BOX 2.4.1 Informality in the Middle East and North Africa

Middle East and North Africa's (MENA's) informal sector output, on average, amounts to nearly one quarter of official GDP. However, there is wide heterogeneity across the region. Informality is high among non-GCC economies, the young population, as well as the agricultural workforce. Levels of informality in the region are closely linked to its economic structure and governance climate, including low private sector vibrancy and limited economic diversification. Policy options that reduce regulatory barriers, streamline public sector efficiency, and enhance workforce skills can help improve access to the formal sector and unlock the potential of a relatively young informal workforce.

Introduction

The extent of informal output in the Middle East and Africa region amounts to nearly one quarter of official GDP during 2008-16, lower than in other EMDE regions. However, there is considerable heterogeneity within the region, with higher informality among non-Gulf Cooperation Council (GCC) economies. Moreover, although the share of informal activity in MENA has been steady over the past two decades, perceptions of informality in the MENA region have edged upward. Employment informality is high among lower-skilled workers and the youth, which poses important challenges for MENA's ongoing transition to a more diversified economic structure and jobs-oriented growth.

Against this backdrop, this box examines the following questions:

- How has informality evolved in the Middle East and North Africa?
- What are the macroeconomic and social correlates of informality?
- What policy options are available to address challenges associated with informality?

Evolution of informality

On average during 2008-2016, informal sector output in MENA amounted to about one quarter of official GDP, lower than other EMDE regions (Figure 2.4.1.1; Chapter 3). During the same period, about 24 percent of the labor employment are reported to be self-employed.

Broadly stable over time. The extent of informal sector output in MENA appears to have remained steady over the past two decades, although survey-based measures of informality suggest that perceived informality may have increased. The persistence of informality is linked to the long-standing economic structure of MENA economies, including dependence on commodities production in oil exporters, a limited private sector, low labor mobility, and lack of economic diversification.

Regional heterogeneity. The moderate average level of informality masks disparate trends within the region. The share of informal output in GCC economies is about 8 percentage points less than in non-GCC economies (18 percent and 26 percent, respectively), and the share of self-employment to total employment in non-GCC economies is about 10 times that of the GCC.

Correlates of informality

Informality in MENA has reflected a number of economic and development challenges. These ranged from limited private sector activity to conflict situations. Large informal sectors have been associated with lower productivity, low wages, and less inclusive growth. Although informality can provide helpful employment opportunities where the formal sector features distortions and governance is poor, the structural, policy, and institutional features that foster informality in MENA poses challenges for the region's efforts to diversify and reduce its reliance on commodity production and the public sector.

Economic structure. Low informality in the GCC reflects high reliance on expatriate workers and high public employment for nationals (World Bank 2018o). In the non-GCC economies, informal workers constitute the vast majority of the employed in the agriculture and mining sectors. Across countries, a higher share of agricultural employment had been associated with higher informality (Elshamy 2015; Gatti et al. 2014; UNDP 2013; World Bank 2014c). Urban workers were also 5-12 percent less likely to be informally employed than rural workers (Angel-Urdinola and Tanabe 2012), altogether consistent with the negative correlation between stage of development and informality.

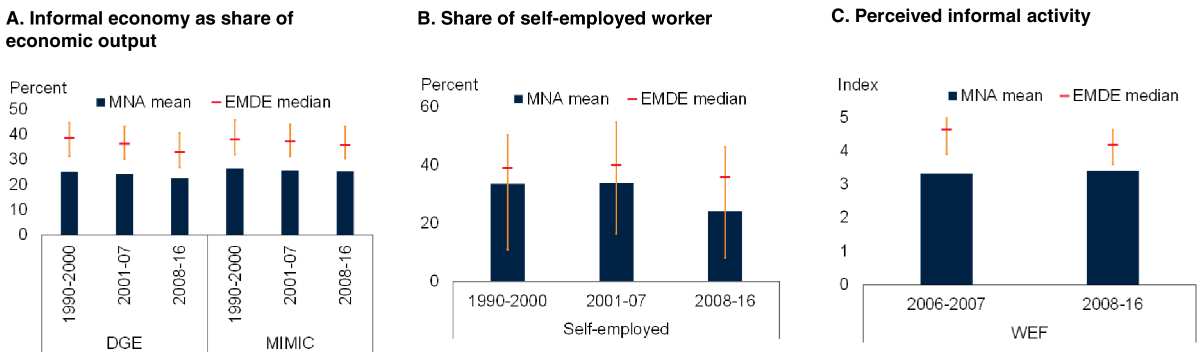
Governance and business climates. Informality in MENA is closely linked to governance quality, which has been negatively correlated with informality (Elbadawi and Loayza 2008). In non-GCC economies, where informality is higher, institutional quality indicators also tend to be markedly lower than in the GCC. This issue is further

Note: This box was prepared by Lei Sandy Ye. Research assistance was provided by Mengyi Li and Jinxin Wu.

BOX 2.4.1 Informality in the Middle East and North Africa (*continued*)

FIGURE 2.4.1.1 Informality in the Middle East and North Africa

MENA's informal sector output comprises nearly one quarter of official GDP, lower than other EMDE regions. However, perceptions of informality in MENA has risen somewhat while they have declined in the median EMDE.



Source: Elgin et al. (forthcoming), International Labor Organization, World Bank, World Economic Forum.

A.-C. Blue bars show simple averages of economies in the region. Red markers show the median of all EMDEs. Vertical lines denote interquartile range of all EMDEs.

A. DGE = dynamic general equilibrium model. MIMIC = multiple indicators multiple causes model. The DGE model estimates the size of the informal sector as a percent of official GDP (see Elgin and Oztunali 2012). The MIMIC model is a structural equations model that considers multiple causes of informal activity and captures multiple outcome indicators of informal activity (see Schneider, Buehn, and Montenegro 2010). It also estimates the informal output as a percent of official GDP. DGE measure includes 6 GCC economies and 9 non-GCC economies. MIMIC measure includes 6 GCC economies and 10 non-GCC economies. Excludes Djibouti, Iraq, Libya (DGE only), and West Bank and Gaza.

B. Self-employed is the share of self-employment in total employment. Includes 6 GCC economies and 10 non-GCC economies (excludes Djibouti, Iraq, and Libya).

C. WEF index is the average responses at the country-year level to the following question (surveyed by World Economic Forum): "In your country, how much economic activity do you estimate to be undeclared or unregistered? (1=Most economic activity is undeclared or unregistered; 7 = Most economic activity is declared or registered)." WEF indices are re-ordered (i.e. 1= Most economic activity is declared or registered; 7= Most economic activity is undeclared or unregistered) so that a higher average at the country level indicates a larger informal economy. The index does not use data for year 2004-2005 due to inconsistency in survey methods. Includes 6 GCC economies and 10 non-GCC economies (excludes Djibouti, Iraq, and West Bank and Gaza).

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compounded by poor public services and burdensome regulatory environment, which raise the costs of operating in the formal sector (World Bank 2016d).

Conflict. In a number of countries (e.g., Syrian Arab Republic), wars and violent conflicts have severely limited the number of public sector jobs, which also led workers to shift into the informal sector for lack of alternatives (Devarajan and Mottaghi 2017; Ianchovichina and Ivanic 2014). In neighboring countries of fragile and war-torn economies (e.g., Jordan, Lebanon), the massive influx of refugees—many of whom are unregistered—has boosted the informal sector, where jobs tend to be labor intensive and low skilled.

Lower productivity. High informality has been associated with lower labor productivity and more limited export potential, partly reflected in its relatively low informal share of output compared to that of employment (Box 3.2; Elbadawi and Loayza 2008; Gatti et al. 2014). Hindrances in the formal sector, including regulatory barriers to entry and burdensome taxation, divert otherwise productive firms and workers to enter and remain in the informal sector where productivity is lower.[1] Moreover, based on enterprise survey data, a sizable portion of firms in oil importers (e.g., Morocco, Tunisia) consider competitors' practices in the informal sector as hindering their own business operations (Figure 2.4.1.2; World Bank 2004).[2]

Restricted market access. Informal workers in the region tend to be concentrated in small and medium-sized firms, which constitute more than 90 percent of MENA's private enterprises (Purfield et al. 2018). Although these firms can include young start-ups with high entrepreneurial potential, they have tended to be oriented toward local markets, with limited regional or global market access (World Bank 2004, 2016d). Among these enterprises, a 1 percentage point increase in the share of informal workers was associated with a 6-percentage-points lower

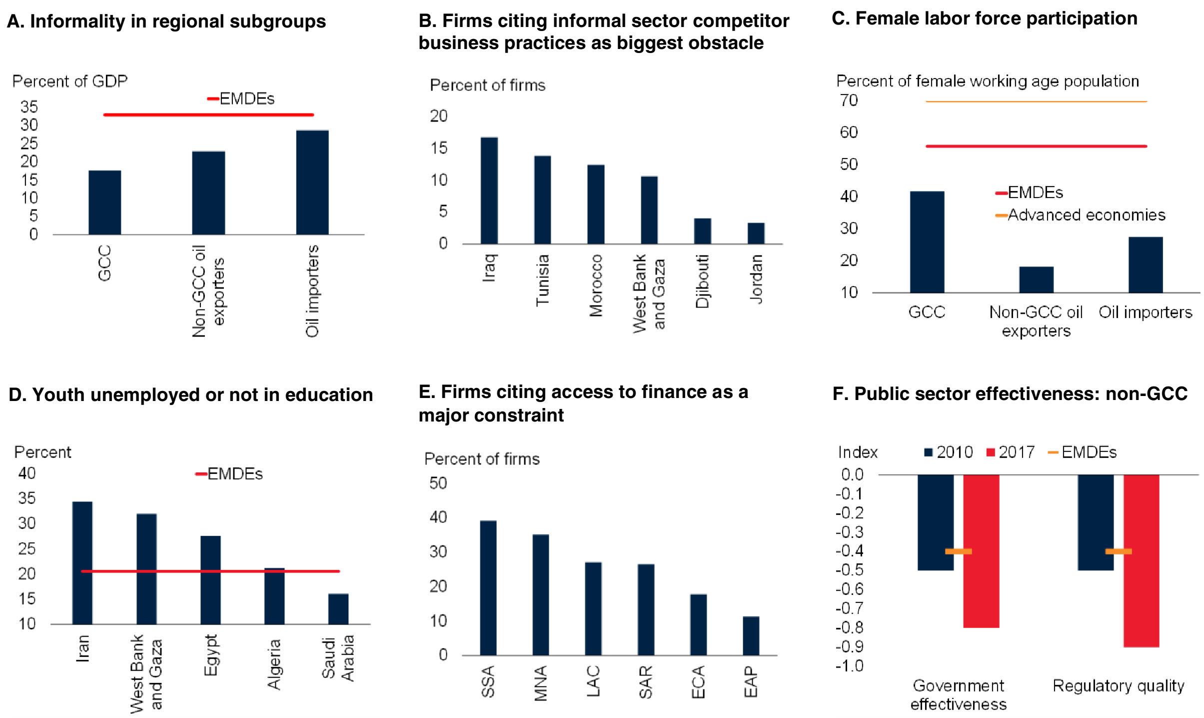
[1] Within small and medium-sized enterprises in MENA, a 1 percentage point increase in the share of informal workers was associated with 3 percentage point lower relative wages (Elbadawi and Loayza 2008).

[2] Informal business operations may also imply lower contributions to government revenues, while possibly raising resource utilization on public services, such as infrastructure use (Galal 2005; Gatti et al. 2014).

BOX 2.4.1 Informality in the Middle East and North Africa (*continued*)

FIGURE 2.4.1.2 Correlates of informality and policy challenges

Informal activity is higher among non-GCC economies in the MENA region, and competition from the informal sector presents a major obstacle to businesses in several large economies. Low wages for informal sector women workers have been associated with particularly low female labor force participation rates in the region. Informality is also high among the youth in MENA, a group that often has insufficient access to education and training programs. In non-GCC economies, where informality is more pervasive, policies that improve access to finance and public-sector effectiveness can help increase mobility from the informal to the formal sector.



Source: Elgin et al. (forthcoming), International Labor Organization, World Bank, World Economic Forum.

A. Based on DGE estimates of informal output in percent of official GDP (chapter 3). 2008-16 averages. "EMDEs" denote the median of all EMDEs during the same period. Includes 6 GCC economies, 2 non-GCC oil exporters, and 5 oil importers. Excludes Djibouti, Iraq, Libya, Syria, Yemen, and West Bank and Gaza.

B. Columns denote the percent of firms citing "informal business practices" as the biggest obstacle to their business. Based on the latest available World Bank Enterprise Survey year since 2013 for each economy denoted.

C. Workforce as a percent of female population ages 15-64. Based on 2017 data. Unweighted averages. Includes 6 GCC economies, 3 Non-GCC oil exporters, and 7 oil importers.

D. Denotes share of youth (aged 15-24 years) not in education, employment, or training in percent of youth population. Based on latest available data since 2010 for each country.

E. Percent of firm citing access to finance as a major constraint to business, based on World Bank enterprise surveys (surveys in the MENA region only include non-GCC economies). EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA=Middle East and North Africa, SAR = South Asia, and SSA = Sub-Saharan Africa. Based on latest survey year since 2010 for each country. Includes 9 MNA economies.

F. Based on the Worldwide Governance Indicators of regulatory quality and government effectiveness, in which a lower index denotes weaker regulatory quality and weaker effectiveness. Index ranges from -2.5 to 2.5. Includes 13 non-GCC economies. Unweighted averages. "EMDEs" denotes the year 2017.

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revenue share destined for non-local markets (Elbadawi and Loayza 2008).

Wage differentials. Informality presents a source of employment but also income vulnerability among women and the youth. The wage gap between informal and formal workers (i.e., formality premium) has been higher for women than men. For example, in Egypt, the formal wage premium was about 20 percent for males but more than 50 percent for females (Gatti et al. 2014). Informality rates are higher among the young workers, who often do not enter public sector jobs until later in age (Angel-Urdinola and Tanabe 2012; Elbadawi and Loayza 2008). In Morocco, the formal wage premium among the youth was more than 50 percent (Gatti et al. 2014). Further, returns to education have been lower in the informal sector than

BOX 2.4.1 Informality in the Middle East and North Africa (*continued*)

the formal sector, which has discouraged skills acquisition (Angel-Urdinola and Tanabe 2012).[3]

Less inclusive growth. High informality in the region is associated with lower levels of educational attainment and enrollment, as in many economies a majority of informal workers are school dropouts or have not received a secondary education (Gatti et al. 2014). High informality is associated with limited access to health care and legal services, especially in fragile areas (Cho 2011). Workers in the informal sector have also reported harsher job conditions and poorer work safety, and among young informal workers, lower levels of job satisfaction (Gatti et al. 2014). These social disparities have the potential to slow reform momentum in the region by constraining consensus-building.

Policy challenges

Informality in non-GCC MENA countries, where informality is widespread, reflects deep-rooted economic structures. These economies have some of the highest youth unemployment rates and lowest female labor force participation rates among all EMDEs. Public sector employment constitutes more than 15 percent of total employment, about twice the EMDE average (IMF 2018b). Multi-pronged policies can aim to create a more vibrant private sector and strengthen human capital of workers, part of building a new social contract in the region (Devarajan and Mottaghi 2015). Policies targeting specific vulnerable groups can lessen the negative externalities associated with informality.

Fiscal reforms. Burdensome taxation has been a key constraint to formal sector firms in MENA (Gatti et al. 2014). In non-GCC MENA economies where informality is more pervasive, reforms to align tax systems with international best practices and strengthen enforcement could further attract informal firms to productive formal activity while also raising revenue collection. Such reforms may include reducing excessive corporate tax rate burdens and enhancing revenue collection through harmonized electronic filing systems (e.g., Morocco).

[3] Evidence from Egypt, for example, suggests that a worker in the formal sector who has completed 5 years of education earns comparable wages to those of an informal sector worker with 12-14 years of education (Angel-Urdinola and Tanabe 2012).

Access to finance. Access to finance is a larger obstacle to doing business in non-GCC MENA than in most other EMDE regions. Boosting access to finance, including through a stronger legal framework and improved credit protection regimes, can help promote private sector activity by increasing transparency of firms to investors and facilitating investment (Farazi 2014; Straub 2005). A number of economies in MENA have recently adopted policies in this area, such as new insolvency resolution laws in Egypt, Saudi Arabia, and the United Arab Emirates. The adoption of financial technologies (Fintech), such as innovations that automate financial transactions, can also facilitate financial services to informal unbanked individuals or small and medium-sized enterprises (Arezki et al. 2018; Lukonga 2018).

Regulatory effectiveness. Beyond its large size, public sector effectiveness and regulatory quality in non-GCC MENA countries have deteriorated in the last decade. Corruption is cited among the biggest hindrances to MENA firm operations and increases incentives for firms and workers to operate informally (World Bank 2016d). Together with low regulatory efficiency, corruption reduces the effectiveness of labor market regulations and enforcement (Gatti et al. 2014). Policies that reduce regulatory costs help increase mobility of MENA firms between the informal and formal sector, while those that strengthen property rights may assist the rural or agricultural-sector populations to access financing (e.g., enabling collateralized loans). Policies to promote entrepreneurial activities, such as easing of business licensing requirements, can also facilitate entry of informal workers into more productive jobs in the formal sector.

Education. Policies that encourage higher education and expand job training can be especially relevant for younger workers by facilitating their entry into more productive formal jobs. Training programs may be particularly effective if coupled with mechanisms to increase women's mobility, which is constrained in the region, and offer a combination of soft and hard skills. Training is also more effective if extended to areas (e.g., rural) where educational levels are lower, as MENA region's training programs tended to serve higher income and more educated individuals (Angel-Urdinola, Semlali, and Brodmann 2010). A holistic approach that combines job training with job creation efforts, such as through public-private sector programs, can also be effective; given higher unemployment rates for university graduates than low-skilled workers in the region (World Bank 2018r).