payment deficit, high interest rates and high inflation rate. All those things affected the

economy negatively, while the government role was decreasing and focused on infrastructure industry and ignored the agricultural industry [3]. During the period of 1990s Egypt suffered from high economic imbalances during the late 1980s, so a reform plan was set to improve these conditions and improve the macroeconomic imbalances in the public sector by an agreement with the IMF and the World Bank. The reform main aim was to privatize a lot of the public sector, regulate the exchange rate of the Egyptian currency against foreign currencies and to decrease the restrictions of foreign trade. As a result of this reform the private sector became the main opportunities to provide jobs to workers, therefore they started to harden the process of employing as they were become monopoly. As a result, people that were cut off their jobs in the government and those with low skills or education had no other option except the informal jobs to be gain the money needed to provide the basic needs of life [13]. As a consequence of the reform the informal sector became the main job provider, it was found that approximately 69 percent of new entrance in the labour market in 1998 were informally employed which is 8 percent more that the percentage before the reform [16]. As mentioned by Ernst and Schneider (1998), the informal sector is about 68 percent of the GDP of Egypt.

The effect of the reform that was applied during the 1990s started to show it affects in 2004, in fact the deficit in the balance of payment decreased and the exchange rate stabilized. In addition, many units of the public sector were being privatized which showed a negative effect on the employment in Egypt. As the public sector was being privatized many people were cut off their jobs so they started to join the informal sector to find jobs [3]. In 2009 it was estimated that the number of informal enterprises reached about 82 percent of the whole economy and the informal employment is about 40 percent of the total workforce.

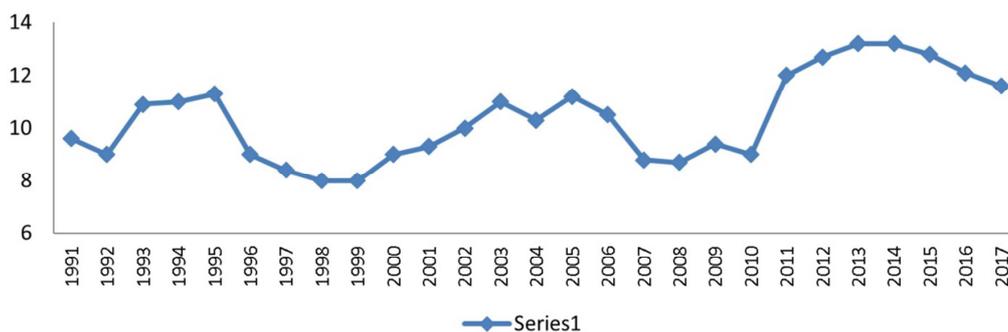


Figure 1. Unemployment as percent of total labor force.

Source: ILO.org

It is clear in figure 1 that the unemployment rates in Egypt shows massive fluctuations. The unemployment rate was increasing during the late 1990s as a result of the reform that took place, and as mentioned above that any reform has a negative consequence on the unemployment. Also during 2011 the unemployment showed increasing pattern as a result

of the 25th January Egyptian revolution. Lately, research showed that education is from the main factors in the decision to be informally employed in addition to the institutions factors. It was found that in Egypt about 90% of informal employees didn't enter post secondary education, which is a vital proof of the negative relation between

education and informality in any country [7].

### 3.2. History of Informalities in China

China is the second largest economy in the world nowadays, however, its economy consist of formal and informal sector like any other country. People in China started to move from rural areas to urban cities and through their transaction the informal employment was their main source of income. The Chinese government didn't spot the light on the informal employment that were increasing in their country, thus they didn't apply any policy to overcome this issue. In 2007 the formal employees percentage was 65%, this percent dropped by 2013 it became 43%, and the ownership of small businesses increased by 4% which

increased the informal sector [14]. The informalities has been increasing in china post the openness to the market era, this information is supporting by the numbers as in 1978 the number of employees outside in the formal sector was fifteen thousand but by 2006 this number became 168 million out of 283 million labour [11].

During 1990s the Chinese economy went through various economic reforms on state owned enterprises which cause distortion in the labor market, thus the unemployment rates increased. Unemployed people (mostly rural migrants) started to work in the informal sector and gain low salaries, low social protection and they were vulnerable. However, when the Chinese government became aware of this issue they started to impose policies in urban areas [8].

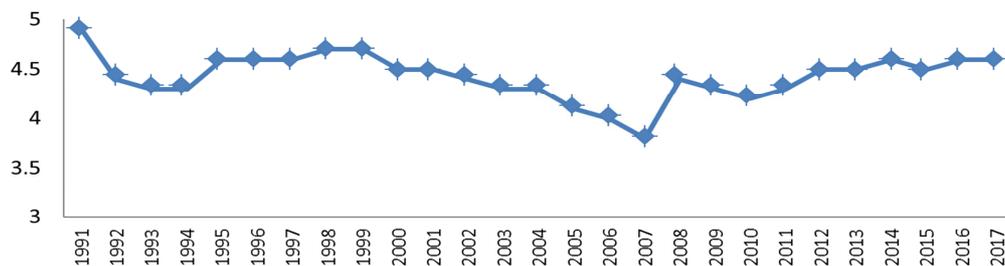


Figure 2. Unemployment as percent of total labor force 1991-2017.

Source: ILO.org

The relation between the formal and informal sector can be represented through two forms, the first is called the complementary form which prefers to produce in the informal sector than in the formal one, and the other is the competitive form which is benefiting from the cheap labor and the cheaper prices to become more productive. There are two sub-theories of this issue one that encourages the informal sector as it leads to efficient allocation of resources in the economy, and the other one –which is suitable for

Egypt and China-, is to combine both sectors to give the government the ability to approximately estimate the size of the economy. It is also believed that when an economy is going through a recession that the people start to engage more in the informal sector to be able to maintain their livings, and on the other hand when the economy is growing the demand on products produced by the informal sector will increase directly or indirectly which will as a consequence will increase the informal sector [1].

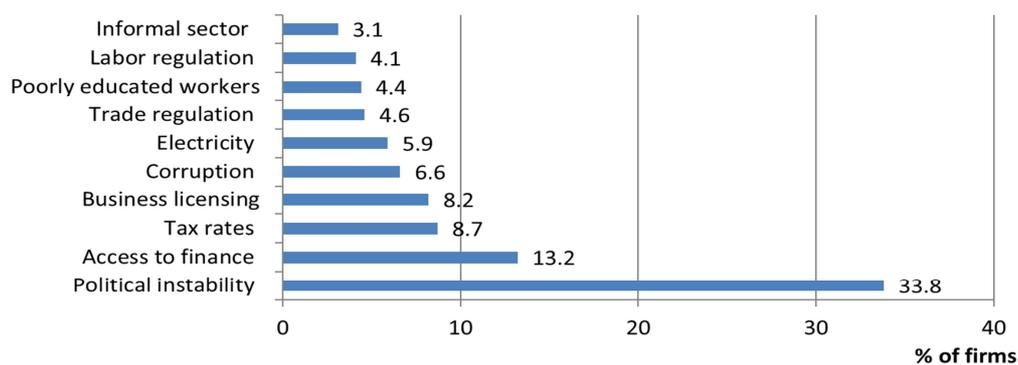


Figure 3. Percentage of firms choosing the major obstacle in business environment in Egypt 2017

Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), The World Bank.

When analyzing the major obstacles for business to enter the market in both countries the World Bank survey showed that the informal sector is from the main barriers to enter the market while in Egypt the political instability is the main one, see figure 3 and 4.

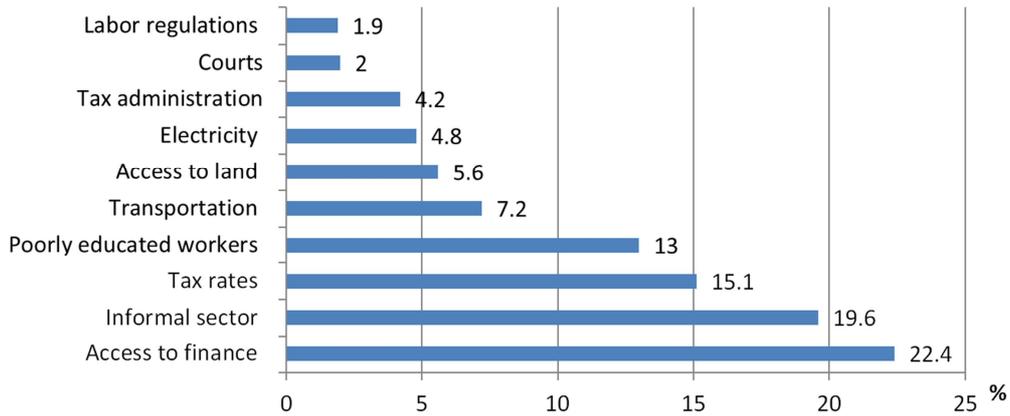


Figure 4. Percentage of firms choosing the major obstacle in business environment in China 2017.

Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), The World Bank.

Recently, Yang, K., & Pisani, M. J. (2018) showed that the informal and formal economy complements each other. As well, informal workers work on municipal solid waste recycling and formal and informal firms are competing in certain market and industries such as construction and mining. On china, there are many positive effects of the informal economy; it is advisable not to totally restrain the growth of the informal economy at the current stage of economic growth [17].

### 3.3. Causes of Informalities

Taxes is considered one of the main factors that push people to informal economy, because as the tax burden increase people find doing business is extremely expensive. Informalities increased massively in Egypt during the 1990s for several reasons, firstly because the costs of formally doing businesses is much higher than the benefits in terms of financial costs or time consuming procedures, so people started to shift to the easier option which is doing the same

business but informally. Moreover, hiring a labor formally costs the business very high expenses so the owners start to hire fewer formal workers and more informal workers to cut the costs. Entrepreneurs suffer from countless obstacles but the main one is to access finance, the banks in Egypt require many paper works and often don't guarantee a loan to SME (small-medium enterprise) without collateral. Therefore, people start to borrow form family or friends to overcome such issue. Egypt's tax burden rate reached more than 25 percent which approximately mean that the informal economy is about 30-40 percent of the total GDP of Egypt [13]. Therefore the incentives people have to work in the formal economy are very and in terms of social welfare it is much better in the informal sectors which explain the condition in Egypt. On the other hand, China's tax burden is much lower than Egypt, which explains why China has lower number of people working in the informal sector. Recently Jorge Alonso-Ortiz and Julio Leal inelastic to changes in taxes and transfers

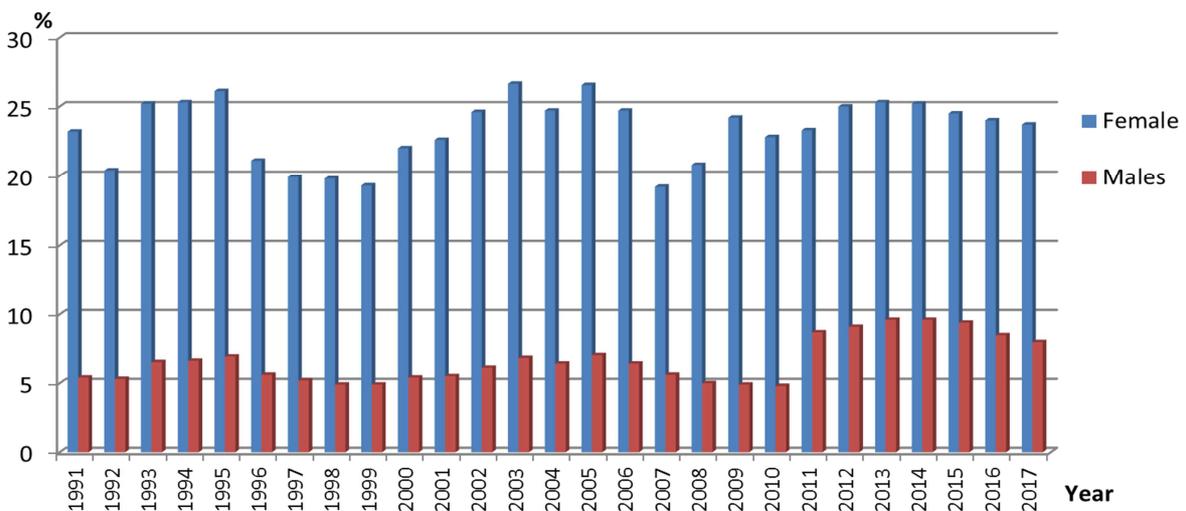


Figure 5. Unemployment of females as percentage of female labor force, and unemployment of males as percentage of male labor force (Egypt).

Source: world Bank (World development indicators 1991-2017).

High level of unemployment: As a result of the high unemployment level in Egypt people start to switch to the informal sector to find jobs and gain money. The main reason behind the high unemployment is the diminishing of working opportunities provided by the public sector, so the informal sector becomes the main absorber of the unemployment in

Egypt, which as a result increase its size, see figure 5. However, China has much lower unemployment rate than Egypt and that encourage citizens in China to work in the formal sector as it provides social security and protection. They only seek the informal employment during crisis or transition periods.

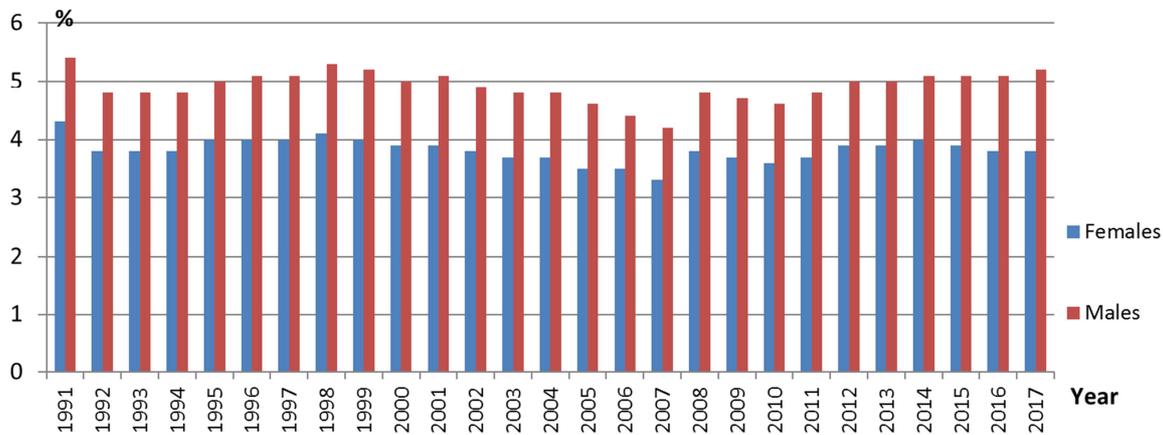


Figure 6. Unemployment of females as percentage of female labor force, and unemployment of males as percentage of male labor force (China).

Source: world Bank (World development indicators 1991-2017).

Poverty: As the level of poverty in a country/area increase people become more encourage to join the informal sector in order to gain money. In fact, in Egypt the poverty in rural areas is really high and as a result the informality there is high too, as people have no other option to access to finance. Therefore, they start their businesses from home by selling their agricultural products with no need of formal papers or licenses to start the business. But China has low poverty level, and as a result smaller informal sector, and they are seeking to reach zero poverty in the near future. Thus, as level of poverty increase the informality increase, which is direct relation?

Age of entrepreneur: According to Abou -Ali & Rizk (2015), it was found that the age of the entrepreneur is inversely proportional to the informality. As younger entrepreneurs tend to engage more in the informal sector, however older entrepreneurs usually targets the formal sector as it is more secure even if they started in the informal sector as they grow older they will switch [1].

Gender discrimination: Egypt suffer from high level of gender discrimination concerning work places, which push females to either start their own businesses and be self employed or to work in the informal sector. Either way this leads to increase in the informal sector participation

percentage of females [13].

### 3.4. Characteristics of Informal Sector in Egypt

There is no regulations or formal records in the state of the informal businesses, therefore they don't get taxed or charged for public utilities as a business which makes them free riders and frauds. About 90 percent of the informal enterprises are SMEs, which are usually owned by one person who indicates the small capital available and is small in size and have small output. The majority of workers in the informal sector are from rural areas as they suffer from high level of poverty and unemployment. As big proportion of workers are from rural areas they tend to have low level of education, and take very low wages with no insurance or medical care which makes them very attractive to be employed the cost of the business that way will be very low [13].

Comparing Egypt and China from the table 1, it became clear that the percentages of informalities in China are higher than Egypt's. This conclude the fact that Egypt has higher informalities than China which makes sense as China has lower unemployment, poverty and much higher GDP.

Table 1. Indicators of informalities 2017 (Egypt and China).

Indicator	Egypt	China	All countries
Percent of firms competing against unregistered or informal firms	43%	57.7%	54%
percent of firms formally registered when they started operations in the country	91.4%	95.8%	89%
Number of years firm operated without formal registration	0.4	0.1	0.7
Percent of firms identifying practices of competitors in the informal sector as a major constraint	22.7%	7.4%	28.1%

Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), The World Bank.

### 3.5. Effects of Informalities in Egypt

Segmentation of markets: One of the negative effects of the large informal sector in Egypt is the segmentation of the markets, as the formal sector is mainly depended on the capital intensive technique of production and the informal is depended on the labour intensive technique. As a consequence of this issue the formal sector become extremely expensive and the informal sector is relatively cheap. Another form of segmentation is that those whom work in the formal sector get higher wages than those in the informal sector [13].

Tax evasion: The informal sector doesn't pay any taxes as businesses and employees in it are not legally registered by the government. Therefore, the government revenue decrease massively as the informal sector increase, which as a result makes the government to increase taxes on those who actually pay or decrease the subsidies it provides to those in need for example the subsidies on essential products. The tax evasion of the informal sector makes it not fair for the legal

people in the formal one.

### 3.6. How Informal Sector Affect the Economic Growth

There is a relation between the economic growth and the informality, based on the facts over the years it was found that as the economic growth drops the informal sector grows, however not always when the economic growth increase the informal sector decrease. Therefore, it is very hard to conclude neither a positive or native relation because it depends on countless other factors. While on the other hand, the informal sector is a safety net for those whom live under poverty line, as those people are either self employed or working in the informal sector to be able to stratify the survival needs. Thus it is concluded that there is a positive relation between the poverty and the informal sector, as poverty increase the informal sector increases and vice versa [3]. Egypt and China follows this assumption that as economic growth decrease informal sector increase.

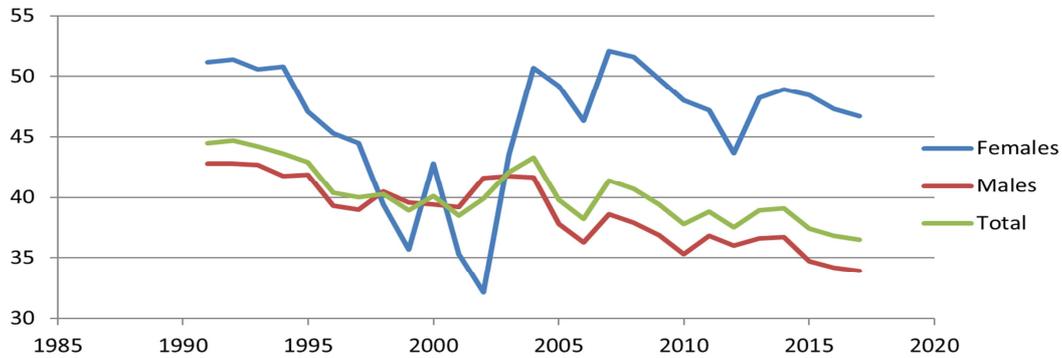


Figure 7. Percentage of self-employed (Egypt).

Source: ILO.org

The percentage of self employed in Egypt range from 52% to 30%, while in china the percentage decrease from below 80% to less than 40% during the period from 1990 till 2017, see figure 7 and 8. Moreover, the female percentage to be self employed is higher than in china the incident that reflects the gender discrimination in the Egyptian labor market in contrast to the Chinese labor market.

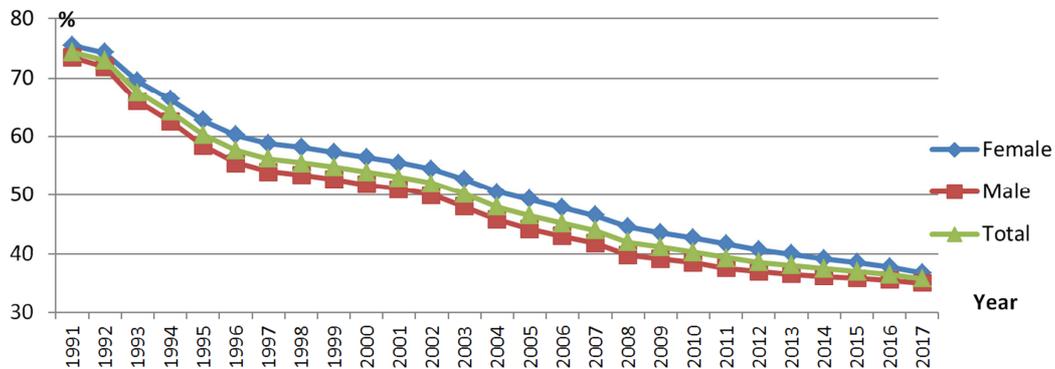


Figure 8. Percentage of self-employed (China).

Source: ILO.org

As shown in figure 8 that the percentage of females that are self-employed is much higher than the males over the years, which is a result of gender discrimination in the formal sector. Therefore, females shift to the informal sector to overcome this issue and it's obvious from the data.

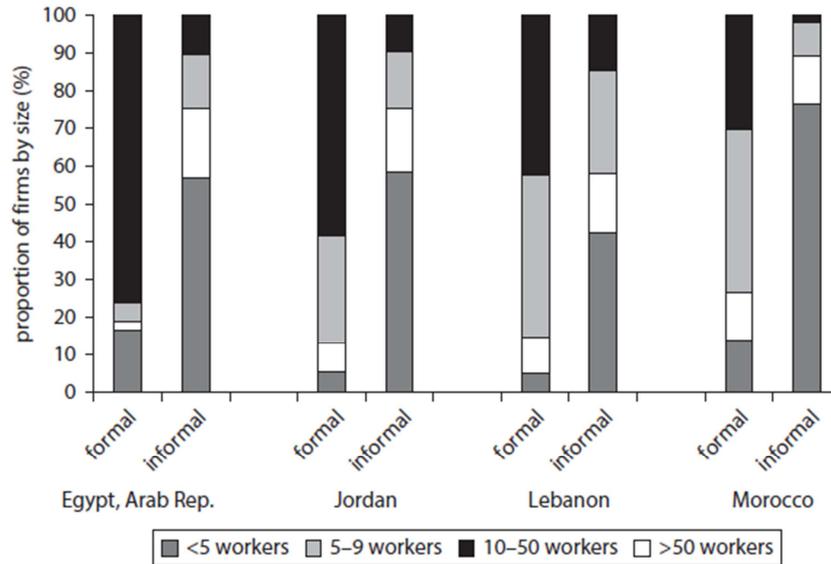


Figure 9. Number of worker in the formal and informal sectors Egypt (2006).

Source: Egypt market panel survey 2006.

As seen in figure 9, that in the informal sector the greatest percentage of firms have less than 5 workers, which means those firms are micro or macro enterprises- the incident that reflect the potentiality in the market.

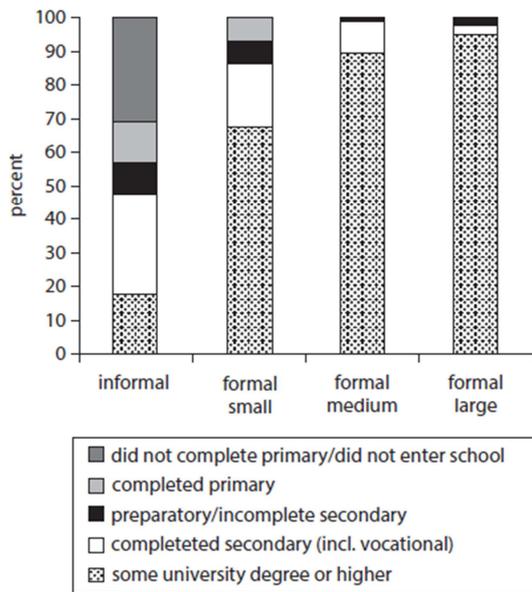


Figure 10. Educational degree in informal and formal businesses Egypt (2014).

Source: world Bank 2014.

Only small percentage of those in the informal sector have university degree, which support what mentioned above that people in informal sector are below poverty line. As highlighted before that about 92% of informal employees

during 2017 in Egypt do not hold a university degree [7].

#### 4. Conclusion and Recommendation

The easiest policy that can be applied to overcome the issue of informalities is registering the informal enterprises and register these entities to be legalized but the fear of paying taxes hinder that. This could increase the formal job opportunities and increase government revenue as more taxes would be paid by businesses. Moreover, decreasing the procedures needed to register the business and providing entrepreneurs with incentives. Another policy could be that the government main aim shouldn't be to reduce the informal sector but to make the informal sector more productive as it employ many poor people and its production could boost economic growth in a country.

Taking all the above into consideration, it became clear that every economy all over the world has informal sector or any sort of informalities; however the size of the informal sector varies. Also, there are relation between informal sector and level of unemployment, poverty, inequality, level of education and regulation in a country, as the unemployment increase people seek more informal jobs, and as poverty level increase people start joining the informal labor force to be able to survive. Also, as the equability gap increase poor people and young adults start seeking less formal jobs and activities, moreover, as the poverty in a country increase the level of education decrease, and the greatest percent of employees in informal sector are not well educated or not educated at all. Thus, there is mostly negative relation between the size of informal sector and the economic growth of a country. The causes that were discussed in the paper

were the high unemployment, poverty, high tax burden, and gender discrimination in work places. And the effects were segmentation of the market and tax evasion which decrease the government revenue and increase the budget deficit. In a nut shell, Egypt's informal sector is much bigger than China's due to countless economic reasons.

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