

MIDDLE EAST AND NORTH AFRICA
DEVELOPMENT REPORT

Informality and Inclusive Growth in the Middle East and North Africa



Gladys Lopez-Acevedo, Marco Ranzani,
Nistha Sinha, and Adam Elsheikhi



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Foreword

Over the past two decades, the economic performance of the Middle East and North Africa (MENA) has been subpar relative to low- and middle-income countries. Between 2000 and 2019, gross domestic product per capita increased by 1.7 percent per year on average, compared to growth rates about two times as high in the East Asia and Pacific and South Asia Regions. The MENA Region is also facing various challenges—subpar labor market outcomes, growth setbacks, and deteriorating fiscal and current account deficits in the aftermath of the COVID-19 (coronavirus) pandemic and in the wake of high inflation and supply chain disruptions triggered by the Russian Federation–Ukraine war. For too long, the private sector in MENA has primarily created informal jobs without offering social protection benefits, leading to the public sector becoming the main source of formal employment. In short, creating more formal job opportunities in the private sector has become increasingly important and is key to transition to a more socially inclusive growth path.

Although informal employment keeps many from living in abject poverty, it is associated with negative outcomes, such as limited safety net coverage, reduced risk pooling, limited redistribution, low productivity, and inequitable growth.

A key purpose of this report is to understand the characteristics and incentive structures that drive informal employment in the MENA Region, with a focus on the Arab Republic of Egypt, Morocco, and Tunisia. The report aims to help MENA policy makers foster more socially inclusive growth by (1) designing better social protection systems to protect workers and their families against contingencies as well as vulnerability or poverty, (2) improving the functioning and effectiveness of the welfare state by means of more effective risk pooling and higher tax revenues to help reduce inequality, and (3) incentivizing firms to grow and thereby raise overall productivity and economic growth in the long run.

The report adopts a framework that focuses on the legal, regulatory, and institutional contexts affecting incentives and disincentives that economic agents face to operate (in)formally. This “environment”

generates a set of incentives determined by laws, institutions, and policies that affects the decisions of economic agents and can be considered to be composed of three broad realms: Realm 1, entrepreneur-worker relations; Realm 2, taxes and transfers; and Realm 3, market conditions. Employment relationships are often informal due to incentives in this direction generated by a lack of, or distorted, legal and regulatory frameworks, whereby it is convenient for firms to hire workers informally. Taxes and transfer policies play a significant role in driving informality: firms may reduce their tax burden and have more flexibility in managing their workforce when operating at a small scale and partially informally; workers might in certain contexts benefit from social assistance while working informally without paying taxes on their income. In addition, market conditions—including limited competition, little private sector dynamism, difficult access to credit and enforcement of credit, and commercial contracts—contribute to widespread informality in the MENA Region.

To take on informality and achieve more socially inclusive economic growth, the MENA Region needs a new approach. This report calls for progressive and consistent actions to transition from a suboptimal equilibrium characterized by high informality, little coverage against risks, low productivity, and subpar growth. A shift is needed to a more inclusive social protection system, where the principles of universality with respect to the relevant population and equality of benefits replace the existing segmentation of social protection schemes and implicit unequal coverage of workers and families. Moreover, the source of financing would change. The risks common to all citizens would be funded from general taxes, risks common to all workers would be funded from workers' earnings, and risks specific to workers employed in firms would be funded from firms' contributions and be proportional to workers' wages.

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Executive Summary

The long-standing debate about informality in the Middle East and North Africa (MENA) has taken on a new urgency as the region looks for a pathway to more socially inclusive and sustainable growth. This debate is occurring against a backdrop of subpar labor market outcomes, further growth setbacks, and deteriorating fiscal and current accounts deficits in the aftermath of the COVID-19 pandemic, and in the wake of high inflation and supply chain disruptions triggered by the Russian invasion of Ukraine.

A key pathway to more inclusive growth in MENA lies in stronger job creation in the private sector. Yet the private sector has not only underperformed in this area but also has largely created jobs that do not provide social protection benefits. At 68 percent, MENA features one of the highest rates of informal employment, after the Sub-Saharan Africa and East Asia and Pacific Regions. Among the country cases studied in this report, the share of informal employment ranges from 43.9 percent in Tunisia, to 62.5 percent in the Arab Republic of Egypt, to 77.3 percent in Morocco.

A focus on understanding informal employment in the region is timely. Governments are increasingly seeking to move away from reliance on universal subsidies and job creation in the public sector—elements that have been the cornerstone of the social contract. *The high level of informality matters for several reasons:*

- A large share of workers (and thus households) does not participate in social insurance, which hinders the efficiency and inequality-reducing power of social protection systems via limited coverage, reduced risk pooling, and limited redistribution.
- Informal employment tends to be associated with small firms—and the concentration of resources in such firms can dampen productivity and economic growth.

- Informality limits domestic revenue mobilization, which diminishes the fiscal space to provide high-quality public goods and services.
- Informality represents deeper, structural challenges in the economy, as it locks countries into a low-level equilibrium that results in subpar and inequitable growth.

This report examines and maps the characteristics and incentive structure of the institutional environment that has led to the prevalence of informal employment in three MENA countries, namely, Egypt, Morocco, and Tunisia. The report builds on the framework put forward by Levy and Cruces (2021), who argue that informality is endogenous to the legal, regulatory, and institutional contexts in which firms and workers operate and make economic decisions. The size of the informal sector is thus not a given; instead, it grows or shrinks, depending on a country's economic environment. In other words, informality does not represent a constraint in itself; rather, it is an outcome of the institutional context that economic agents face.

The report analyzes the economic environment in three broad realms: entrepreneur-worker relations, taxes and transfers, and market conditions. For example, the design of social insurance systems affects employers' and workers' preferences to operate formally because of factors such as contribution rates, risk coverage, and the quality of the services provided. Similarly, if the tax burden associated with operating formally (fully or partially) is high and enforcement is weak, economic agents may opt to operate informally. Informality can also prevail for other reasons: if it is costly for firms to register their business or resolve commercial disputes, if it is cumbersome or risky to obtain credit because of high collateral requirements or uncertainties linked to the protection of borrowers' and lenders' rights, or if markets are uncontestable due to corruption and unfair competition. Whatever the reason, if firms and workers perceive few benefits from operating formally, or if the benefits are low compared to informal alternatives, informality will remain high.

The analysis suggests that countries in MENA can take the following actions:

- Design better social protection systems to protect workers and their families against contingencies such as illness, longevity, job loss, disability, and work accidents, as well as vulnerability or poverty.
- Improve the functioning and effectiveness of the welfare state by means of more effective risk pooling and higher tax revenues to help reduce inequality.
- Incentivize firms to grow and thereby increase overall productivity and economic growth in the long run.

THREE KEY FINDINGS OF THE REPORT

- The current design of social protection systems offers suboptimal coverage to workers and their families, delivers little redistribution, and often provides inadequate protection against risks, particularly those associated with longevity and health. Combined with the minimum wage and collective agreements; lengthy, costly, and complicated dismissal procedures; and weak enforcement of labor regulations, this situation encourages informality and hampers productivity growth.
- The existence of special tax regimes, loopholes, and exemptions hurts firm expansion, productivity growth, and formal job creation, which are all compounded by a lack of tax enforcement. In addition, enterprise registration offers few benefits to firms in terms of enforcement of commercial and credit contracts, providing little incentive to register and operate formally.
- Addressing workers' informality and achieving higher and more inclusive growth would require a policy shift leading to a social protection and tax system. The system will allow all citizens access to basic health services, citizens to enjoy at least a minimum income in old age, and there are no special tax regimes. At the same time, the system will promote the creation and growth of high-productivity businesses.

HOW CAN GOVERNMENTS START TO ADDRESS INFORMALITY TO ACHIEVE HIGHER AND MORE SOCIALLY INCLUSIVE GROWTH?

This report calls for progressive and consistent actions, starting from the premise that to date the interactions of the three institutional realms—entrepreneur-worker relations, taxes and transfers, and market conditions—have led to a suboptimal equilibrium. The region has high informality, little coverage against risks, low productivity, and subpar growth. It is key that governments identify a clear vision of where they are headed and set a path to get there before embarking on a complex set of reforms. Governments should design a clear map of intertemporally consistent reforms that would contribute to the desired social protection system, because a better understanding of the desired outcome can help to build the necessary coalitions to support the reform agenda.

The report calls for a shift to a more inclusive social protection system, in which the principle of universality with respect to the relevant population and equality of benefits replaces systems comprised of segmented social protection schemes and implicitly unequal coverage of

workers and families. Moreover, the source of financing would change so that risks common to all citizens would be funded from general taxes, risks common to all workers would be funded from workers' earnings, and risks specific to workers employed in firms would be funded from firms' contributions and proportional to the workers' wages. The report outlines a road map for countries to move toward realizing these goals through five sequential key elements:

1. *Coordinated reform.* To oversee the compatibility of the policy changes with government objectives, each country sets up a cross-ministerial implementation group to ensure a holistic and coordinated approach in the policy arena.
2. *Tailored, gradual, and incentive-compatible social protection reform.* Countries introduce gradual reforms to the social protection system, particularly the health and retirement components, a noncontributory universal pension, and a poverty-targeted cash transfer program.
 - As a first step, health coverage should be extended to all citizens, regardless of their employment status; the pension system may move toward providing benefits to every worker, conditional on paying contributions, which should take place together with payment of income taxes.
 - Workers, not their employers, would be responsible for paying contributions for pension benefits, and such payments would finance individual accounts as opposed to cross-subsidizing the pension benefits of current retirees or other workers. Vesting periods in number of years of contributions would be eliminated, except for the minimum retirement age. Every worker who pays income taxes and therefore contributes to the pension system would be entitled to an actuarially fair benefit. This system could also increase compliance because all workers, irrespective of their employment status, would know that their pension benefit will be proportional to their income taxes.
3. *Expansion of the tax base to ensure that general revenues are available to fund universal health insurance.* Countries reduce or eliminate tax expenditures; introduce new taxes and/or increase the rates of existing taxes on certain activities, such as those that damage the environment and taxes on property; and remove universal consumption subsidies, particularly on energy products.
4. *Improved quality of service delivery.* Countries improve the supply of health care by providing more human resources and infrastructure. It is essential to increase the quality of public services. Doing this would

incentivize workers to pay income taxes, curb resentments, and build trust, leading to increased revenue from income taxes in the future, including through progressivity, to expand the fiscal base. These measures would increase investment, protect the vulnerable, and reduce inequality.

5. *Private sector reforms.* Countries prioritize a range of measures that affect firms:

- Special tax regimes could be abolished gradually, and economic units that are registered as firms would be required to pay standard corporate income tax rates, regardless of size, sector of activity, or other conditions. This change would be disruptive in the short term; but together with the new social protection system, it would contribute to raising firm and economywide productivity and thereby translate into higher income levels and higher growth in the long term. Overall tax revenues would also increase because, first, more firms would pay taxes under the standard corporate regime; and, second, the change would eliminate the value added tax (VAT) exemption that often comes with special tax regimes and the VAT exemption for certain consumption goods. It may also have a positive or at least neutral distributional impact. A recent study finds that eliminating VAT exemptions does not have regressive effects because in contexts with high informality, a significant share of consumption of the poor takes place in establishments that elude the VAT (Bachas, Gadenne, and Jensen 2020).
- In parallel, job stability regulations could be made more flexible and minimum wages less binding as the introduction of unemployment insurance and job loss compensation would support workers in transitioning between jobs, and workers would be covered against health risks even after losing their jobs. Moreover, in the medium term, the proposed changes would support higher productivity and economic growth, which would lead to increases in wages.
- Simplifying the registration process and improving the benefits available to registered firms would increase the dynamism of the private sector and improve market conditions. The benefits can be improved by strengthening the enforcement of commercial and credit contracts, thereby incentivizing firms to register because they will be able to access credit on better terms. Firms could also enter more and larger markets since their transactions would be secure and backed by strong commercial contracts, benefit from technical and technological transfers due to interacting with larger firms, and face reduced risk as their business assets would be separate from

the household. Other institutions would also benefit, including governments and banks, as a larger pool of registered firms translates into higher tax revenues and more diversified credit markets. Given that registered firms are more likely to hire formal workers than informal ones, this policy intervention alone is likely to have a positive impact on formal employment.

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Abbreviations

| | |
|--------|---|
| ACAPS | Supervisory Authority of Insurance and Social Welfare (Morocco) |
| AMG | Assistance Médicale Gratuite (free medical assistance program for the vulnerable population) (Tunisia) |
| AMO | Mandatory Health Insurance (Assurance Maladie Obligatoire) (Morocco) |
| ANAM | National Health Insurance Agency (Agence National Assurance Maladie) (Morocco) |
| ANAPEC | National Agency for the Promotion of Employment and Competencies (Morocco) |
| CA | collective agreement |
| CAPMAS | Central Agency for Public Mobilization and Statistics, Government of the Arab Republic of Egypt |
| CIMR | Moroccan Interprofessional Pension Fund (Caisse Inter-professionnelle Marocaine de Retraite) |
| CIT | corporate income tax |
| CMR | Moroccan Pension Fund (Caisse Marocaine des Retraites) |
| CNAM | National Health Insurance Fund (Tunisia) |
| CNOPS | National Fund of Social Welfare Organizations (Caisse Nationale des Organismes de Prevoyance Sociale) (Morocco) |
| CNRPS | National Pension and Social Insurance Fund (Caisse Nationale de Retraite et de Prévoyance Sociale) (Tunisia) |
| CNSS | National Social Security Fund (Caisse Nationale de Sécurité Sociale) (Morocco and Tunisia) |
| CRES | Center for Research and Social Studies |
| DAAM | cash transfer program for widows with children (Morocco) |
| DH | Moroccan dirham |
| EAP | East Asia and Pacific |
| ECA | Europe and Central Asia |
| ESCWA | Economic and Social Commission for Western Asia |
| ETA | Egyptian Tax Authority |
| FDI | foreign direct investment |
| G | ratio of benefits to contributions |

| | |
|--------|--|
| GDP | gross domestic product |
| HCP | High Commission for Planning, Government of Morocco |
| ILO | International Labour Organization |
| IMF | International Monetary Fund |
| ITCEQ | Tunisian Institute of Competitiveness and Quantitative Studies |
| Karama | cash transfer program for the elderly and people with disabilities (Arab Republic of Egypt) |
| LAC | Latin America and the Caribbean |
| LE | Egyptian pound |
| LFPR | labor force participation rate |
| MENA | Middle East and North Africa |
| MIE | main income earner |
| MoF | Ministry of Finance (Tunisia) |
| MoMM | Ministry of Manpower and Migration (Arab Republic of Egypt) |
| MoSA | Ministry of Social Affairs (Tunisia) |
| MPED | Ministry of Planning and Economic Development (Arab Republic of Egypt) |
| MSMEs | micro, small, and medium-size enterprises |
| NEET | not in education, employment, or training |
| NHIO | National Health Insurance Organization (Arab Republic of Egypt) |
| NIS | National Institute of Statistics, Government of Tunisia |
| NOSI | National Organization for Social Insurance (Arab Republic of Egypt) |
| ODR | other developing regions |
| OECD | Organisation for Economic Co-operation and Development |
| PIT | personal income tax |
| PNAFN | National Program of Assistance to Needy Families (Programme national d'aide aux familles nécessiteuses) (Tunisia) |
| PPP | purchasing power parity |
| RACI | social insurance for artists and intellectuals in the private sector (régime des artistes, des créateurs et des intellectuels) (Tunisia) |
| RAMED | Medical Assistance Plan (Morocco) |
| RIA | general scheme for agricultural employees in the private sector (régime des indépendants agricole) (Tunisia) |
| RINA | general scheme for nonagricultural self-employed workers in the private sector (régime des indépendants non agricoles) (Tunisia) |
| RSAA | general scheme for agricultural employees in the private sector (régime des salariés agricole amélioré) (Tunisia) |
| RSNA | general scheme for nonagricultural employees in the private sector (régime des salariés non agricoles) (Tunisia) |

| | |
|---------|---|
| RTFR | social security insurance for low-income salaried workers in the private sector (régime des travailleurs à faible revenu) (Tunisia) |
| SAR | South Asia Region |
| SMAG | guaranteed minimum agricultural wage |
| SMIG | guaranteed minimum interprofessional wage |
| SOE | state-owned enterprise |
| SSA | Sub-Saharan Africa |
| Takaful | cash transfer program for families with children (Arab Republic of Egypt) |
| Tayssir | cash transfer program for children (Morocco) |
| TD | Tunisian dinar |
| TFP | total factor productivity |
| UNDP | United Nations Development Programme |
| VAT | value added tax |
| WHO | World Health Organization |
| WIEGO | Women in Informal Employment: Globalizing and Organizing |

Overview

INTRODUCTION

The long-standing informality debate in the Middle East and North Africa (MENA) has taken on new urgency as the region looks for a pathway to more socially inclusive growth that is less reliant on fossil fuels. This is occurring against a backdrop of subpar labor market outcomes, further growth setbacks, and deteriorating fiscal and current account deficits in the aftermath of the COVID-19 (coronavirus) pandemic—and in the wake of high inflation and supply chain disruptions triggered by the Russian Federation–Ukraine war.

It is well recognized that a key pathway to making MENA's growth more inclusive lies in stronger job creation in the private sector (Assaad 2014; World Bank 2014). But this sector has not only underperformed in this area; it has also largely created jobs that do not provide social protection benefits: at 68 percent, MENA features one of the highest rates of informal employment after Sub-Saharan Africa and Asia and the Pacific (figure O.1). At the same time, the public sector has remained the dominant source of formal employment.

A focus on understanding informal employment in the region is timely. Governments are increasingly seeking to move away from reliance on universal subsidies and job creation in the public sector—elements that have been the cornerstone of the social contract. The high level of informality matters greatly for several reasons:

- A large share of workers (and thus households) does not participate in social insurance, which hinders the efficiency and inequality-reducing power of social protection systems via limited coverage, reduced risk pooling, and limited redistribution.

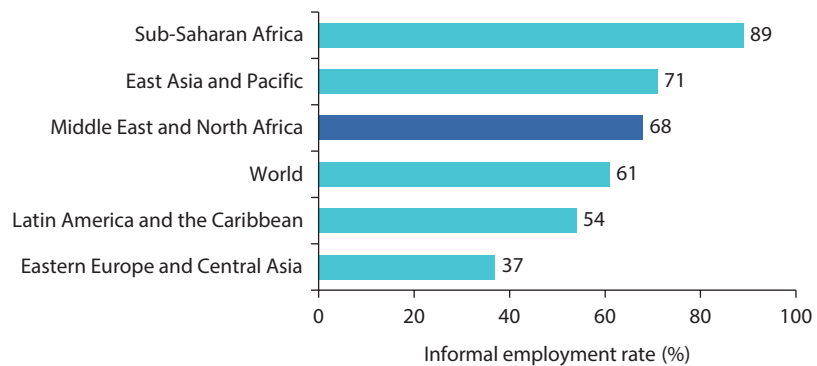
- Informal employment tends to be associated with small firms—and the concentration of resources in such firms can dampen productivity and economic growth.
- Informality limits domestic revenue mobilization, which diminishes the fiscal space to provide high-quality public goods and services.
- Informality represents deeper structural challenges in the economy, as it locks countries in a low-level equilibrium, which results in subpar and inequitable growth.

What do we know about the causes and correlates of informality in MENA? Some studies find that policy changes that reduce the costs of formality or increase labor market flexibility boost formal employment and vice versa (Angel-Urdinolo, Gadir Barry, and Guennouni 2016; Souag and Assaad 2017; Wahba and Assaad 2017). Others find that institutional labor reforms may not equally translate into positive outcomes for the informal sector due to segmented labor markets, leaving the informal sector no incentives to formalize (Boughzala 2017). Some studies point to the limited dynamism in the private sector and stagnating private investment as causes of informality in MENA (World Bank 2014, 2021a; World Bank, EBRD, and EIB 2022). Together, these findings suggest that there is no single cause of informality, and the size of the informal sector likely depends on a combination of factors.

This report aims to better explain the characteristics and incentive structure that have led to the prevalence of informal employment in three MENA countries (that is, the Arab Republic of Egypt, Morocco,

FIGURE O.1

Informal Employment Rates, by Region, 2019



Source: Based on data from ILO 2019.

and Tunisia, collectively referred to as “pilot countries” hereafter). It breaks new ground by adopting a comprehensive perspective to focus on features of, and interrelationships between, various aspects of a country’s institutional landscape—such as contributory and noncontributory social insurance, labor regulations, taxes, and market conditions—to make sense of the complex incentive structure that workers and firms face when deciding whether to work formally or informally. The report groups these issues in three broad realms: Realm 1, entrepreneur-worker relations; Realm 2, taxes and transfers; and Realm 3, market conditions.

The hope is to enable MENA countries to:

- Design better social protection systems to protect workers and their families against contingencies such as illness, longevity, job loss, disability, and work accidents, as well as vulnerability or poverty.
- Improve the functioning and effectiveness of the welfare state with more effective risk pooling and higher tax revenues to help reduce inequality.
- Incentivize firms to grow and thereby raise overall productivity and economic growth in the long run.

The report is based on an in-depth institutional analysis of the three broad realms in the pilot countries, which, as of 2021, collectively accounted for about 38 percent of MENA’s population and 39 percent of MENA’s gross domestic product (GDP).¹

Four key messages emerge from the report:

- At 68 percent in MENA, informality matters as it: (1) hinders social protection systems in terms of coverage, risk pooling, and redistribution; (2) dampens productivity and economic growth; (3) diminishes tax revenues; and (4) can lower the quantity and quality of the provision of public goods and services.
- The current design of social protection systems offers suboptimal coverage to workers and their families, delivers little redistribution, and often provides inadequate protection against risks, particularly risks associated with longevity and health. Combined with the minimum wage and collective agreements; lengthy, costly, and complicated dismissal procedures; and weak enforcement of labor regulations, this encourages informality and hampers productivity growth.
- The existence of special tax regimes, loopholes, and exemptions hurts firm expansion, productivity growth, and formal job creation, which

are all compounded by a lack of tax enforcement. In addition, enterprise registration offers few benefits to firms in terms of enforcement of commercial and credit contracts, providing little incentive to register and operate formally.

- Addressing informality and achieving higher and more inclusive growth would require a policy shift leading to a social protection and tax system in which all citizens have access to basic health services and enjoy at least a minimum income in old age, and there are no special tax regimes, while promoting the creation and growth of businesses with high productivity.

MENA'S TRACK RECORD: A NEED FOR MORE SOCIALLY INCLUSIVE GROWTH

Over the past two decades, the economic performance of the MENA Region—that is, the low- and middle-income countries but not the high-income ones—has been subpar compared to peers in a similar income category.² Between 2000 and 2019, their GDP per capita increased on average by 1.7 percent per year, while other developing regions, such as East Asia and Pacific and South Asia, experienced growth rates about two times as high. As a result, MENA has lost ground, and income gaps with other developing regions, such as East Asia and Pacific and South Asia, have widened.

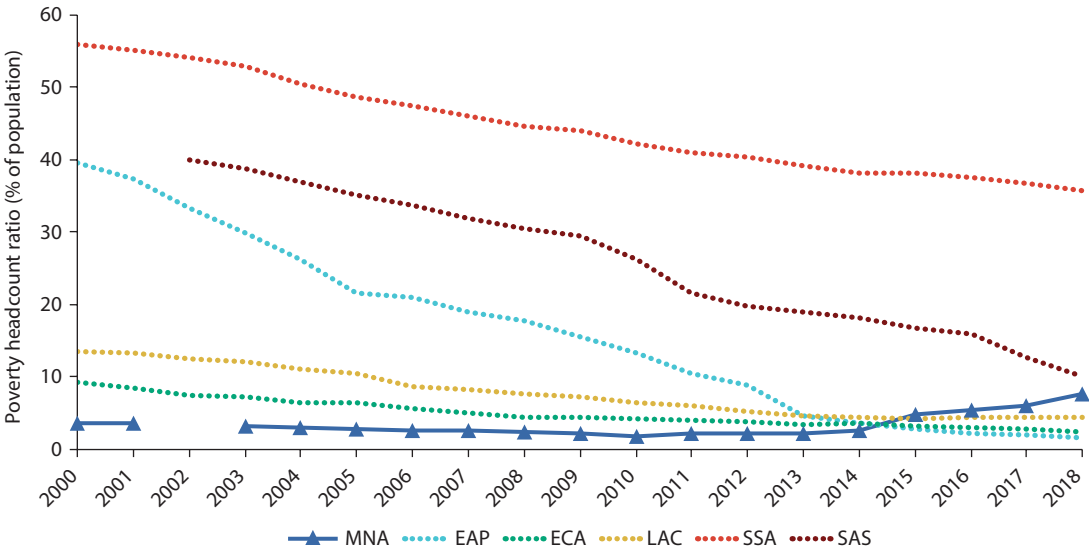
The modest economic growth not only generated few jobs compared to the size of the working-age population but also few jobs of good quality. Labor market outcomes also remain unsatisfactory across the board. In 2019, MENA stood out for the lowest employment-to-population ratio, at 38.2 percent; the lowest female labor force participation rate, at 19.5 percent; the highest youth unemployment rate, at 27.9 percent; and the largest share of youth “not in education, employment, or training,” at 26.9 percent in North Africa and 34.2 percent in the Arab states (World Development Indicators and ILOSTAT).

Further, there has been little improvement in living standards. Although the international measure for extreme poverty (those living on less than US\$2.15 income per day, 2017 purchasing power parity) remained lower in MENA than in other regions between 2000 and 2014, it grew by 56 percent between 2015 and 2018—from 4.8 percent to 7.5 percent—making MENA the only region where poverty has been increasing in recent years. This compares with 2.4 percent in Europe and Central Asia, 4.3 percent in Latin America and the Caribbean, and 35.7 percent in Sub-Saharan Africa in 2018 (figure O.2).

In the pilot countries, the results are mixed. In Morocco, the poverty headcount rate, measured against the national poverty line, declined considerably, thanks to “pro-poor” growth, coupled with investments in education, health, and other social services, whereas transfers and subsidies were largely regressive (World Bank 2018). In Tunisia, the acceleration of the rate of poverty reduction between 2010 and 2015 was associated with more public transfers (World Bank 2022a). However, progress has been limited in Egypt, where the lower poverty headcount achieved between 2012 and 2015 was undone between 2015 and 2017.

Faced with declining life satisfaction, citizens in MENA countries are once again questioning the ability of governments to deliver on the “social contract” that emerged post independence: a quid pro quo in which the government would provide jobs in the public sector, free education and health care, and subsidized food and fuel, in return for citizens keeping quiet and tolerating some degree of repression and elite capture in the private sector (Ianchovichina and Devarajan 2021). According to Arab Barometer data, citizens in the pilot countries are becoming increasingly dissatisfied with their country’s economic situation. In Morocco and Tunisia, the share of respondents describing their country’s economic situation as “bad” or “very bad” rose from 49.0 and

FIGURE O.2
Poverty Level, by Region, 2000–18



Source: Based on data from the World Development Indicators, World Bank.
Note: The poverty headcount ratio is calculated based on US\$2.15 per day, 2017 purchasing power parity. EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MNA = Middle East and North Africa; SAS = South Asia; SSA = Sub-Saharan Africa.

70.6 percent in 2010, respectively, to 56 and 90.7 percent in 2018. In Egypt, by contrast, the share of negative responses fell from 75.4 to 44.1 percent over the same period.

Recently, some governments in the region have started to acknowledge the need for a new development model and a new social contract. Here, it is important to note that this report's review period leaves out pertinent reforms introduced after 2019 in Egypt—including the new social insurance law that extends protection to irregular employees (temporary and seasonal workers), who were previously exempted. Similarly, since 2020, Morocco has gradually extended specific components, namely, health insurance, of contributory social insurance to certain categories of own-account workers.

HOW DOES THIS REPORT MEASURE INFORMALITY?

Informality arises from a nexus of factors, and thus it is not surprising that—despite its prevalence in the developing world—it does not have a universal definition. In some cases, it is viewed in terms of the shadow economy, unaccounted-for proportions of GDP, or even illegal economic activity. In others, it is seen as a lack of compliance among firms in terms of registration or tax obligations or other applicable regulations, lack of social security coverage of workers, or lack of written contracts.

Importantly, informality assumes different meanings according to the interlocutor. A minister of finance and a businessperson might be more concerned about informality in terms of the amount of taxes to be paid; a minister of labor or a union leader might think about the lack of social insurance and noncompliance with job stability and minimum wage regulations among workers; and the average citizen might think of a street vendor not complying with health and safety standards or not issuing a receipt of purchase.

In this report, informality refers to informal employment—defined as workers, salaried or nonsalaried, not covered by contributory social insurance (see box O.1). This means that informal workers are not insured against risks (such as illness, work accidents and disability, loss of life, longevity, and loss of employment). In principle, firms are defined as informal if they employ all their workers informally, while they are considered formal if they employ at least one worker formally.

Formality and informality may best be seen as states of employment: workers might start working informally and then contribute from a certain point of their working life onward; or they might continuously alternate periods of informality and formality as they contribute (perhaps, for example, only a few months in a year). In addition, the same

BOX O.1**Slight Variations in How Informality Is Defined for the Three Realms of the Institutional Landscape for Informal Employment**

Throughout this report, informality refers to informal employment—defined as workers, salaried or nonsalaried, not covered by contributory social insurance. The one exception is for the in-depth analyses of tax systems (Realm 2) and market conditions (Realm 3), where firms are defined according to their registration status. This adjustment reflects the absence of representative enterprise surveys that match firms and workers.

The two definitions largely overlap because (1) unregistered firms cannot hire formal workers, and (2) registered firms are formal under the first definition, as they very likely hire at a minimum one worker formally.

In addition, for market conditions, the first definition is applied implicitly, given that:

- Registered firms can hire formal workers and compared to unregistered firms, registered firms are more likely to be caught and sanctioned for hiring informal workers.
- Strong contract enforcement encourages firms to register with official authorities to benefit from the regulatory environment (including secure and low-cost transactions and credit contracts).
- Contestability drives the natural selection of firms and increases the integrity and benefits of the regulatory environment, encouraging firm registration and growth.

worker could hold both formal and informal jobs. Such fluidity in labor markets implies that a full understanding of the incentives and disincentives built into institutions, laws, regulations, and policies might be complex.

An in-depth analysis of the pilot countries shows that informal employment need not violate the law and that legal provisions contribute to shaping the extent of informality observed. That is why this report argues for the need to go beyond enforcement as a solution to tackling informality and to consider the role of workers' and firms' incentives that result from how laws, regulations, and institutions are designed.

In the pilot countries, the legal framework, which differs significantly among them, consists of the constitution and labor and social security codes. It establishes rights and responsibilities for employers and workers, including for social insurance (table O.1):

- In Tunisia, almost every worker must contribute to social insurance, except unpaid family workers, which means that almost all informal employment is illegal.
- In Morocco, only private and public sector wage and salaried workers must contribute, which means that for most categories of workers (like employers, own-account workers, and contributing family workers), informal employment is legal.
- In Egypt, only private sector wage and salaried workers in regular employment and public sector workers must contribute, which means that for some categories of workers (like wage and salaried workers in irregular employment, own-account workers, and contributing family workers), informal employment is legal.

The legal framework—together with firms' and workers' compliance with it, the composition of employment, and the degree of enforcement—impacts the size and composition of informal employment. Among the pilot countries, the overall rate of informal employment ranges from 43.9 percent in Tunisia to 62.5 percent in Egypt and 77.3 percent in Morocco (figure O.3). One reason informality varies by country is because some countries exclude by law specific categories of workers from contributory social insurance, implicitly allowing legal informal employment. Among workers who must contribute to social insurance, as defined in table O.1, about 54 percent do not do so in Tunisia, compared to about 65 percent in Morocco and Egypt.

The problem is that limiting the number of workers who must contribute to social insurance *de facto* imposes a constraint on the extent of risk pooling that the contributory pillar can achieve, as well as on the amount of revenues that the system can potentially raise.

Moreover, the viability of contributory social insurance systems, including their ability to protect workers, is reduced by job transitions, with the same worker switching between informal and formal jobs over their lifecycle. This decreases the appeal of contributory social insurance, as workers do not know for how long they will be formally employed, or if they will be able to benefit from their social security contributions—such as through benefits in the distant future, like an old-age pension. In Morocco, in 2019, only half of registered private salaried workers paid contributions for the entire year, whereas the rest contributed for a fraction of the year, thus operating semi-informally. In Egypt, from 2012 to 2018, about 16 percent of (illegal) informal salaried workers became formal and 24 percent of formal salaried workers became (illegal) informal salaried workers.

TABLE O.1

Informal Employment, by Type of Work, Arab Republic of Egypt, Morocco, and Tunisia, 2018 and 2019

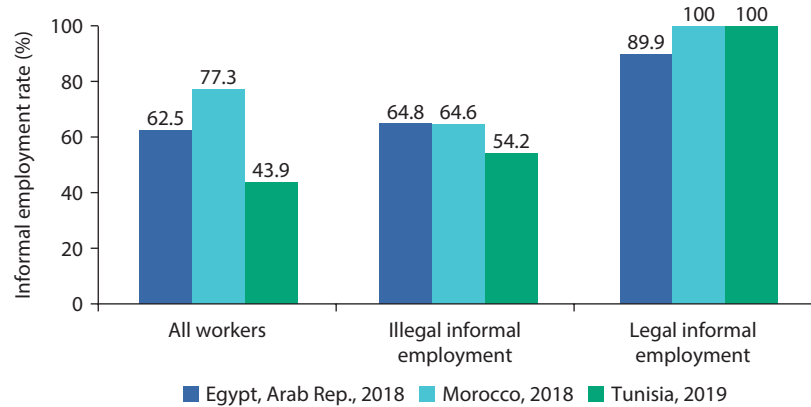
| | Egypt, Arab Rep. (2018) | | | | | Morocco (2018) | | | | Tunisia (2019) | | | |
|----------------------------|-------------------------|------------------------------------|--------------------------------------|---------------------------------|-----------------------------|-----------------------|--------------------------|---------------------------------|-----------------------------|-----------------------|--------------------------|---------------------------------|-----------------------------|
| | Public sector workers | Private sector employees (regular) | Private sector employees (irregular) | Own-account workers / employers | Contributing family workers | Public sector workers | Private sector employees | Own-account workers / employers | Contributing family workers | Public sector workers | Private sector employees | Own-account workers / employers | Contributing family workers |
| Retirement pension | Green | Red | Red | Red | Red | Green | Red | Red | Red | Green | Green | Green | Red |
| Health insurance | Green | Red | Red | Red | Red | Green | Red | Red | Red | Green | Green | Green | Red |
| Family allowance | Red | Red | Red | Red | Red | Green | Red | Red | Red | Green | Green | Green | Red |
| Unemployment allowance | Green | Red | Red | Red | Red | Green | Red | Red | Red | Green | Green | Green | Red |
| Sickness/maternity benefit | Green | Red | Red | Red | Red | Green | Red | Red | Red | Green | Green | Green | Red |
| Work accident insurance | Green | Red | Red | Red | Red | Green | Red | Red | Red | Green | Green | Green | Red |

Source: Original table for this publication.

Note: Green cells indicate that workers are covered by law against a specific risk and thus informal employment is illegal; red cells indicate that workers are not covered by law against a specific risk and informal employment is legal.

FIGURE O.3

Informal Employment Rates, by Sector, Arab Republic of Egypt, Morocco, and Tunisia, 2018 and 2019



Sources: Calculations based on Labor Force Surveys in the Arab Republic of Egypt (2018); Morocco (2018); and Tunisia (2019).

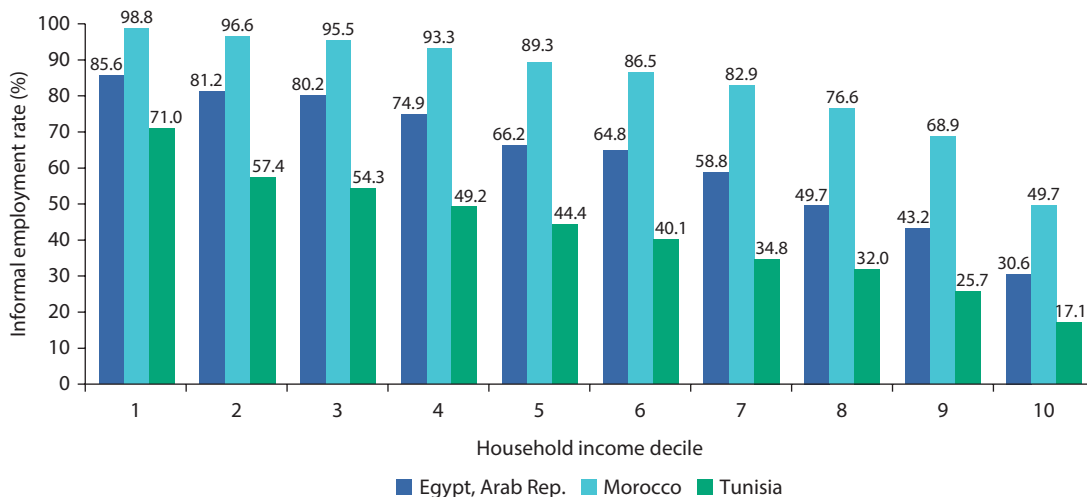
Note: The percentages are for the most recent year available. The groups of bars refer to informal employment rates among all workers and illegal and legal informal employment rates among private sector workers, respectively.

The evidence of informal-formal transitions implies that for some workers, informality is not only an outcome of exclusion but also a choice. This is further confirmed by its pervasiveness across income levels: in Egypt, Morocco, and Tunisia, 31, 50, and 17 percent of workers, respectively, among households in the highest welfare deciles, are informally employed, representing more than 5 percent of the countries' entire populations (figure O.4). The same is true for the presence of informality across education levels: in Egypt, Morocco, and Tunisia, 31, 31, and 14 percent of informal workers, respectively, have a university degree. In addition, the wage distributions of formal and informal wage workers partially overlap, which means that some informal workers earn more than some formal ones.

Informality is mostly concentrated in small firms, which represent the largest section of the production fabric in the pilot countries. In Tunisia, about 97 percent of firms employ fewer than 10 workers and contribute almost 65 percent to total employment. In Morocco, small firms with fewer than 10 workers contribute around 90 percent of informal wage employment and 30 percent of formal wage employment. In Egypt, about 53 percent of total employment is concentrated in micro firms with fewer than five workers.

FIGURE O.4

Informality Rates, by Income Decile Levels, Arab Republic of Egypt, Morocco, and Tunisia



Sources: Based on data from CAPMAS 2018 for the Arab Republic of Egypt; HCP 2015 for Morocco; NIS 2015 for Tunisia.

Note: Due to data limitations in the case of the Arab Republic of Egypt, it was not possible to use deciles of per capita household expenditures—alternatively, wealth deciles were constructed based on a factor analysis approach using household ownership and durable assets and housing conditions.

FRAMEWORK FOR THE REPORT

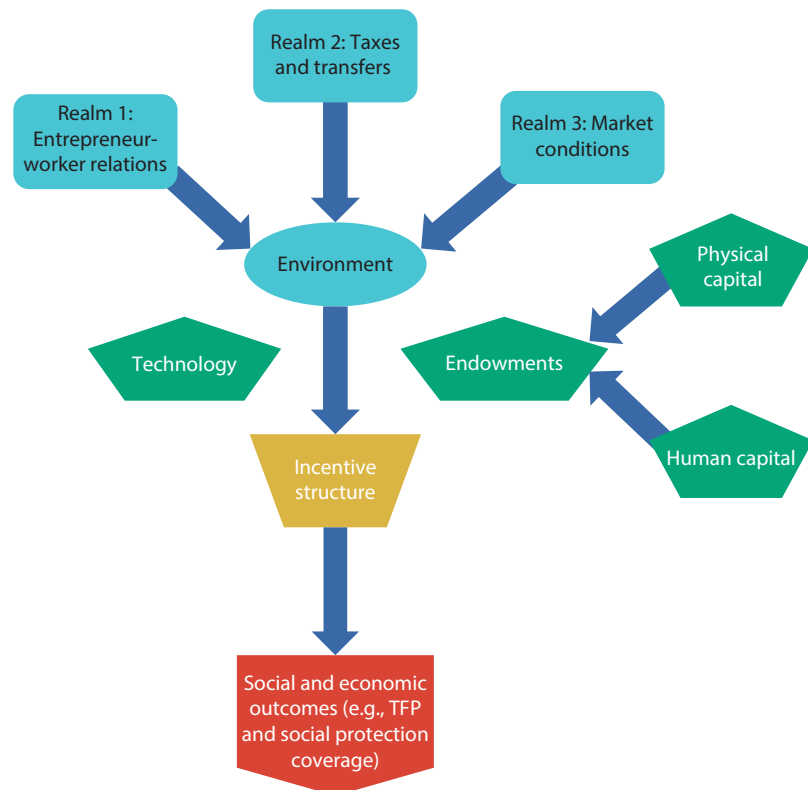
This report adopts the framework put forward by Levy and Cruces (2021) to shed light on the legal, regulatory, and institutional context affecting the incentives and disincentives that economic agents—primarily workers and firms—face to operate (in)formally in selected MENA economies. A cornerstone of the framework is that informality is endogenous to the legal, regulatory, and institutional context in which firms and workers operate and make decisions. The size of the informal sector is not given and grows larger or shrinks depending on a country’s environment. In other words, it does not represent a constraint but rather an outcome of the institutional context that economic agents face.

The framework focuses on the legal, regulatory, and institutional context affecting incentives and disincentives that economic agents (primarily workers, firms, and banks) face to operate (in)formally. This “environment”—what economic agents consider the “rules of the game”—influences these decisions, based on a set of incentives

determined by laws, institutions, and policies, as well as by the functioning of institutions that enforce and determine the extent of the rule of law function. It is composed of three broad realms: Realm 1, entrepreneur-worker relations; Realm 2, taxes and transfers; and Realm 3, market conditions (figure O.5). Unlike approaches that view the drivers of informality through a single lens, this approach takes a comprehensive perspective to focus on features of, and interrelationships between, each broad realm of the environment to make sense of the complex incentive structure that different groups of workers and firms face when making economic decisions. Together with technology and countries' endowments of physical and human capital, this determines social and economic outcomes, including social protection coverage, distribution of income,

FIGURE O.5

The Environment and Social and Economic Outcomes in a Country



Source: Original figure for this publication.

Note: TFP = total factor productivity.

poverty and inequality, productivity (total factor productivity), and economic growth.

In the context of this report, the environment creates an incentive structure that influences actors' decisions to operate informally or formally. For example, the design of social insurance systems affects employers' and workers' preferences to operate formally because of factors such as contribution rates, risk coverage, and the quality of services provided. Similarly, if the tax burden associated with operating formally (fully or partially) is high and enforcement is weak, economic agents may opt for hiding under the radar and operate informally.

Informality can increase for various other reasons: (1) if it is costly for firms to register their business or resolve commercial disputes, (2) if it is cumbersome or risky to obtain credit because of high collateral requirements or uncertainties linked to protection of borrowers' and lenders' rights, or (3) if markets are uncontestable due to corruption and unfair competition. Whatever the reason, if firms and workers perceive few benefits from formalization, or these benefits are low compared to informal alternatives, informality will remain high.

Although the report applies both quantitative and qualitative methods to understand why workers and firms are informal, data limitations are severe and constitute a significant caveat. In the pilot countries, the report gauges how informality is influenced by the design of the social protection system and labor regulations, the tax system, and market conditions. It uses household survey data, tax and social security administrative data, secondary sources from international organizations and academics, and, for Morocco, interviews with workers and employers. On the investigative nature of the work, there were significant challenges in accessing data in areas like wage distributions, contribution densities, number of taxpayers, and firms (especially those operating in the informal sector). Thus, some of the results should be taken with an element of caution. Future analysis will help to shed light on areas that are not fully explored in this report due to important data gaps.

REALM 1: INFORMALITY AND ENTREPRENEUR-WORKER RELATIONS

The design and implementation of contributory social insurance provides suboptimal coverage to workers and their families. This occurs for several reasons. First, informality does not necessarily mean poverty or vulnerability. In the pilot countries, the share of informal workers who are neither poor nor vulnerable ranges from 63 percent in Egypt, to 70 percent in Tunisia, to over 90 percent in Morocco. Even so, informal

workers and their families are not covered against longevity and health risks unless they can afford private insurance, meaning that they might become poor or vulnerable in old age or in case of a health shock. Informal workers are also left without protection in case of work accidents that might lead to temporary or permanent disability and in case of job loss, as well as without entitlement to sickness, maternity, or annual leave.

Second, many workers who should contribute to social insurance do not. This defeats the purpose of social insurance and limits the extent of risk pooling—thus delivering suboptimal coverage even to formal workers compared to a scenario where every employer and worker who is required to pay contributions does so.

Third, the exclusion of specific categories of workers by design further limits the efficacy of the contributory system. In Egypt and Morocco, employers and own-account workers are not required to contribute to social insurance (as of the latest available year used in the analysis, 2018 or 2019). However, these countries have recently started to extend social insurance coverage to specific categories of self-employed workers, using a system that works similarly to the one currently in place for private sector employees for health insurance and a retirement pension.³

Contributory social insurance delivers little redistribution, given strong incentives for high earners to be formal but few incentives for low earners. The labor markets in the pilot countries feature an important public/private wage employment divide, with the public sector providing on average better monetary and nonmonetary benefits and job security. Contributory social insurance makes the situation worse by providing higher-quality social insurance benefits at a lower cost to public sector workers (such as family allowances at no cost to workers and access to better health insurance). In the private sector, workers with short formal careers are likely to be taxed, as they do not contribute continuously to social insurance, making it less likely for them to meet the eligibility requirements. Further, the probability of working formally for long periods of time is likely to be higher on average among high-wage workers, which defeats the redistribution component of the system.

Pension systems do not provide adequate protection against the longevity risk to private sector workers with short formal careers. Pension systems are designed as pay-as-you-go and feature important discontinuities that can play in favor of informal employment. In the pilot countries, the pension systems base benefits on the number of years of contributions. Workers who do not meet the minimum number of years of contributions are entitled to a lump sum that corresponds to the contributions the

workers paid, but it excludes the contributions paid by their employers. In other words, such workers are taxed by contributory social insurance, with the amount of the tax corresponding to the discounted value of contributions paid by employers.

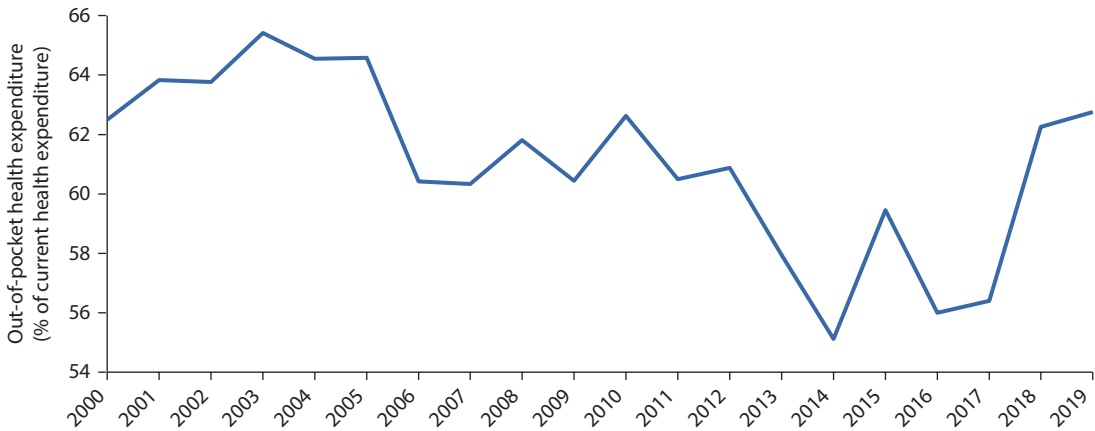
This feature exposes such workers to longevity risk, as no right to an annuity is accrued. It also exposes them to health risk, as the elderly without entitlement to a pension benefit are left without health insurance. On the one hand, the pension systems in Egypt, Tunisia, and Morocco redistribute from informal and low-wage workers who do not accumulate the minimum number of years of contributions to formal and high-wage workers. Moreover, for workers who meet the eligibility requirements, the system is more than actuarially fair, as it provides retirees a pension that is higher than what they paid for and provides little incentive to contribute beyond the minimum number of years required by the law. On the other hand, in countries like Tunisia, which lack wage ceilings for contributions and a cap for benefits, there is an element of redistribution from high- to low-wage workers.

Contributory health insurance does not deliver good coverage to workers in the private sector, thereby exposing households to hefty out-of-pocket health expenditures. Although specific features of contributory health insurance vary across the pilot countries, in practice, access to health care services depends on workers' income level, despite all formal employees being covered in principle. Long waiting lines, the low quality of services provided, and regional imbalances push workers to opt for private providers. However, workers are only refunded a percentage of the legal tariff, which is typically lower than the market price that families actually paid. Contributory health insurance is an option that only high-wage workers can afford, and it comes at the cost of high catastrophic health expenditures for the rest.

In Egypt, it is common for employers in the upper segment of the labor market to opt out of the system, to provide workers better service quality, although this defeats the purpose of insurance risk aggregation across the private sector. Such opting out helps explain the large (and growing) share of out-of-pocket health expenditure in Egypt—which has remained high, despite fluctuations, at about 63 percent since 2000 (figure O.6).

Noncontributory social insurance provides partial and erratic coverage. Informal workers who belong to poor or vulnerable households typically have access to noncontributory social insurance, which provides free or subsidized health insurance—but it does not provide a retirement pension benefit or protection against disability, death, accidents at work, or job loss.

FIGURE 0.6

Out-of-Pocket Health Expenditures, Arab Republic of Egypt, 2000–19

Source: Based on World Bank data.

In Morocco and Tunisia, poor and vulnerable workers who are employed informally receive free or subsidized health coverage, which grants them access to public health care facilities. In Egypt, every uninsured person has access to public hospitals and health care facilities at a subsidized rate. There are also cash transfer programs (Le Programme National d'Aide aux Familles Nécessiteuses [PNAFN] in Tunisia, Tayssir and Project DAAM in Morocco, and Takaful and Karama in Egypt) that provide income support to help the poor make ends meet.⁴ Although these programs can be helpful if they are designed as a temporary support to help poor families invest in the human capital of their children to break the intergenerational transmission of poverty, they do not provide insurance and protection against contingencies.

Noncontributory social insurance might act as a subsidy to informal employment, particularly for low-wage workers. In Tunisia, the incentives for private sector wage workers to comply with contributory social insurance are weak. Being formal and paying social security contributions would imply the loss of both free or subsidized health care and cash transfers. Insurance provided for other risks, particularly a retirement pension, might give little value for money. However, in Egypt and Morocco, the noncontributory pillar does not seem to have direct effects on the incentives to work formally. Even so, in a context of constant supply of health care and inadequate resources, free or subsidized health care might reduce the value of contributory health insurance for low earners—who must use the same public channels as formal workers and are less likely to be able to afford to opt for private health care.

Most social protection expenditures are absorbed by contributory social insurance, particularly for public sector workers, and little is captured by social assistance. In the pilot countries, expenditures on contributory social insurance for salaried workers account for the largest share of social program outlays—with Egypt, Tunisia, and Morocco spending 10.9, 11.7, and 6.6 percent of GDP, respectively. This compares to the averages of 6.1 percent of GDP for lower-middle-income countries, 10.3 percent for upper-middle-income countries, and 17 percent for high-income countries.⁵

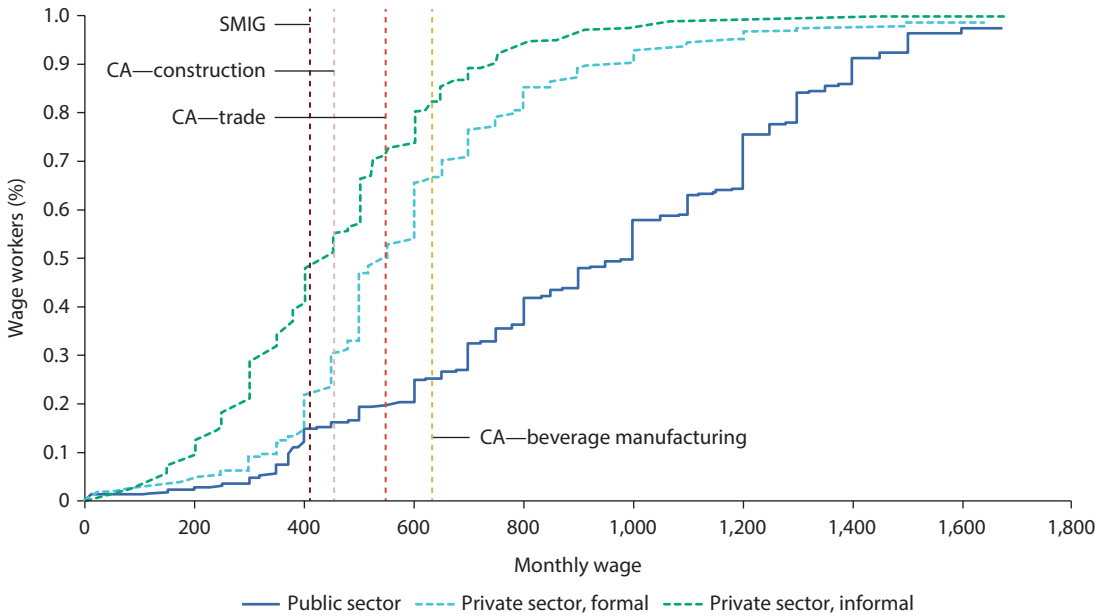
Moreover, universal consumption subsidies, aimed at providing households specific consumption items below market price, absorb a considerable amount of public resources. In Egypt, Morocco, and Tunisia, they represented 5.6, 1.30, and 3.91 percent of GDP, respectively, in 2019. However, universal consumption subsidies provide more advantages to the middle class and the most affluent households, as such households consume more of the items typically subsidized (such as gasoline, electricity, and gas), thereby adversely impacting income inequality.

Minimum wages might be set at levels too high for workers with low levels of productivity—as is occurring in Tunisia. The minimum wage in Tunisia is about 79 percent of the median wage (the same as in Egypt), and in Morocco, it is about 51 percent of the average wage.⁶ In Tunisia, collective agreements impose higher minimum wage levels for specific sectors and establish the extent of wage increases, which might not always be well suited to the economic and financial conditions of all firms operating in specific sectors (figure O.7). This might further push employers to hire at least some of their workforce informally, as they cannot shift back the cost of labor in the form of a lower wage to workers. Moreover, Tunisia's wage floor is high by international standards—in developing and emerging economies, the average is about 67 percent of the median wage. In Egypt, although the minimum-to-median-wage ratio is comparable to other developing countries, private sector workers were unable to benefit until 2022.

Firing costs and dismissal procedures might further hinder formality, as firms need flexibility to adjust the workforce in case of shocks. In Egypt and Morocco, dismissal costs (excluding damages) start at about 8 and 4 percent of workers' wages, respectively, and increase with seniority. In Tunisia, based on the labor code, the cost of dismissal (excluding damages) is 5 percent of accumulated wages, while it is 6.25 percent if a sectoral agreement is in place, and both decline with seniority. However, uncertainty about the length of dismissal procedures might push firms to hire part of their workforce informally. Often, strict firing regulations are created as a substitute for limited, or lack of, unemployment insurance—but they are not a good substitute, as they protect formal workers while shifting the risk to informal workers.

FIGURE O.7

Minimum Monthly Wages, by Sector, Tunisia, 2019



Source: World Bank 2022a.

Note: The figure shows the cumulative distribution function of monthly wages of private (by formality status) and public sector wage workers in 2019. Monthly wages are expressed in TD (2019 prices). CA = collective agreement; SMIG = minimum monthly wage for nonagricultural workers, set at TD 403 in 2019.

Enforcement of labor laws and regulations is weak. Given low penalties and a low probability of getting caught due to limited resources available for labor inspections, the pilot countries cannot implement an adequate level of enforcement of labor laws and regulations, thus facilitating evasion of labor regulations and informal employment.

REALM 2: INFORMALITY AND THE TAX SYSTEM

Preferential tax treatment offered by “special regimes” attracts many small, unincorporated enterprises. Special regimes are often implemented with the intention of facilitating participation of self-employed and micro firms in contributory programs and bringing them within the purview of the tax authority. They provide preferential tax treatments to specific enterprises compared to those obtained under the corporate income tax regime. Such treatments are granted if firms meet certain requirements—such as single ownership or limited partnership, operating as an unincorporated business, and keeping annual sales below specified thresholds.

- In Tunisia, individual enterprises can file their tax returns under one of two special regimes and pay a flat rate or 3 percent on sales if their annual sales are below a specific threshold. Their tax burden compares favorably to those of enterprises in the personal income tax (PIT) and corporate income tax (CIT) regimes, which charge minimums of 26 and 25 percent, respectively, and they are also exempt from value-added tax (VAT). Here, an individual enterprise refers to a firm owned by a single person, that is, with only one shareholder, registered as a natural person regardless of the number of employees, and with no distinction and no separation between assets of the owner and assets of the enterprise.
- In Morocco, self-employed workers can apply for auto-entrepreneur status and benefit from preferential tax rates and VAT exemption, if their turnover is less than DH 500,000 (or DH 200,000 for those operating in the service sector, equivalent to about US\$55,617 and US\$22,247, respectively).
- In Egypt, commercial and industrial unincorporated enterprises structured as sole proprietorships and simple partnerships can file taxes under the PIT regime regardless of their size. The tax burden is significantly less than the CIT regime: the highest personal income tax rate is equal to the standard corporate income tax rate of 22.5 percent.

However, this comes at a cost as special tax regimes are inconducive to firm expansion, productivity growth, and formal job creation. The reasons why are many. First, special regimes do not generate incentives to expand the size of enterprises beyond the qualifying threshold, and firms will only do so if they expect sales to rise such that after-tax profits are higher than before, which is unlikely to occur for most micro and small firms. Second, the special regimes help micro and small enterprises that operate at low productivity levels to survive, which distorts the natural process of firm selection, trapping resources in unproductive firms rather than more productive ones. Third, operating at small scale reduces firms' likelihood of being caught by tax enforcement authorities and sanctioned, thereby encouraging fraudulent behavior and informality.

Special regimes interact with other taxes in pilot countries, such as the VAT, distorting market dynamics further and stifling productivity and formality. In Morocco and Tunisia, small firms and the self-employed under special regimes are exempt from paying the VAT, which encourages them to remain small and pay lower taxes. It also discourages interacting with other firms, as goods and services purchased from a firm under the special regime cannot be included in the calculation of the deductible VAT. As a result, firms and the self-employed under the special regime mostly trade with other informal firms or sell to final consumers—a situation

that prevents technical and technological knowledge transfer and inhibits economies of scale, growth, value chain development, and the creation of formal jobs.

The structure of the PIT regime can disincentivize formal employment of low-wage workers. In the pilot countries—especially in Tunisia—low-wage earners, particularly those earning an annual income around the minimum wage, have little incentive to pay income taxes. The marginal tax rate rises sharply from zero for workers earning a monthly income at or below the minimum, to 26 percent in Tunisia and to 10 percent in Egypt and Morocco. This might further discourage formal employment of low-wage workers, given the few incentives provided by contributory social insurance, the minimum wage, and dismissal regulations.

The lack of tax enforcement encourages tax evasion and informality, which raises the cost of formality. Tax enforcement is weak because of poor information exchange and communication between tax authorities and a lack of human and financial resources. As a result, tax evasion and underreporting are widespread. In Tunisia, tax fraud was estimated at US\$8.5 billion—or 20.4 percent of GDP—in 2019 (Bouzaiene 2021), while in Morocco, as much as US\$2.45 billion—or about 2 percent of GDP—was lost due to the tax practices of multinational corporations alone in the same period (Oxfam and Reuters 2021). As a result, a small number of taxable formal private and public wage workers and mostly large firms face a high tax burden compared to most economic actors in their respective countries. As of 2019, Tunisia’s and Morocco’s tax burdens were comparable to the Organisation for Economic Co-operation and Development (OECD) average despite having a narrower tax base, representing 25.1 and 21.4 percent of GDP, respectively, while it was slightly lower in Egypt, at 15.5 percent (IMF 2022). Still, weak enforcement coupled with a high tax burden increases the appeal of arbitrage, fraud, and evasion among workers and firms in the pilot countries, as the probability of getting caught is low and most other economic agents do not pay direct taxes. This situation produces a vicious circle of informality, tax evasion, subpar tax collection, limited redistributive power, and low quantity and quality in the provision of public goods and services, which encourages further informality.

REALM 3: INFORMALITY AND MARKET CONDITIONS

The process of registering a business is the first step an entrepreneur must take before starting an economic activity. The more complex, lengthy, and costly the procedures are, the less attractive and likely that micro and small firms will comply with the law and operate formally.

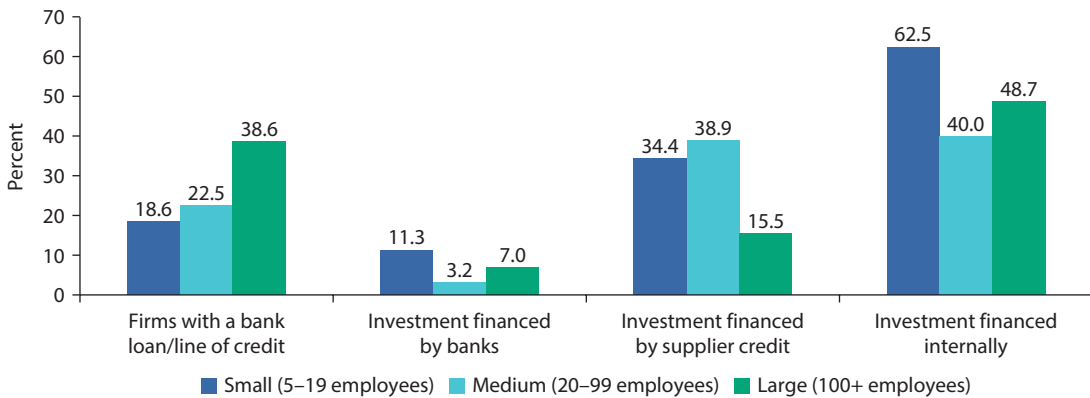
In Morocco and Tunisia, starting a business is a relatively fast and inexpensive process, taking an average of 6.4 and 9 days, respectively, while costing 3.6 and 2.9 percent of income per capita, performing similarly to the OECD average of 9.2 days and 3 percent of income per capita (World Bank 2021a). In Egypt, however, starting a business takes 12 days and registration costs are about 20.3 percent of income per capita, much higher than regional peers, which might dissuade firms from registering their businesses.

Enforcement of commercial and credit contracts remains challenging and can discourage formality and hamper firm growth. In the case of commercial contracts, strong enforcement directly affects the level of security and integrity of economic transactions. For firms, it corresponds to lower transaction costs, higher incentives to register with official authorities, and a greater likelihood of interacting with many firms beyond a small and trusted network of suppliers and customers. Such factors are associated with firm formality because not only are they growth-enhancing, but also the risk of getting caught and sanctioned for hiring informal workers increases with firm registration. In the pilot countries, however, resolving a commercial dispute is typically a costly and slow process. The biggest downfall is the low quality of judicial processes, reflecting inefficient court structures and proceedings, poor case management, and a lack of court automation and alternative dispute resolution.

On credit contracts, weak enforcement generates uncertainty and increases the legal costs to impound collateral in case registered firms fall into bankruptcy or default on their loans. This might lead banks to provide less credit or offer costly loans, which dissuades firms from registering with official authorities to benefit from credit contracts and often prompts them to rely on internal finance—a route that limits their growth prospects and ability to formalize by hiring formal workers. In the pilot countries, the rights of borrowers and lenders are weakly protected, as shown by their poor performance on an index that captures the strength of legal rights—with Egypt, Morocco, and Tunisia scoring 5, 2, and 3 (out of 12), respectively. This translates into difficulties in getting credit, which is particularly challenging for the smallest firms, which largely rely on internal sources of finance (figure O.8).

Restrictive regulations, a heavy state-owned enterprise (SOE) footprint, and cronyism hamper competition in product markets, causing unfair and non-contestable market structures and high market concentration. Product market competition is related to firms competing on an even field and speaks to the cost that firms face when starting operations in a market for specific goods or services and when they interact with existing firms. The presence of SOEs and monopolies in sectors where such market structures are not justified on economic grounds dissuades firms from registering

FIGURE O.8

Access to Credit, by Firm Size, Morocco, 2019–20

Source: Based on data from Enterprise Surveys, World Bank.

with official authorities (to hide under the radar) or even entering markets. As a result, firms stay small after entry, or are pushed out of markets, which depresses the number of formal firms, their size and level of productivity, and ultimately economic growth.

In the pilot countries, SOEs are widespread, with their presence extending to 41 sectors in Egypt, 23 sectors in Morocco, and 40 sectors in Tunisia, compared to an average 26 sectors in developing countries. The situation is made worse by cronyism and political connections that further undermine market contestability and fair competition.

GUIDING PRINCIPLES FOR MOVING TOWARD HIGHER, MORE SOCIALLY INCLUSIVE GROWTH

A Starting Point

As the pilot countries move away from regressive subsidies and reliance on the public sector to provide jobs, there is an opportunity to realize sustained and socially inclusive growth. That means a social protection and tax system in which all citizens have access to basic health services, are provided at least a minimum level of financial protection against health risks, and enjoy at least a minimum income in old age, while promoting the creation and growth of businesses with high productivity. Although there has been a welcome and needed recognition of the role that targeted income transfers can play in reducing poverty, these programs alone cannot provide the key ingredients needed for a growing and youthful workforce.

How can governments start to address informality to achieve higher and more socially inclusive growth? This report calls for progressive and consistent actions, starting with the premise that to date the interactions of the three institutional realms have led to a suboptimal equilibrium—notably, high informality, little coverage against risks, low productivity, and subpar growth in the region. Six policy principles emerge from the analysis of institutions in the realms of worker-entrepreneur relations, the taxation system, and market conditions that will shift individuals' incentives. The goals are (1) making the formal and informal dichotomy irrelevant as social protection policies will operate through the tax and transfer system (Realm 2) and not through entrepreneur-worker relations (Realm 1); (2) fostering universal protection, redistribution, and efficiency gains; and (3) shifting pilot countries onto a higher, more socially inclusive development trajectory. Table O.2 describes the six policy principles.

TABLE O.2

Policy Principles to Encourage Formal Employment

| Policy principle | Realm(s) | Description | Impact of policy on informality |
|---|--------------------|---|---|
| 1. Policies should not be designed or evaluated in isolation. | Realms 1, 2, and 3 | Policy makers must be mindful about the change in incentives offered to firms and workers to operate informally when introducing a new, or altering an existing, policy because it is the effect of the policy mix on individuals' behavior that matters for policy reforms. | By adopting a holistic view on the policy front, policy makers will be able to improve the effectiveness and predictability of policy interventions on workers' and firms' behavior, thereby minimizing unintended and often undesirable outcomes, including informality. |
| 2. All the population exposed to a given risk should be covered by the same program. | Realm 1 | When contributory social insurance schemes are not standardized across groups of workers, including noncontributory programs for the poor and vulnerable, it reduces the protective capacity of programs, can encourage informality, and creates opportunities to arbitrage the system. Providing coverage to all individuals exposed to the same risk with one single program can ensure more risk pooling, can increase efficacy and diversification of risk, as well as ensure that all individuals receive the same quality of service. | Following the report's definition of informality, universality with respect to the relevant population solves the informality problem, at least from a standpoint of protection against the fundamental risks of health and longevity. |
| 3. The source of financing should vary with the type of risk covered. | Realm 1 | Risks of different natures are best covered through different sources of financing: (1) risks common to all citizens should be funded from general taxes; (2) risks common to all workers should be funded from workers' earnings; and (3) risks specific to workers in firms (employees) should be funded from firms' contributions based on workers' wages. | |

(continued)

TABLE O.2

Policy Principles to Encourage Formal Employment (continued)

| Policy principle | Realm(s) | Description | Impact of policy on informality |
|---|----------|---|---|
| 4. Social protection for the poor via non-contributory programs should be targeted based on family income and not tied to the work formality of beneficiaries. | Realm 1 | All the poor should receive income transfers, and eligibility must not be conditional on workers' formality status. This is to avoid informality and poverty traps and to support the vulnerable during the labor market adjustment period in response to proposed changes to health insurance and retirement benefits. | The fact that income transfers are conditional on income, and not formality status, creates an incentive for poor workers to search for a formal job. Moreover, poor workers may prefer a formal to an informal job if the former offers better working conditions. |
| 5. The taxation structure should strengthen incentives for formal employment and, together with social protection, be progressive. | Realm 2 | The number of tax regimes offered to economic agents must be minimized such that tax loopholes, special regimes, and exemptions are abolished. Tax schedules must exhibit sufficient progressivity to fund redistribution and create opportunity, not to discourage productivity, and to assure public services of high quality. In addition, enforcement and tax collection must increase in tandem. | Standardizing the tax system by abolishing exemptions or discounts encourages firm natural selection, productivity growth, and formal job creation. Coupled with increased enforcement, it also broadens the tax base and, in turn, tax revenues, which can be invested in funding the universality of health care and old-age transfers, and improve the quality of services provided, making formality more attractive. |
| 6. Governments should ensure that market conditions are conducive to firms' entry, growth, and exit. | Realm 3 | (i) The registration process for new enterprises should be further simplified with the aid of digital technologies. (ii) Measures should strengthen commercial contract enforcement, most notably by strengthening the quality of the judicial process in the pilot countries. (iii) Measures should strengthen credit contract enforcement, particularly the legal rights of borrowers and lenders. The pilot countries should implement measures to reduce the time and cost required to resolve an insolvency. (iv) Policies should address product market competition, price controls, the presence of state-owned enterprises, and cronyism. See World Bank (2022b). | By making the registration process simple in addition to improving the benefits of being registered—for example, by enhancing contract enforcement—more firms will register with the authorities. Since registered firms can benefit from commercial and credit contracts and cannot easily hide under the radar from their tax and social obligations, formal employment will increase. |

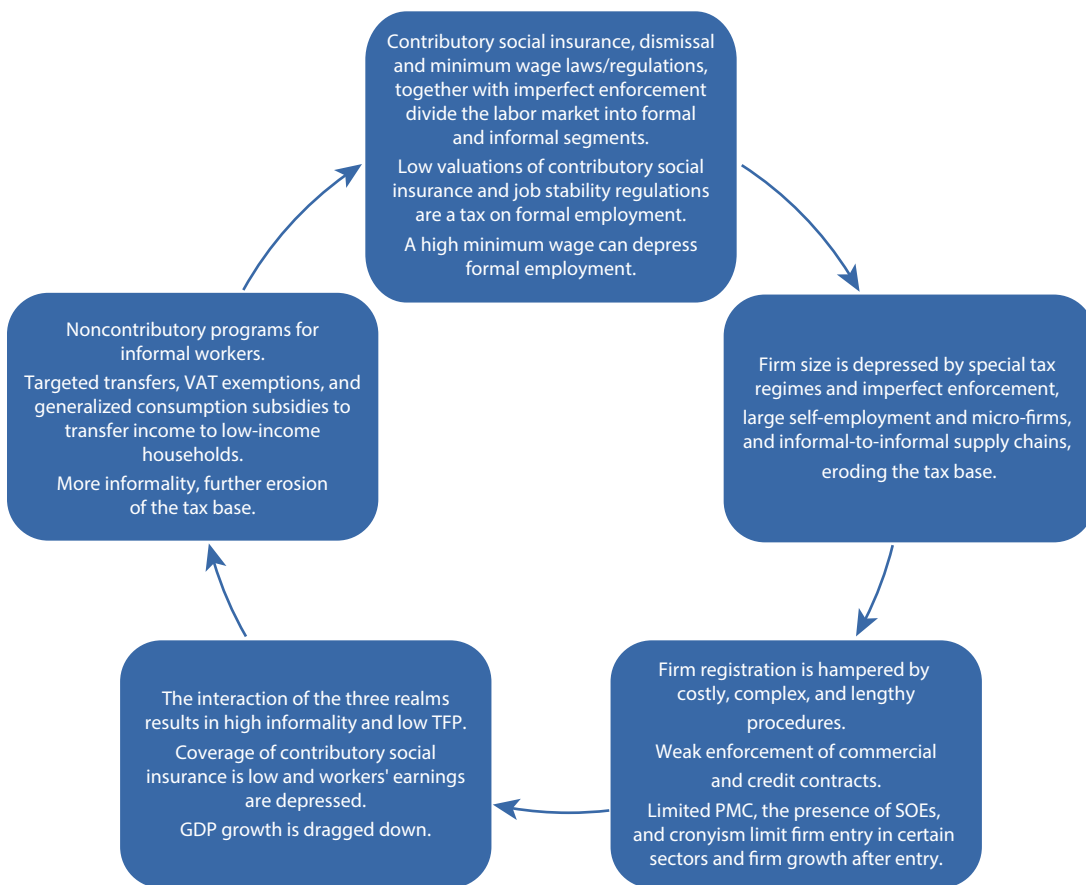
Source: Original table for this publication.

Policy Principle 1: Policies Should Not Be Designed or Evaluated in Isolation

Each policy lever in each of the three realms has direct effects on firms' and workers' incentives to operate formally or informally (figure O.9). Moreover, policies interact with each other, and it is the effect of the policy mix on economic agents' behavior that matters—and thus should be considered when evaluating policy reforms. Potential policy interactions could fall into the following areas:

FIGURE O.9

Interactions among Social Protection, Labor Regulation, Taxation, and Market Conditions, and Their Effects on Firms' and Workers' Formality Status



Source: Based on Levy and Cruces 2021.

Note: GDP = gross domestic product; PMC = product market competition; SOEs = state-owned enterprises; TFP = total factor productivity; VAT = value added tax.

Noncontributory social insurance. These programs, which deliver free or subsidized health coverage to poor and vulnerable workers—often combined with a cash transfer—might help reach population groups that would otherwise be left unprotected against health risk. Yet, the programs typically provide only partial social insurance coverage (in the pilot countries, only health risk is covered) and top up the income levels of the poor to boost current consumption. The problem is that they might unintentionally subsidize informal employment, particularly when (i) the quality of free or subsidized health care is adequate, and (ii) the income transfer is large enough to discourage poor informal workers from getting a formal job, which would mean losing this health care.

Job regulations. Policies that govern when firms can dismiss employees—such as advance notice requirements, specific reasons for dismissal, and workers’ compensation—may be insufficient to adequately protect workers. The policies can be adequate when they are combined with unemployment insurance that provides income replacement in case of job loss and active labor market policies aimed at retraining workers.

Taxation. Although indirect taxes, such as the VAT, are regressive in nature because poorer households spend a larger share of their income on consumption, the resulting tax revenues can be channeled into financing transfer programs to poorer households. This would ensure that the combined effect of the VAT and income transfers delivers the desired degree of progressivity.

Special tax regimes. These offer discounted tax rates to small, unincorporated businesses that register with the tax authorities. The problem is that they often interact with other taxes—such as when firms must consolidate income taxes and the VAT into a single payment, and thus may not be allowed to sell to firms that pay the VAT in the general regime. Paradoxically, while these regimes try to reduce inequality by subsidizing low-income entrepreneurs and helping the self-employed move into contributory programs, they hinder firm expansion, productivity growth, and formal job creation.

Business regulations. If procedures to register a business are costly, lengthy, and complex, and enforcement of commercial and credit contracts is weak, the incentives built into special tax regimes to comply with tax laws and register with tax authorities might not be obvious, given that the benefits are few.

Policy Principle 2: All the Population Exposed to a Given Risk Should Be Covered by the Same Program

Often, programs are created for small groups of workers, such as civil servants, and are gradually extended to other workers. In the pilot countries, at first, the system was expanded to include private sector employees, in some cases with different schemes depending on the sector of employment or income levels to encourage participation in the system. In a second step, which is currently underway in Egypt and Morocco, the system is being further expanded to include nonwage workers, particularly employers and own-account workers. Although the incremental approach was adopted with the best of intentions—to cover more workers with contributory social insurance—it has also generated an array of programs that not only provide different benefits but also benefits of different quality.

In addition, noncontributory social insurance provides poor and vulnerable informal workers protection against the health risk for free or at a subsidized rate. However, the presence of a multitude of programs to cover the same risk (such as health) poses numerous problems: less risk pooling and diversification, less efficacy of insurance, higher costs, and unequal benefits in terms of quality (depending on workers' employment status or sector of employment). By contrast, providing coverage to all individuals exposed to the same risk with one program can ensure more risk pooling, greater efficacy and diversification of risk, and the provision of the same quality of service for all individuals.

Policy Principle 3: The Source of Financing Should Vary with the Type of Risk Covered

Risks of differing natures are best covered through different sources of financing: (i) risks common to all citizens should be funded from general taxes, (ii) risks common to all workers should be funded from workers' earnings, and (iii) risks specific to workers in firms (employees) should be funded from firms' contributions based on workers' wages.

Given that all individuals are exposed to health and longevity risks, there is no rationale for financing these risks out of workers' contributions and leaving individuals with no formal job uncovered. The policy objective is to provide every individual access to health care when it is needed, since it is not known *ex ante* who will get sick or when. Similarly, in the case of longevity, the goal is to provide a minimum income in old age to every person. Thus, there is a need for both universal health insurance for individuals of all ages and a universal policy for the elderly.

Universal health insurance. Health services provided by one program for all would achieve a greater degree of risk pooling and ensure that the same quality of health care was provided, regardless of labor market status or informality status. Moreover, if health care services were to be financed via general tax revenues, it would ensure a higher extent of redistribution through health care. In this area, the most significant obstacle would be the fiscal cost.

In the pilot countries, many workers are not covered by contributory or noncontributory social insurance (40 percent in Egypt, 31.1 percent in Morocco, and 2.2 percent in Tunisia). Even among those who are covered, there is significant variation in the overall quality of services received. Back-of-the-envelope calculations using data on current health coverage and expenditures suggest that it would cost an additional 2.1 and 1.75 percent of GDP in Morocco

and Tunisia, respectively, to provide universal health insurance to the remaining uncovered population, as well as to switch individuals from noncontributory to contributory social insurance. The total cost of universal health insurance would be 3.45 percent of GDP in Morocco and 3.01 percent of GDP in Tunisia.

Universal policy for the elderly. All individuals face uncertainty about the duration of their life. Some might save for retirement when they work, others might have never worked, and others might not save enough. A policy to avoid old-age poverty would be a flat pension benefit, financed from general revenues, for all the elderly—independent of whether they worked and for how long. It would be a noncontributory universal pension. However, it is important to consider how this policy would interact with contributory pension benefits to strike the right balance between redistribution via noncontributory benefits and individual-level incentives to work and save for retirement via the contributory system.

Contributory pension policy for all workers. Contributory pensions are associated with workers employed in firms for a wage, which implies that some workers (such as own-account workers and contributory family workers) are excluded. The proposal for contributory pension insurance would require all workers (i) to contribute, irrespective of employment status; and (ii) to participate in the same system that pools the longevity risk of all workers once they retire. This would mean shifting the obligation to contribute from the firm to the worker. It could be combined with an obligation to pay PIT, although revenues from contributions for a pension benefit would be earmarked for workers' pension benefit and could not be used for other purposes (as in the case of PIT revenues).

The proposal would also align the incentives to contribute, as only workers would be responsible for contributing to health insurance and pension benefits—unlike now, where employers are required to pay contributions, partly on behalf of workers. For example, in Morocco and Tunisia, employers contribute 8.98 and 7.76 percent, respectively, of their employees' salaries for retirement pensions (table O.3). If workers assigned a positive value to the benefits provided, they would have incentives to contribute. Linking the obligation to save for retirement with PIT might provide an incentive at the margin to comply, as pension benefits would be proportional to income taxes. Further, transferring the obligation of contributing to the worker implies a reduction in employers' labor cost, which might partially or fully benefit workers as an increase in gross wages.

TABLE O.3

Contribution Rates for Private Sector Employees, by Type of Benefit, Morocco, 2018

| Benefit | Cap on gross monthly wage (DH) | Employer (%) | Employee (%) | Total (%) |
|---|--------------------------------|--------------|--------------|--------------|
| Retirement pension | 6,000 | 8.98 | 4.48 | 13.46 |
| Health insurance ^a | — | 4.11 | 2.26 | 6.37 |
| Family allowance | — | 6.40 | — | 6.40 |
| Job loss allowance | 6,000 | 0.38 | 0.19 | 0.57 |
| Professional training | — | 1.60 | — | 1.60 |
| Work accident and disability insurance ^b | — | 1.90 | 0.84 | 2.74 |
| Illness and maternity, death | 6,000 | 0.67 | 0.33 | 1.00 |
| Total | — | 21.77 | 7.77 | 29.54 |

Source: Original table for this publication.

Note: — = not applicable.

a. Companies that provided medical insurance before the introduction of Assurance Maladie Obligatoire (AMO) are exempt from health insurance contributions and pay a solidarity rate of 1.85 percent.

b. These benefits are provided by private insurance companies and are not administered by the Caisse Nationale de Sécurité Sociale (CNSS).

A big obstacle to implementing contributory pension insurance for all workers is enforcement, as pension benefits would be proportional to individual savings without cross subsidies or any additional costs to the state budget. In the pilot countries, many informal workers do not pay PIT, given that enforcement is weak and large shares of workers are not registered with the tax authority. But the analysis shows that the distributions of earnings of formal and informal wage workers largely overlap, meaning that there is space to tax informal workers. Moreover, the proposal would incentivize workers to contribute, as they would be solely responsible for paying for their contributions to health insurance and pension benefits. Therefore, if workers assigned a positive value to the benefits provided, they would have incentives to contribute to the system.

In sum, the proposals sketched here for insuring risks would entail a rebalancing of the source of financing of social insurance between contributions and taxes. The two largest components of contributory social insurance—health insurance and retirement pensions—would disappear, with the first being universal and funded via general tax revenues, and the second being levied on workers only and collected with PIT.

What about risks (like death and disability in the performance of work duties) that are faced only by workers? These would require a policy that covers all workers. Risks (like job loss and accidents at work) that are only associated with employment in a firm would concern only workers hired as employees by firms.

Policy Principle 4: Social Protection for the Poor via Noncontributory Programs Should Be Targeted Based on Family Income and Not Tied to the Work Formality of the Beneficiaries

Making social insurance more inclusive with the proposed changes to health insurance and retirement pension benefits would provide protection to the poor and vulnerable against fundamental risks, while also improving the conditions under which the poor and vulnerable participate in the labor market, thereby positively affecting their income and contributing to reduce poverty. However, systemic policy changes proceed slowly, and labor market adjustment might take time to display the full effects. Thus, the poor will need help via income transfers to support their current consumption levels.

More concretely, all the poor should receive income transfers, and eligibility should not be conditional on workers being employed informally. Moreover, the amount of the transfer should balance, on the one hand, the need to support current consumption and, on the other hand, the need to minimize an implicit tax on poor workers who lose the transfer when their earnings place them above the eligibility threshold. In combination with universal health insurance and contributions to the retirement pension benefit, fewer households will likely fall into poverty if negative shocks occur, as they will be covered against key contingencies. In addition, more productive jobs would be available in the economy, thus helping the poor to escape poverty on their own and reducing the likelihood of poverty traps.

Policy Principle 5: The Taxation Structure Should Strengthen Incentives for Formal Employment and, Together with Social Protection, Be Progressive

Special tax regimes for firms come with specific requirements in terms of sales, legal entity, and type of ownership. They provide preferential tax treatments relative to standard corporate tax rates, which average about 20 percent in the pilot countries. The special tax regimes also impose constraints on capital diversification, access to credit, and economies of scale. Plus, VAT exemptions that accompany these regimes imply that firms cannot sell to firms under the standard corporate tax regime and thus end up being trapped in operations with a small network of firms, informal or under the special tax regimes, or selling only to final consumers, which disallows technological transfer from larger to smaller firms.

Thus, eliminating these regimes and exemptions can help boost tax revenues while also removing barriers to firms' growth. Some firms would be forced to exit the market, as the higher tax burden under the CIT regime would require higher sales to maintain positive posttax profits. Therefore, the process of firm selection would gradually contribute to raising total factor productivity, as more productive formal firms would prosper and grow, entry of firms with very low productivity levels would be discouraged, and firms with low productivity would exit the market. The latter would have economic and social implications for employers and workers employed in those firms. However, if the key assumption for special tax regimes is that many such small firms are owned by low-income families, the proposals illustrated above to modify contributory social insurance would increase redistribution and coverage and question the need for inefficient special tax regimes as a redistributive tool.

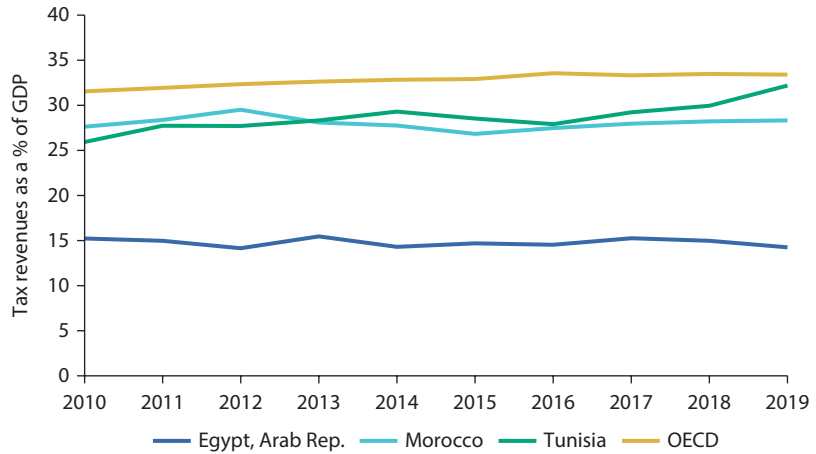
Overall, the tax-to-GDP ratios in the pilot countries range from about 15 percent in Egypt in 2018 to 32 percent in Tunisia in 2019 (figure O.10), which are below the OECD average (33.4 percent in 2019). These figures point to the possibility of raising more revenues, for example, to fund universal health insurance and improve its quality. In addition, resources can be obtained from current allocations to universal consumption subsidies. The pilot countries allocate between 1.3 and 5.6 percent of GDP to universal consumption subsidies on food, transportation, and energy. The largest share of subsidies is typically spent on energy: in Egypt, energy subsidies were valued at about 0.3 percent of GDP in 2020; in Morocco, 0.8 percent of GDP; and in Tunisia, 2.1 percent of GDP.

Although the pilot countries have been gradually decreasing the amount spent on energy subsidies, some of these subsidies still exist and redistribute resources inefficiently, with middle- and high-income households receiving higher subsidies in per capita terms than low-income households. In Morocco, households in the top decile received over twice the amount in per capita terms than those in the bottom decile for the liquefied petroleum gas subsidy in 2013/14; in Tunisia, households in the fifth quintile received 25 percent of the per capita energy subsidy benefits, compared to 15 percent for households in the first quintile in 2014/15 (Cuesta, El-Lahga, and Ibarra 2015).

On the composition of taxes, there are important differences between the pilot countries and the OECD. First, the pilot countries typically collect more indirect taxes and less income taxes than the OECD. For example, about 56 percent of Morocco's tax revenue comes from indirect taxes (like the VAT and other consumption taxes) (figure O.11),

FIGURE O.10

Tax Revenues as a Percentage of GDP, Arab Republic of Egypt, 2010–19

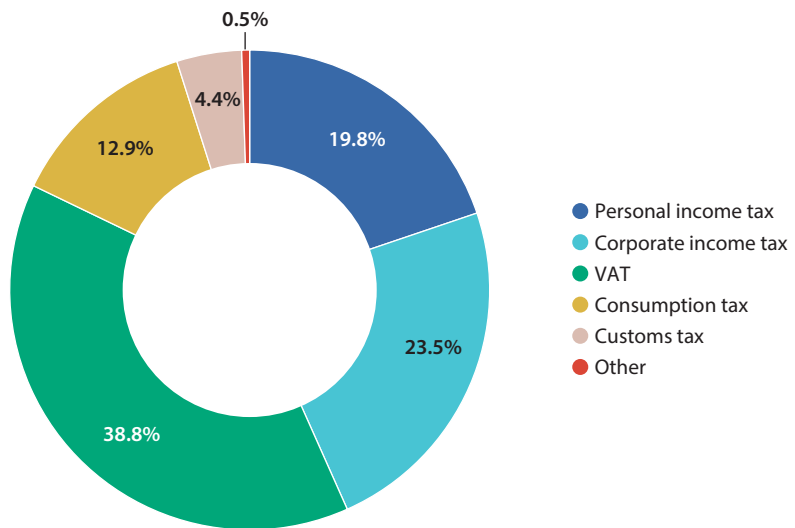


Source: Based on data from the OECD tax database.

Note: GDP = gross domestic product; OECD = Organisation for Economic Co-operation and Development.

FIGURE O.11

Share of Tax Revenues, Morocco, 2018



Source: Original figure for this publication.

Note: The figure shows the composition of tax revenue. Direct taxes are levied on taxpayers' income and profits; however, indirect taxes are charged on goods and services. Whereas the VAT, consumption tax, and customs tax are examples of indirect taxes, the personal income tax and corporate income tax are examples of direct taxes. VAT = value added tax.

which is significantly higher than the OECD average (about 31 percent in 2019). Similarly, the CIT represents 30.6, 21.0, and 13.3 percent in Egypt, Morocco, and Tunisia, respectively, far above the 10.7 percent in the OECD. By contrast, the PIT accounts for smaller shares of tax revenues in Egypt (10.6 percent) and Morocco (17.7 percent) than in Tunisia (30.8 percent) and the OECD (41.4 percent). While property taxes contribute negligible tax revenue shares in Egypt and Tunisia (0.7 and 1.3 percent, respectively), they represent 6.7 percent in Morocco, which is nevertheless far less than the average in OECD countries (11.6 percent).

Thus, additional revenues could come from higher property taxes (especially in Egypt and Tunisia), new taxes levied on environmentally unfriendly activities, or better tax enforcement. The last would require far more financial and human resources than are currently allocated—along with the use of digital technologies to identify individuals and firms evading taxes and for better communication across entities to reduce tax evasion.

Policy Principle 6: Governments Should Ensure That Market Conditions Are Conducive to Firms' Entry, Growth, and Exit

Market conditions are key for the creation and growth of new and high-productivity firms—and making improvements here could be a first step toward higher and more socially inclusive growth. Firms' decisions to formalize depend on incentives stemming from the complexity and costs of business registration procedures, and the degree of enforcement of commercial and credit contracts.²

First, the registration process of a new enterprise should be further simplified, and the costs associated with the process can be reduced by implementing the use of digital technologies. While in the pilot countries starting a business has been made easier in recent years with the introduction of one-stop shops, there is still room for improvement, particularly in Egypt, where costs remain high.

Second, on contract enforcement, two policy avenues should be explored to increase the level of security and integrity of formal firms' economic transactions:

- *Commercial contract enforcement.* Measures to strengthen the quality of the judicial process are at the forefront of much needed policy intervention in the pilot countries. A commonality across the countries is that dealing with disputes is an inefficient process, which is long in duration and expensive. Improvements can be realized by devoting

additional resources to establishing more efficient court structures and management of proceedings, with the support of court automation, which is currently nonexistent.

- *Credit contract enforcement.* Measures to strengthen the legal rights of both borrowers and lenders are required, as this is a weak area in the three pilot countries (World Bank 2021b). Insolvency laws and performance represent another dimension of doing business that requires attention: pilot countries should implement measures to reduce the time and cost required to resolve an insolvency, which currently lag aspirational leaders, such as the OECD.

Taken together, these policies would increase the benefits of registering for firms, encouraging them to go beyond a trusted network of suppliers and clients; absorb skills, techniques, and technologies from interacting with more and larger firms; and increase their external credit take-up—thereby spurring productivity, firm expansion, and formal job creation.

ROAD MAP

The policy principles put forward in this report are aimed at indicating a way forward to achieve higher and more socially inclusive growth. Importantly, the specific policy changes may differ across countries and can create winners and losers. Therefore, broad and deep reforms will likely face opposition from various groups and setbacks in many contexts. For this reason, it is key that governments identify a clear vision of where they are headed and set a path to get there before embarking on a complex set of reforms. Governments should design a clear map of intertemporally consistent reforms that contribute to the desired social protection system, as a better understanding of the desired outcome can help build the necessary coalitions to support the reform agenda.

Providing a road map can help groups representing various interests to grasp what the proposed policy changes intend to bring for them, which may spur sentiments of inclusion and trust that were beforehand fragile but are fundamental to cohesive societies. Although some parts of the reform process might penalize some groups, the overall redesign of the system will be more acceptable and should produce a net societal gain as the proposed policy principles offer a route to fiscally sustainable and socially inclusive growth.

Identifying a country-tailored way forward is a challenging task, as countries differ in terms of initial conditions, administrative capacity, and political context, and thus is beyond the scope of this report.

Nevertheless, a road map can help governments navigate the reform process along the lines of the principles sketched in this report. The policy proposals identified would entail a shift toward a more inclusive social protection system, where the principles of universality with respect to the relevant population and equality of benefits substitute the existing segmentation of social protection schemes and implicit unequal coverage of workers and families. Moreover, the source of financing would change. Risks common to all citizens would be funded from general taxes, risks common to all workers would be funded from workers' earnings, and risks specific to workers employed in firms would be funded from firms' contributions and proportional to workers' wages. A road map for countries to move toward realizing the vision and goals outlined in this report would contain the following five sequential key elements:

1. *Coordinated reform.* To oversee the compatibility of the policy changes in the overall policy mix with government objectives, each country sets up a cross-ministerial implementation group to ensure a holistic and coordinated approach in the policy arena.
2. *Tailored, gradual, and incentive-compatible social protection reform.* Countries introduce gradual reforms to the social protection system, particularly the health and retirement components, complemented by a noncontributory universal pension and a poverty-targeted cash transfer program.
 - As a first step, health coverage should be extended to all citizens, regardless of their employment status, and the pension system may move toward providing benefits to every worker conditional on paying contributions, which should take place together with payment of income taxes, as suggested by policy principles 2 and 3.
 - Only workers, not their employers, would be responsible for paying contributions for pension benefits, and such payments would finance individual accounts as opposed to being used to cross-subsidize the pension benefits of current retirees or other workers. Vesting periods in number of years of contributions would be eliminated, except for the minimum retirement age. Thus, every worker who pays income taxes and therefore contributes to the pension system would be entitled to an actuarially fair benefit. This could also increase compliance, since workers, employees, and the self-employed would know that their pension benefit will be proportional to their income taxes.
3. *Expanded tax base to ensure that general revenues are available to fund universal health insurance.* These measures include reducing or eliminating tax expenditures; introducing new taxes and/or raising rates for

existing taxes on certain activities, such as those that damage the environment and taxes on property; and removing universal consumption subsidies, particularly on energy products.

4. *Improved service delivery quality.* Countries increase the quality of public services in parallel with element 3. This would incentivize workers to pay income taxes, curb resentments, and build trust, potentially to increase the income tax in the future, including its progressivity, to expand the fiscal base, increase investment, protect the vulnerable, and reduce inequality. Therefore, the road map calls for improving the supply of health care with more human resources and more infrastructure.
5. *Private sector reforms.* Countries prioritize a range of measures that affect firms.
 - o Special tax regimes would be gradually abolished, and economic units registered as firms would be required to pay standard corporate income tax rates regardless of size, sector of activity, or other conditions. This change would be disruptive in the short term but, together with the new social protection system, it will contribute to raising the productivity of firms and the economy, and thereby translate into higher income levels and higher growth in the long term. Overall tax revenues will also increase because, first, more firms will pay taxes under the standard corporate regime and, second, thanks to the elimination of the VAT exemption that often comes with special tax regimes and possibly the elimination of the VAT exemption of certain consumption goods. Abolishing special tax regimes may also have a positive or at least neutral distributional impact. A recent study finds that eliminating VAT exemptions does not have regressive effects since in contexts with high informality, a significant share of the poor's consumption takes place in establishments that elude the VAT (Bachas, Gadenne, and Jensen 2020).
 - o In parallel, job stability regulations could be made more flexible and minimum wages less binding as the introduction of unemployment insurance and job loss compensation can support workers in transitioning between jobs, and workers would be covered against health risk even after losing their job. Moreover, in the medium term, the proposed changes would support higher productivity and economic growth that would lead to increases in wages.
 - o To increase the dynamism of the private sector and improve market conditions, countries must simplify the registration process and improve the benefits available to registered firms. Benefits can be improved by strengthening the enforcement of commercial and

credit contracts, thereby incentivizing firms to register because they will be able to access credit on better terms, enter more and larger markets since their transactions would be secure and backed by strong commercial contracts, benefit from technical and technological transfers due to interacting with larger firms, and face reduced risk as their business assets would be separate from their household. Other institutions will also benefit, including government and banks, as a larger pool of registered firms translates into higher tax revenues and more diversified credit markets. Given that registered firms are more likely to hire formal workers than informal ones, this policy intervention alone is likely to have a positive impact on formal employment.

NOTES

1. GDP and population figures are from the World Development Indicators database, World Bank.
2. Statistics are derived from the World Development Indicators database and Feenstra, Inklaar, and Timmer (2015).
3. A notable exception is the taxable base, which in the case of own-account workers and employers is typically a measure of business income, with brackets defined in some cases as a multiple of the minimum wage.
4. In Morocco, in addition to targeting based on poverty rates at the municipality level, the transfers are conditional on having children in school (Tayssir) or restricted to widows with children (DAAM).
5. Social protection expenditure as a proportion of GDP is calculated as the sum of expenditure data from ILOSTAT and the World Health Organization data portal (2020). Specifically, GDP contributions from “total expenditure on social protection (excluding health)” and “domestic general government health expenditure” have been added together.
6. Due to data limitations, Morocco’s Kaitz index has been computed as the minimum wage as a proportion of the national mean wage.
7. Policies on product market competition, price controls, the presence of SOEs, and cronyism are not discussed here, as there is a broad literature covering these topics (see World Bank 2022b).

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Why Does Informality Matter? A Framework

KEY MESSAGES

- Informality—measured in terms of workers not covered by contributory social insurance—is a complex phenomenon that must be addressed for countries in the Middle East and North Africa (MENA) Region to achieve long-term, inclusive growth.
- It matters because (1) it hinders social protection systems in terms of coverage, risk pooling, and redistribution; (2) it dampens productivity and economic growth; (3) it diminishes tax revenues; and (4) it can lower the quantity and quality of the provision of public goods and services.
- This report is a first attempt to conduct a comprehensive analysis of the effects of the institutional environment on informality in MENA countries—with a focus on Arab Republic of Egypt, Morocco, and Tunisia.
- A cornerstone of the framework is that informality is shaped by the environment in which firms and workers operate—which includes institutions, laws, regulations, and policies that determine employer-worker relationships, tax and transfer systems, and market conditions.

INTRODUCTION

Informality has long been at the forefront of academic and policy debates because of both its pervasiveness and its links with development outcomes. Yet it is a complex phenomenon, covering a broad range of contexts, and—despite its importance—it lacks a universal definition. In some cases, it is viewed as the shadow or underground economy. In others, it is seen as a lack of registration of firms with the tax authority, a lack of compliance of registered firms with tax laws or other applicable regulations (such as keeping formal accounting books or holding a bank account), a lack of social security coverage of workers, a lack of written contracts, or even illegal economic activity.

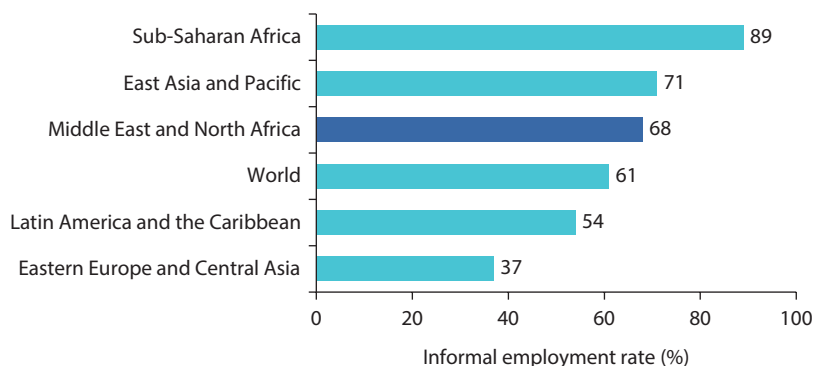
Further, informality typically assumes different meanings according to the interlocutor. A minister of finance or a businessperson might be more concerned about informality in terms of the amount of taxes to be paid; a minister of labor or a union leader might think about a lack of social insurance and noncompliance with job stability and minimum wage regulations among workers; and the average citizen might think of a street vendor not complying with health and safety standards or not issuing a receipt for a purchase.

The informality debate has taken on new urgency as countries in the Middle East and North Africa (MENA) look for a pathway to inclusive growth, against a backdrop of further growth setbacks and deteriorating fiscal and current account deficits in the aftermath of the COVID-19 pandemic. The region is already struggling with important structural challenges in the labor arena, such as low labor force participation (especially among youth and women), high unemployment rates (particularly among tertiary-educated youth), and little job creation. In addition, MENA's informality rate, at an estimated 68 of total employment, is one of the highest among the world regions, after Sub-Saharan Africa and East Asia and Pacific (figure 1.1).

This report aims to better explain the characteristics and incentive structure that has led to the prevalence of informal employment in selected countries in the region. The objectives are to:

- Help design social protection systems that better protect workers and their families against risks (such as health, longevity, job loss, sickness, disability, and work accidents) and vulnerability or poverty.
- Improve the functioning and effectiveness of the welfare state (more risk pooling and higher tax revenues) and help reduce inequality.
- Incentivize firms to grow and thereby raise aggregate productivity and foster economic growth in the long run.

FIGURE 1.1

Share of Informal Employment in Total Employment, by Region, 2019

Source: Based on data from ILO 2019.

The report breaks new ground by applying Levy and Cruces' (2021) framework to the MENA Region—zeroing in on three countries—Arab Republic of Egypt, Morocco, and Tunisia, which were chosen based on data availability. Their informal employment as a percentage of total employment ranges from an estimated 44 percent (Tunisia), to 64 percent (Egypt), to 77 percent (Morocco). In addition, the report makes use of microdata—including household budget data, labor force surveys, and enterprise surveys, some of which have rarely been used before, particularly the data on wages and labor market transitions—combined with administrative data from national institutes of social security and tax administrations (see table 1.1 for definitions of selected items).

THE LONG-STANDING INFORMALITY DEBATE

In this report, informality refers to informal employment—defined as workers, salaried or nonsalaried, not covered by contributory social insurance. This means that informal workers are not insured against risks (such as illness, work accidents and disability, loss of life, longevity, and loss of employment). In principle, firms are defined as informal if they employ all their workers informally, while they are considered formal if they employ at least one worker formally (see box 1.1). Two key points follow from the definition of informality adopted in the report.

TABLE 1.1

Definitions of Key Labor Market Concepts

| Labor market status | Definition |
|--|--|
| Working age | The working-age population includes all individuals age 15 and older. |
| Labor force | The labor force is all working-age individuals who were employed or unemployed during the reference week. |
| Employed | The employed population consists of working-age individuals who have worked for pay, profit, or household gain for at least one hour during the reference week. It includes individuals who are temporarily absent from work for reasons such as working time arrangements, the nature of their work, public holidays, annual leave, sick leave, or maternity/paternity leave. |
| Unemployed | The unemployed population comprises all working-age individuals who were not employed during the reference week, looked for work during the past month, and were available for work during the reference week. |
| Inactive | The inactive population includes individuals who were neither employed nor unemployed during the reference week. |
| NEET | These are young people age 15 to 24 who were not in employment, education, or training (NEET). |
| <i>Type of employment</i> | |
| Wage worker or employee | A wage worker or employee is a person who works for pay for someone else, even in a temporary capacity. |
| Irregular wage worker or employee (Egypt, Arab Rep.) | A wage worker or employee who holds a “part-time,” “temporary,” or “seasonal” job. |
| Apprentice | An apprentice is a person being trained for a job or trade. The individual may be paid or may receive pocket money; a paid apprentice is considered in employment. |
| Employer | An employer is a person who operates his/her own business or trade and hires one or more employees. |
| Own-account worker | An own-account worker is a person who operates his/her own business or trade and does not hire employees. He/she may be working alone or with the help of contributing family workers. |
| Unpaid or contributing family worker | A contributing family worker is a person who works without pay in a market-oriented enterprise operated by a household member. |
| <i>Public/private employment</i> | |
| Public sector employment | Employment in the public sector comprises all employees working in a public establishment or in a public company. |
| Private sector employment | Employment in the private sector includes all employees not working in a public establishment or in a public company, as well as all employers, own-account workers, and unpaid family workers. |

Source: Original table for this publication.

First, informality and illegality are not the same—although there continues to be a great deal of confusion about where one starts and the other ends and when they overlap. The only case where the two overlap perfectly is the case of a country that by law requires every worker to contribute to social insurance (box 1.2).

Second, the formality status of firms matters because (1) it has implications for social protection as it directly affects the social protection benefits that workers receive; and (2) it matters for productivity because it affects the relative prices and incentives that firms face when deciding about the number of workers to hire, under what types of contracts, and the technology to adopt—which, in turn, affect productivity.

BOX 1.1**Slight Variations in How Informality Is Defined**

Throughout this report, informality refers to informal employment—defined as workers, salaried or nonsalaried, not covered by contributory social insurance. The one exception is for in-depth analyses of tax systems and market conditions, where firms are defined according to their registration status. This adjustment reflects the absence of representative enterprise surveys that match firms and workers.

The two definitions largely overlap because (1) unregistered firms cannot hire formal workers; and (2) registered firms are formal under the first definition, as they likely hire at a minimum one worker formally.

In addition, for market conditions, the first definition is applied implicitly given that:

- Registered firms can hire formal workers and, compared to unregistered firms, are more likely to be caught and sanctioned for hiring informal workers.
- Strong contract enforcement encourages firms to register with official authorities to benefit from the regulatory environment (including secure and low-cost transactions and credit contracts).
- Contestability drives the natural selection of firms and increases the integrity and benefits of the regulatory environment, encouraging firm registration and growth.

BOX 1.2**Legal versus Illegal Informal Employment**

The definition adopted in this report—informality measured in terms of workers not covered by contributory social insurance—makes it clear that formality is not defined with respect to compliance with tax laws or other requirements, such as firms' registration or having a bank account or keeping formal account books. This definition implies that countries can have legal and illegal informality. In countries with laws that require every worker to contribute to social insurance, all informal employment is illegal; in other words, workers are illegally informal. Other countries have

different legislation that mandates contributing to social insurance only for certain workers (for example, salaried workers). In such case, own-account workers, employers, and unpaid family workers are informal and legal. There might also be situations with unclear requirements in terms of contributing to social insurance due to ambiguities in the legislation, which would make the legal status of informal workers unclear.

In practice, formal and informal workers are not always separate individuals. Workers might start working informally and then contribute from a certain point of their

(continued)

BOX 1.2**Legal versus Illegal Informal Employment (*continued*)**

working life onward, or they might continuously alternate between periods of informality and formality as they contribute (maybe, for example, only a few months in a year). In addition, the same worker could hold both a formal and an informal job. Such fluidity in labor markets implies that a full understanding of the incentives and disincentives built into institutions, laws, regulations, and policies might be complex.

Some firms might employ all workers formally, others hire all workers without

paying contributions, and others work with part of their workforce employed formally and part informally. In this report, to the extent that data are available, firms are categorized as formal if they employ at least one worker covered by contributory social insurance, and they are informal if they do not have any workers covered by social insurance. Similar to the case of workers, informal firms can be legal or illegal, depending on the country's legislation.

In general, the concept of informality can refer to production units, the type of activity carried out by production units, or workers and/or jobs. Often, these concepts are mixed together under the big umbrella of informality (see box 1.3). From a statistical perspective, the term “informal sector” refers to production units; the term “informal employment” refers to jobs held by individual workers; and the concept of “underground, shadow, and illegal economy” concerns the type of activity conducted by production units. Although any production unit can be engaged in activities that are legal and not underground, or legal and underground, or illegal, most production units in the informal sector carry out legal activities. In this report, the terms “informality” and “informal employment” are used interchangeably, and they are always intended to refer to workers not covered by contributory social insurance.

THE CASE FOR BETTER UNDERSTANDING INFORMALITY

Why does informality matter? Some commentators argue that firms and workers choose to operate informally to reduce costs and evade taxes, social contributions, and compliance with standards and licensing requirements (Dabla-Norris, Gradstein, and Inchauste 2008; Rauch 1991). Others argue that workers cannot access formal employment because of

BOX 1.3

How Statisticians Define Informality

The *informal sector* is defined in terms of the characteristics of the production units (enterprises) in which the activities take place (enterprise approach):

- The term “sector” follows the System of National Accounts, so that the definition of the informal sector refers only to the productive activities of households within the System of National Accounts production boundary.
- The term “enterprise” refers to any unit engaged in the production of goods or services for sale or barter—which comprises informal own-account enterprises and enterprises of informal employers.

National definitions can specify whether all own-account enterprises should be considered informal or only those that are not registered under specific national legislation (such as lack of legal identity or lack of a complete set of accounts). Enterprises of informal employers should be defined at the country level according to one or more of the following criteria: (1) small size of the enterprise in terms of employment; (2) non-registration of the enterprise (as defined in the case of informal own-account enterprises); and (3) nonregistration of its employees.

Informal employment is a statistical concept that refers to jobs, not to individuals, as some workers might hold more than one job and not all jobs held by the same individual are formal or informal. It refers to

the total number of informal jobs—whether carried out in formal sector enterprises, informal sector enterprises, or households in a given reference period. Informal employment includes the following:

- Own-account workers employed in their own informal sector enterprises
- Contributing family workers
- Employees holding informal jobs, whether employed by formal or informal sector enterprises, as well as domestic workers employed by households
- Members of informal producers’ cooperatives
- Own-account workers engaged in the production of goods only for their household’s own final use
- Employees with formal jobs in informal sector enterprises.

Underground production concerns production activities that are legal when performed in compliance with relevant standards or regulations but are deliberately concealed from public authorities to avoid (1) paying income, value added or other taxes, or social security contributions; or (2) having to meet legal standards (such as minimum wages, maximum hours, and safety or health regulations) or comply with administrative procedures (such as completing statistical questionnaires, tax returns, or other administrative forms).

(continued)

BOX 1.3

How Statisticians Define Informality (*continued*)

Illegal production includes “(a) the production of goods and services whose sale, distribution or possession is forbidden by law and (b) production of activities that are usually legal but become illegal when carried out by unauthorized producers” (OECD, IMF, and ILO 2002, 216).

Statistical underground refers to production missed due to deficiencies in data collection programs.

Source: ILO (2013).

a. According to the 17th International Conference of Labour Statisticians guidelines, “employees are considered to have informal jobs if their employment relationship is, in law or in practice, not subject to national labor legislation, income taxation, social protection, or entitlement to certain employment benefits (advance notice of dismissal, severance pay, paid annual or sick leave, among others) for reasons such as: the jobs or the employees are not declared to the relevant authorities; the jobs are casual or of a limited duration (for example, through on-call arrangements); the hours of work or wages are below a specified threshold (e.g., below that qualifying for social security contributions); the workers are employed by unincorporated enterprises or by persons in households; the employee’s place of work is outside the premises of the employer’s enterprise (e.g., outworkers without an employment contract); or regulations are not applied, enforced, or complied with for any reason” (ILO 2003, 6).

circumstances beyond their control and a lack of economic opportunities, such as no or limited access to education, few economic resources, or poverty—in other words, informality is due to exclusion (Arias Diaz et al. 2007; Gatti 2014; ILO 2019; Ohnsorge and Yu 2022). Whether firms and workers engage informally in production and employment relationships because they opt out of formality or they have been excluded, informal employment and informal firms take a serious socioeconomic toll.

Informality hinders social protection systems in terms of coverage, risk pooling, and redistribution. Lacking contributory social insurance, informal workers sometimes rely on noncontributory insurance—typically restricted to health insurance or retirement pensions—a situation that recent studies suggest makes informal workers more vulnerable to economic fluctuations (OECD 2019; Williams and Horodnic 2019; Williams and Lansky 2013). In some countries, informal workers from poor or vulnerable households receive conditional cash or in-kind transfers. Although these transfers can help overcome temporary shocks and even lift individuals and their families to the poverty line, they do not cover workers or families against socioeconomic risks. Moreover, if eligibility conditions depend on the formality status of workers, transfers might end up trapping the poor in a state of informality and vulnerability. The existence of a large number of informal workers limits the extent of

risk pooling of social insurance systems, which results in suboptimal or more expensive coverage for formal workers. Depending on the profiles of workers who contribute and those who do not, informality might compromise, or at best reduce, the extent of redistribution from high- to low-income workers.

Informality can dampen productivity and economic growth. Informal firms tend to be smaller and less productive, generate lower value added, and have limited market reach (La Porta and Shleifer 2008). Small firms cannot take full advantage of economies of scale in production and might use less sophisticated technologies compared to formal firms, even when they produce the same or similar goods. Informal firms often adopt outdated and cheap technology, as they can afford to survive in the market with a low marginal revenue product of labor. Further, as the number of informal firms can be very large, the effect on overall productivity can be sizable—with many small and low-productivity firms absorbing a significant share of resources (labor and capital) that could be used more efficiently by larger and more productive firms. This also discourages investing in human capital, which is key for innovation. Economies with low productivity growth cannot reach sustained long-term economic growth.

Informality can diminish the quantity and quality of public goods and services. The high fiscal costs of informality, as documented in the literature, could significantly shrink a country's tax revenue base, thus imposing a higher fiscal burden on a smaller number of formal firms and workers (Bardey and Mejía 2019; Ohnsorge and Yu 2022). This reduces the resources available to governments to provide public goods and services, such as hospitals, schools, roads, social protection benefits, and so on. Governments must then provide a lower quantity of public goods and/or borrow money to maintain the same level of supply, thus incurring fiscal deficits and public debt. In extreme cases, the failure of a government to repay its debts can lead to a default, with long-lasting social and economic costs that can undermine a country's social fabric for many years.

The bottom line is that informality can provide a means of escaping unemployment for people who may not be able to access formal jobs—due to low skills, poor endowments, and binding tax constraints and regulatory costs associated with joining the formal sector (IMF 2022; Loayza 2018; Ulyseya 2020). It can act as a buffer against employment and wage losses experienced by low-skilled and less productive workers when they are exposed to economic shocks, especially in developing countries (see, among others, Colombo, Menna, and Tirelli 2019). Informality may also serve as a temporary, medium-term solution for trade-displaced workers, preventing them from falling out of the labor

force completely (Dix-Carneiro and Kovak 2019; Ponczek and Ulyssea 2018). However, the long-run negative effects of informality on social protection, tax revenues, public goods, productivity, and growth far outweigh the short-term benefits.

WHAT WE KNOW AND DO NOT KNOW ABOUT INFORMALITY IN MENA

The phenomenon of informality has been studied less in MENA compared to other regions, especially in terms of its causes. Few studies have rigorously investigated the determining factors of informal employment in the region. It is difficult to compare the findings among the studies, owing to differences in how informality is defined and the methodologies used. This occurs because of limited access to micro-survey data, due to the region's strict national statistics bureau confidentiality guidelines. As a result, the use of micro-surveys (such as labor force surveys, consumption and expenditure surveys, and household budget surveys) remains limited among researchers, academics, nongovernmental organizations, and even public institutions—and MENA is the region with the lowest number of publications in the field of labor markets (Angel-Urdinola, Hilger, and Irvin 2010).

In recent years, most studies of the region have used macroeconomic correlation analyses, specific changes in policy, and interviews to investigate the causes of informality, at least in certain instances or for particular groups. However, the studies look at a small part of the story and do not capture the complex relationships between the institutional environment and informal outcomes. No study to date has comprehensively considered the role of the institutional environment in a MENA country by mapping out the various interactions between institutions, laws, and policies and assessing how the associated incentive structures influence informality.

What does the literature say about informality in MENA? One strand of literature considers correlates of informality at the regional level. A recent World Bank study argues that informality in MENA reflects three factors: economic structure, conflict, and the governance and business climate (Ohnsorge and Yu 2022). It finds that countries with high shares of nonnative populations or high public employment have higher levels of informality. The same is true for countries exposed to prolonged armed conflict (such as Iraq and the Syrian Arab Republic) and those performing poorly in the government effectiveness and regulatory quality index. Similarly, another World Bank study contends that the prevalence of informality depends on a country's structural

characteristics—such as governance, productivity, and economic composition (Gatti et al. 2014). The results indicate that law and order, business regulatory freedom, education, and sociodemographic factors are all remarkably robust determinants of formality; that is, informality decreases as these factors improve. In addition, informality decreases when the share of the population that is young or lives in rural areas decreases.

A recent study that focuses on Egypt, Morocco, Mauritania, and Tunisia distinguishes between “normal” and “excess” definitions of informality (IMF 2022). It argues that normal informality is a function of the level of development and structure of a country, while excess informality is a result of distortionary policy measures or frameworks. The study’s cross-country regressions on the share of employed workers without social insurance show that about 44 percent of the predicted informality surplus in MENA (compared to advanced economies) is associated with the region’s relatively lower level of development, with differences in policy distortions accounting for the rest. However, there are substantial differences in policy distortions across countries. For example, in Egypt, factors such as lower quality of governance, exorbitant tax burden, and limited access to financial services significantly affect individual choice between working in the formal and informal sectors. In Tunisia, the cumbersome government regulatory framework and rigid labor market regulations are the key binding factors.

Another strand of the literature focuses on country-level analyses to evaluate how changes in the regulatory framework influence informality. Wahba and Assaad (2017) find that in Egypt, the 2003 labor law boosted formal employment. By relaxing hiring and firing arrangements, it increased the probability of transitioning to formal employment for noncontractual workers employed in formal firms by about 3–3.5 percentage points, or the equivalent of at least a fifth of informal workers in formal firms. A similar change in the labor law introduced in Algeria in 2008 reduced the cost of hiring and decreased informal employment in firms with five or more workers (Souag and Assaad 2017). A study of Tunisia suggests that such institutional labor reforms may not equally translate into positive outcomes due to segmented labor markets—where labor regulations and protection are strictly applied only in the public and formal private sector, leaving the informal sector no incentives to formalize (Boughzala 2017). Angel-Urdinola, Barry, and Guennouni (2016) calibrate a model for Morocco to assess the effects of labor regulations on formal employment costs (particularly minimum wages and payroll taxes). They find that these regulations (notably minimum wage policy) hampered formal employment, especially for young people and women.

A third strand of literature uses firm interviews to understand constraints on enterprise formalization. An important input here is the World Bank Enterprise Surveys, which provide comprehensive firm-level data on emerging markets and developing countries. The Enterprise Surveys cover a broad range of business environment topics, including access to finance, informality, and performance. However, a notable caveat is that they traditionally only include formal private firms, making the survey findings indicative rather than representative of the private sector challenges informal firms face. A recent study shows the top obstacles that business face: in Egypt, high tax rates (24 percent of firms reporting); in Morocco, corruption (15 percent); and in Tunisia, access to finance (39 percent) (World Bank, EBRD, and EIB 2022). These factors likely limit firm growth and formal private sector job creation. Using Enterprise Survey data, other studies have used regression analysis and found that limited access to loans or other modes of finance present an overarching challenge to growth and job creation. Another study explores the link between jobs, access to finance, and informality using a longitudinal, firm-level data set for countries in MENA (Brancati, Di Maio, and Rahman 2022). The authors find that job creation correlates positively with better access to finance, and that accessing finance is significantly more difficult for firms that are more exposed to competition with informal firms due to worse expectations of future sales growth, which is also aligned with earlier findings from Amin and Viganola (2021) and Distinguin, Rugemintwari, and Tacneng (2016).

A FRAMEWORK FOR AN INSTITUTIONAL ANALYSIS OF INFORMALITY

This report adopts the framework put forward by Levy and Cruces (2021) to shed light on the legal, regulatory, and institutional context affecting the incentives and disincentives that economic agents—primarily workers and firms—face to operate (in)formally in selected MENA economies. A cornerstone of the framework is that informality is endogenous to the legal, regulatory, and institutional context in which firms and workers operate and make decisions. The size of the informal sector is not given and grows larger or shrinks depending on a country's environment. In other words, it does not represent a constraint but rather an outcome of the institutional context that economic agents face.

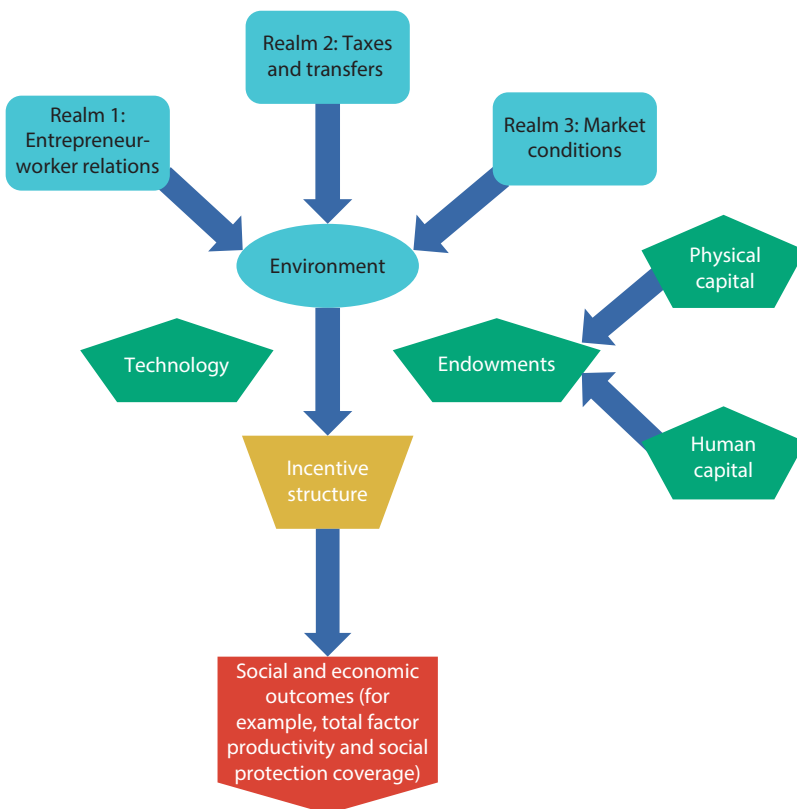
The framework focuses on several actors—government, banks, firms, and workers—and how they interrelate to influence individuals' economic decisions, including whether to work formally or informally, and whether to lend or borrow. This “environment”—what economic agents

consider “the rules of the game”—influences these decisions based on a set of incentives determined by laws, institutions, and policies, as well as by the functioning of institutions that enforce and determine the extent of the rule of law. It is composed of three broad realms: Realm 1, entrepreneur-worker relations; Realm 2, taxes and transfers; and Realm 3, market conditions (figure 1.2). Unlike approaches that view the drivers of informality through a single lens, this approach takes a comprehensive perspective to focus on features of, and interrelationships between, each broad area of the environment to make sense of the complex incentive structure that different groups of workers and firms face when making economic decisions.

For example, the design of social insurance systems affects employers’ and workers’ preferences to operate formally. More concretely, it depends on various factors: contribution rates, benefits that accrue to workers in terms of risk coverage, quality of services provided, and the

FIGURE 1.2

The Environment and Social and Economic Outcomes



Source: Based on Levy and Cruces 2021.

expected costs to employers of hiring workers informally. Expected costs to employers depend on the probability of getting caught and the severity of sanctions. These factors determine the value that individuals attribute to participating in contributory social insurance as opposed to receiving benefits through noncontributory social insurance or transfer programs. Similarly, if the tax burden of operating formally (fully or partially) is high and enforcement is weak, economic agents may prefer to evade to minimize their costs, thereby incentivizing informality. In addition, informality might increase if it is costly for firms to register their businesses or resolve commercial disputes—or if it is difficult or risky to access credit because of high collateral requirements or uncertainties linked to protection of borrowers' and lenders' rights, or if it is difficult to enter a market and grow because some markets are uncontestable due to corruption and unfair competition.

Realm 1: Entrepreneur-worker relations. This realm covers institutions and laws related to how entrepreneurs and workers interact to form firms and establish their respective rights and obligations, as well as the institutions in charge of enforcing those rights and obligations. It includes (1) a country's contributory social insurance programs, with taxes levied in proportion to workers' earnings and earmarked to finance benefits (such as health, disability, work accidents, unemployment insurance, and retirement pensions); (2) labor regulations (such as those on minimum wages, collective agreements, noncontributory social insurance programs, and hiring and firing regulations); and (3) institutions in charge of enforcing such laws and regulations (such as labor tribunals adjudicating disputes on hiring and firing regulations, as well as institutions responsible for collecting social insurance contributions and enforcing minimum wage laws) (figure 1.3).

Each element of Realm 1 consists of several institutions, laws, and policies, which vary by country. For instance, contributory social insurance may be managed by a specialized social security institute in one country, while similar programs may be administered by different agencies in another (like one for health and another for pensions). In some countries, such agencies are charged only with financing-related activities, while in others they also provide services. Although not exhaustive, the aforementioned elements sufficiently capture the core policies to insure workers against risks (such as illness, disability, work accidents, longevity, death, and loss of employment).

Importantly, these risks are bundled and part of a package that includes other elements of Realm 1. Workers in firms covered by contributory social insurance are also protected by firing regulations and minimum wage laws. Firms that employ workers formally are required to comply with all three concurrently. However, not all workers are protected by

FIGURE 1.3

Key Elements of Realm 1: Entrepreneur-Worker Relations



Source: Based on Levy and Cruces 2021.

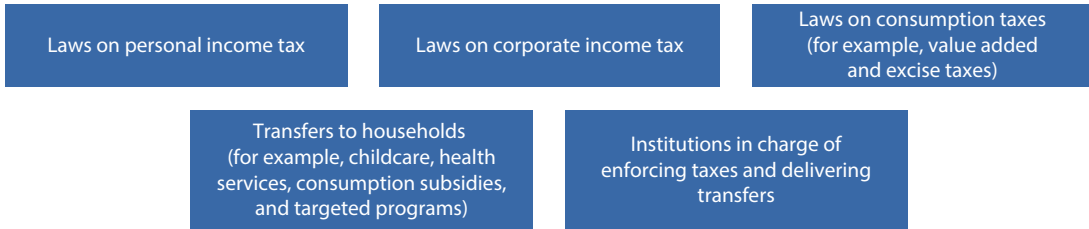
these three elements—possibly due to explicit exemptions, unclear obligations, or noncompliance—and informal workers are excluded from contributory social insurance programs and other labor regulations.

Realm 2: Taxes and transfers. This realm encompasses the laws and institutions that collect taxes and deliver transfers to households. It includes (1) laws on personal income tax, (2) corporate income tax, (3) consumption taxes (like value added and excise taxes), (4) transfers to households in kind or in cash (which are different from contributory and noncontributory social insurance), and (5) institutions in charge of enforcing taxes and delivering transfers (figure 1.4). Like Realm 1, Realm 2 consists of several laws and institutions that may vary across countries. For example, a country’s tax system and tax enforcement may be managed by the ministry of finance, while the ministry of labor and social security may collect and manage social security contributions. Personal and corporate income taxes are not related to contributory social programs; while the former provide a stream of government revenue to use at its discretion, the latter are earmarked to provide risk insurance for contributing workers.

Realm 3: Market conditions. This realm represents the laws and institutions that determine market functioning, including institutions designed to provide legal certainty to parties in an exchange, correct market failures, or promote certain sectors or activities. The realm of market conditions is extensive. Levy and Cruces (2021) identify several elements that are important when considering the overall relationship between a country’s institutional landscape and economic and social outcomes. These include a country’s foreign trade and investment laws that affect the degree of competition domestic firms face from foreign firms,

FIGURE 1.4

Key Elements of Realm 2: Institutions, Laws, and Policies



Source: Based on Levy and Cruces 2021.

FIGURE 1.5

Key Elements of Realm 3: Market Conditions



Source: Based on Levy and Cruces 2021.

to regulate domestic competition that determine the extent of market contestability; policies to promote specific sectors; the functioning of the institutions in charge of enforcing credit or commercial contracts; as well as the procedures and costs to register a firm.

Within Realm 3, this report reviews only a subset of factors that mostly influence the number, size, and productivity of firms, which have important implications for the extent to which firms operate formally, expand in size, and create formal jobs. The three dimensions considered are the procedures and costs to register firms, enforcement of credit and commercial contracts, and competition in product markets (figure 1.5).

Importantly, firms are defined as informal if they employ all their workers informally, while they are considered formal if they employ at least one worker formally. In this report, however, due to the absence of representative enterprise surveys that match firms and workers, firm informality in Realms 2 and 3 is defined according to registration status. The two definitions largely overlap as unregistered firms cannot hire formal workers and registered firms are formal under the first definition as they likely hire at a minimum one worker formally.

HOW THE ENVIRONMENT INFLUENCES PRODUCTIVITY AND GROWTH

Every country is characterized by a certain level of human and physical capital, which changes over time due to several factors, such as population growth, technological advancement, and improvements in education. At a given point in time, there is also a distribution of firms that possess different levels of productivity, which depend on (1) the level and quality of physical capital, (2) the technology that is available and used by different firms, and (3) the skill level of the workers managing such technology. Importantly, a country's total factor productivity (TFP) can be defined as the weighted average productivity of all firms, with weights given by each firm's share of total resources.¹

In developing countries, self-employment is often widespread, with a significant proportion of workers concentrated in micro or small firms, both of which absorb large shares of country resources. In Tunisia, about 97 percent of firms employ fewer than 10 workers and contribute almost 65 percent to total employment. Similarly, in Morocco, small firms with fewer than 10 workers contribute around 90 percent of informal wage employment and 30 percent of formal wage employment. In Egypt, about 53 percent of total employment is concentrated in micro firms with fewer than five workers.² Most firms with low productivity also tend to be small and often operate in the informal sector (IDB 2010; Gatti et al. 2014). In the pilot countries for this report—namely, Egypt, Morocco, and Tunisia—the size of an enterprise's workforce and its TFP are positively correlated, although the strength and shape of this relationship varies by country (figure 1A.1, in annex 1A).

The resource allocation process determines a country's overall productivity, which is also key to determining workers' and households' income levels and access to social protection. If the allocations of resources and TFP are known, then the income level of each individual and the compliance of firms and workers with laws under Realm 1—and therefore their formal and informal status—are also known. Taken together, an environment that creates an incentive structure that allows many informal, small firms with low productivity to survive, thereby absorbing resources and market share from more productive firms, yields subpar social and economic outcomes. At the macro level, it hurts TFP, may not contribute to poverty and inequality reduction, and ultimately stifles economic growth. At the worker level, it reduces coverage against risks and increases vulnerability.

Another factor that affects the formal/informal composition of the economy concerns the system of taxes, or Realm 2. Countries have

introduced special tax regimes for the self-employed as well as for micro and small enterprises, to incentivize compliance with contributory social insurance schemes and the tax system. Special tax regimes typically come with specific requirements (such as the firm's sales or numbers of workers below certain thresholds) only for firms in certain sectors or those with a single owner. Preferential tax treatment consists of a very low tax rate—much lower than the rate levied under the corporate income tax regime—paid on revenues or sales, instead of profits or a flat amount. This allows very-low-productivity firms to stay afloat since their labor cost and tax burdens are considerably lower than for firms operating under the standard tax regime, while diverting resources from more efficient firms.

These special tax regimes impose binding conditions that do not allow firms to grow beyond the threshold imposed by the law, unless the expected growth is such that the jump in revenues is large enough to counterbalance the decline in posttax profits associated with higher taxes. They stop firms from taking advantage of economies of scale and impede the diversification of stakeholders (if firms under a special regime are required to be individual enterprises), thereby reducing access to credit and capital and, ultimately, productivity growth and formal job creation. Special tax regimes interact with other taxes, like the value-added tax. Often, firms under special tax regimes are exempted from the value added tax. This restricts the network of suppliers and customers, as such firms can only sell to final consumers or interact with other firms informally. As a result, interactions across firms of different sizes are limited, thus preventing skill and technology transfer. Ultimately, special tax regimes and their interaction with other taxes provide perverse incentives for firms to operate at a small scale and remain in a low-productivity equilibrium.

Market conditions (Realm 3) also play a role in productivity and growth. First, lengthy and expensive procedures to register a new enterprise might constitute an initial barrier to formality. Second, contract enforcement affects the level of security and integrity of economic transactions of formal firms. For example, weak enforcement of credit contracts generates uncertainty and increases legal costs to impound collateral in case firms fall into bankruptcy or default on loans. This might lead banks to provide less credit, and small firms are more likely to suffer the consequences. Further, this does not incentivize firms to operate formally, as there are no significant advantages in terms of access to credit from being a formal business. Where many small, informal firms are not legally incorporated and operate as individual enterprises—with no distinction between the assets of the firm and the assets of the owner—this

might generate concerns when assets need to be used as loan collateral. Similarly, strong enforcement of commercial contracts can increase the advantages of operating formally and allow firms to go beyond a trusted network of suppliers and clients, as dispute settlement is administered by efficient courts.

Third, product market competition is key to ensuring that firms can compete on an even field and represents the cost that firms face when they enter a market and interact with existing firms. The presence of state-owned enterprises and monopolies in sectors where such a market structure is not justified economically, institutional controls on prices, and restrictions on foreign entry into the domestic market constrain market entry and firms' growth. It lowers the number of firms operating in markets, their level of productivity, and, ultimately, economic growth—a situation made only worse in MENA countries by cronyism and political connections that further undermine market contestability and fair competition.

The bottom line is that the combination of weak contract enforcement, long and expensive registration procedures, limited market competition, and cronyism keeps firms small, at low levels of productivity, and informal. Improvements on these fronts could help firms grow by improving access to credit, allowing firms to diversify their networks, facilitating technology transfer, and increasing productivity. Larger firms would be more likely to hire formal workers, since larger firms have higher productivity and it would be more difficult for them to evade, thus increasing formal job creation and social insurance coverage while improving social protection.

HOW THE ENVIRONMENT INFLUENCES SOCIAL PROTECTION COVERAGE, POVERTY, AND INEQUALITY

To the extent that the elements that compose the three realms affect the formal/informal composition of the economy, the immediate by-product is that a certain number of workers—in some countries, a very large number of workers—do not benefit from contributory social insurance and thus are not covered against a series of risks. This protection gap influences the extent and quality of social protection coverage of workers and ultimately affects poverty and inequality outcomes. Here, the focus is on whether the value of contributory social insurance can equal the cost that firms pay for it.

The largest share of contributions, typically two-thirds paid by the employer and one-third paid by the worker, goes to funding

retirement pensions and health insurance. In the case of pension benefits, some contributing workers might not have access to these benefits because of their discontinuous formal careers, with contributions paid only for a few months in a year, and therefore requiring much more time to achieve the minimum number of years to be eligible for the pension benefit. For workers who meet the eligibility requirements, the design of pension systems might in some cases be more than actuarially fair, meaning that workers receive more than what they paid for in terms of pension benefits. This ends up being an implicit tax on informal workers and a subsidy to formal workers. The presence of pension benefit caps without a cap on contributions might provide an incentive to be partially informal. In other words, high-wage workers as well as the firms employing them might have an incentive to declare and pay contributions only on a fraction of the actual wage.

In the case of health insurance, the low quality of health services provided under contributory social insurance might be a strong disincentive to contribute. Public health care is completely free or provided conditional on a small co-pay for formal workers and their families, but there are hidden costs (such as long waiting lines and limited availability of treatments and medicines). Ceilings on the amount refunded if workers opt for private providers and a disconnect between negotiated and market tariffs decrease the value of contributing to health insurance, particularly in the case of ordinary diseases. Moreover, in some countries, informal workers have access to the same public health care available to formal workers, through noncontributory social insurance. This reduces the value of contributory health insurance, and therefore of formality, unless the supply of health care is scaled up to accommodate the demand for health care coming from both groups of workers. Further, the lack of a cap on taxable wages implies that high-wage workers pay more than low-wage workers and receive the same benefit—which incentivizes only partial compliance, as in the case of pension benefits.

On job stability regulations, workers might appreciate protection against and compensation for unfair dismissal if courts functioned efficiently, rapidly, and independently. However, the level of enforcement tends to correlate with firm size. Indeed, enforcement of contributory social insurance, job stability, and minimum wage regulations focuses on larger firms that are easier to catch and sanction in case of violations.

Could the value of contributory social insurance and job stability regulations equal the cost that firms pay for them? Yes, but it would

depend on factors that are specific to the design of the social insurance system and vary by country. The key point here is that if the value is lower than the cost to firms, then formal employment is implicitly taxed because workers and firms pay for nonwage benefits, and workers only receive a fraction of them.

What happens to those who do not benefit from contributory social insurance, which in some MENA countries is a large share of workers? In some contexts, such workers might have partial coverage, typically health insurance or retirement pensions, through noncontributory social insurance, conditional on belonging to poor or vulnerable households. However, the fact that not everyone who is supposed to contribute does so limits the risk-pooling scope of contributory social insurance, thus decreasing the quality of the benefit for formal workers. In addition, if some informal workers are covered by noncontributory social insurance and have access to the same types of facilities available to formal workers (such as health care), this might further lower the quality of service unless the supply of health care is adequately increased. Noncontributory social insurance is often accompanied by cash or in-kind transfers, which do not provide insurance against the risks that are not covered by noncontributory programs, such as illness, loss of job, loss of life, and disability.

Moreover, the fact that some transfers are conditional on workers' formality status imposes a high implicit tax on moving out of poverty. The only workers who will complete the transition are those who expect a very large increase in their labor income to compensate for the loss of the transfer as well as for payments for their social security contributions. In addition, it is possible that the marginal product of labor of poor workers might be lower than their marginal cost if they were hired formally, considering their low educational level and the low productivity of the firms that could hire them.

Similarly, if workers decide to contribute as self-employed, the cost of contributory social insurance might be excessive, given their level of earnings. In addition, the benefits of contributory social insurance for poor informal workers might be lower if they are more likely to experience frequent transitions in and out of formality—as this makes it less likely that they will be eligible for certain types of benefits (such as a retirement pension that requires a minimum number of years of contributions). The subsidy to informality might be higher for poor workers when some benefits received through noncontributory social insurance are a fixed amount—in other words, the benefits represent a larger share of their earnings. This can end up trapping workers in a poor, vulnerable, and informal status.

How does contributory social insurance affect inequality? There are two main channels:

- Firms pay a share of the contributions, which is typically larger than the share that employees pay. If firms' owners have higher incomes than employees—and firms absorb contributions in the form of lower profits as opposed to covering the cost of social insurance by lowering wages—then contributory social insurance can reduce inequality through redistribution from firms to workers.
- Some programs entail cross-subsidies from high- to low-wage formal workers. This happens when the contribution rates and the quality of services are the same for all workers—in other words, high-wage workers contribute more in absolute terms for the same service (like health insurance).

In practice, however, some high-wage workers do not contribute at all (informal), contribute partially (by declaring a lower wage), or are excluded because they work as self-employed or contribute to separate schemes. For retirement pensions, if the system is actuarially fair—meaning that contributions are proportional to returns—then no redistribution takes place. However, discontinuities in eligibility requirements—such as requiring a minimum number of years of contributions to be eligible—create a redistribution from informal to formal workers. In other words, the contributions that informal workers pay during the few months or years they are formal end up funding pensions for formal workers with sufficiently long formal careers, who are more likely to be high-wage workers.

Noncontributory social insurance can reduce inequality because it is financed from general tax revenues and, on average, informal workers have lower incomes compared to formal workers. In some countries, there is a substantial overlap between the wage distributions of formal and informal workers, meaning that high-wage informal workers capture some subsidies from noncontributory insurance. Typically, the redistribution effects are smaller relative to those of contributory social insurance, as the resources devoted to noncontributory programs tend to be relatively small.

Elements of Realm 2 can also affect inequality. For example, the personal income tax can result in a redistribution from high- to low-income workers and families if the system is progressive. However, the presence of loopholes and evasion limits the extent of such a redistribution. Similarly, under Realm 3, a very high concentration of income at the top of the distribution is often associated with failures in the laws and institutions in charge of regulating monopolies and market power. This can cause a

redistribution from low- to high-income individuals—and it inhibits the political process from changing laws and regulations that serve the interests of privileged groups or insiders, who are often politically connected.

WORKERS AND FIRMS: BALANCING THE COSTS AND BENEFITS OF FORMALITY

For a better understanding of how the environment—particularly the elements of Realm 1—affects incentives to formalize, it is helpful to identify the costs and benefits to workers and firms operating under different contractual arrangements. Following Levy and Cruces (2021), three cases can be considered: (1) formality, (2) illegal informality, and (3) legal informality.

Case 1: Both workers and firms are formal. Firms are incentivized to hire workers formally if the increase in revenues associated with hiring one extra worker, known as the marginal revenue product of labor, exceeds the cost of hiring the additional worker formally. This cost is determined by compliance with regulations on contributory social insurance, job stability, and the minimum wage. For firms with very low TFP—and thus a low marginal revenue product of labor—hiring the extra worker formally would pose a problem, unless the firm can shift some of the cost (especially of contributory social insurance and job stability regulations) back to the worker in the form of a lower wage. But if there are minimum wage regulations that prevent this, firms will hire workers informally or not hire them at all. It is worth noting that the level of a firm's TFP is not sufficient to guarantee that workers will be hired formally, particularly if there are strict job stability regulations that impose high firing costs or make the dismissal process lengthy and uncertain—for example, in the case of a negative shock.

If an extra worker is hired formally, he or she receives a wage at or above the minimum wage and is entitled to social insurance. If the value of social insurance and job stability for the worker is equal to the value for the firm, then the worker will accept what the firm is willing to pay and will be hired formally. However, if the value for the worker is lower than the cost the firm must pay to comply, then there is an implicit tax on formal employment.

Case 2: Workers and firms are illegally informal. This occurs when firms do not comply with social security regulations and the labor code. In this case, their cost of labor is lower than what is determined by contributions to social insurance and compliance with job stability regulations, and potentially below the minimum wage. This implies that firms with very low productivity might be able to exist in the market and absorb

resources, in terms of labor and capital, that could be used more efficiently by firms with higher productivity levels. Although workers do not benefit from contributory social insurance and job stability and might be paid a wage below the legal minimum, they might benefit from non-contributory programs (like health insurance) and cash transfers (free to workers). If the value of such noncontributory programs to workers is positive, then informal employment receives an implicit subsidy. Firms do not pay for such benefits, but they run the risk of being caught and sanctioned—a question of the degree of enforcement and the cost of sanctions if they are caught. In addition to being means-tested, in some countries, cash transfers are conditional on workers' formality status; otherwise, cash transfers do not have a role in the formal-to-informal composition of employment, as their value is positive for all workers regardless of their formal or informal status.

Case 3: Workers and firms are legally informal. This occurs when there are firms owned by one person or firms without salaried workers—hence, there is no need to comply with minimum wage, social insurance, or job stability regulations. These firms pay workers as little as possible and thus can survive even at very low levels of productivity. This might take place in contexts where laws allow for the exclusion of some workers or firms from contributory social insurance, job stability, and minimum wage regulations. Examples include individuals employed in the one-person firm they own, workers in a firm without a direct relationship of dependency or subordination, family members helping without pay in the family business (known as contributing family workers), and legislative ambiguities that place some workers in a gray area. Some countries allow the self-employed to contribute to social insurance under separate schemes, using declared income level at a lower contribution rate relative to salaried workers. The results of legal informality are a limited number of benefits (like retirement pension and health insurance) and lower benefits (especially for pension).

PILOT COUNTRIES AND DATA SOURCES

This report focuses on countries in the MENA Region for which the following data are available: (1) micro-level data with information on employment, social insurance coverage, and household welfare; (2) social security administrative data or reports based on these data; and (3) data on regulatory and institutional dimensions—such as labor regulations and tax laws—from government websites and gathered in collaboration with local think tanks. The final set of MENA countries the report analyzes includes Egypt, Morocco, and Tunisia.

Worker data. Household budget surveys and labor force surveys are at the core of all the worker-level analyses. To characterize the pilot countries' labor markets, including informal employment, the study uses available micro-level data, primarily labor force surveys and household budget surveys (table 1.2).

For Egypt, multiple rounds of annual labor force surveys, conducted between 2007 and 2019 by the Central Agency for Public Mobilization and Statistics, as well as the Labor Market Panel Survey of 2012 and 2018, are used. For Morocco, the annual employment survey is used—namely, the Enquête Nationale sur l'Emploi, conducted by the High Commission for Planning—which provides labor market and socioeconomic information from 2000 to 2018. For Tunisia, the key micro data sets used are the latest rounds of the annual National Survey on Population and Employment (Enquête Nationale sur la Population et l'Emploi) and the National Survey on Household Budget, Consumption and Standard of Living (Enquête Nationale sur le Budget, la Consommation et le Niveau de Vie des Ménages), produced by the Tunisia Institute of Statistics.

TABLE 1.2

Data Sources, by Pilot Country

| Type of source | Egypt, Arab Rep. | Morocco | Tunisia |
|-------------------------|--|---|--|
| Labor force survey | <ul style="list-style-type: none"> Labor Force Survey, 2007–19 Egypt Labor Market Panel Survey, 2012 and 2018 | <ul style="list-style-type: none"> Enterprise Survey, 2000–18 | <ul style="list-style-type: none"> National Survey on Population and Employment, 2006–19 |
| Household budget survey | <ul style="list-style-type: none"> Household Income, Expenditure, and Consumption Survey, 2017/2018 | <ul style="list-style-type: none"> National Household Consumption and Expenditure Survey, 2013/14 | <ul style="list-style-type: none"> National Survey on Household Budget, Consumption, and Standard of Living, 2010 and 2015 |
| Enterprise survey | <ul style="list-style-type: none"> General Census for Population, Housing, and Establishments, 1996, 2006, and 2017 World Bank Enterprise Surveys, 2016 and 2020 | <ul style="list-style-type: none"> World Bank Enterprise Surveys, 2013 and 2019 | <ul style="list-style-type: none"> World Bank Enterprise Surveys, 2013 and 2020 Report based on Survey of Economic Activities of Micro Enterprises, 2016 |
| Administrative data | <ul style="list-style-type: none"> Secondary sources, such as academic papers, reports, and newspaper articles | <ul style="list-style-type: none"> National Social Security Fund / National Fund of Social Provident Organizations reports, 2010–20 | <ul style="list-style-type: none"> Annual reports based on National Business Registry, 2000–19 CRES database, 2019, 2021, and 2022 |
| Tax data | <ul style="list-style-type: none"> IMF and OECD tax data repositories, 2019 | <ul style="list-style-type: none"> IMF and OECD tax data repositories, 2000–18 Central Bank of Tunisia data Ministry of Finance data | <ul style="list-style-type: none"> IMF and OECD tax data repositories, 2011–19 Ministry of Finance data, 2019 |
| Doing Business | <ul style="list-style-type: none"> World Bank Doing Business archive, Egypt, Arab Rep., 2019 | <ul style="list-style-type: none"> World Bank Doing Business archive, Morocco, 2019 | <ul style="list-style-type: none"> World Bank Doing Business archive, Tunisia, 2019 |

Source: Original table for this publication.

Note: CRES = Center for Research and Social Studies; IMF = International Monetary Fund; OECD = Organisation for Economic Co-operation and Development.

Firm data. The enterprise-level analysis is largely based on World Bank Enterprise Surveys and other analytical reports (by country statistical agencies), with data on the distribution of informal enterprises by characteristics (such as size and productivity). In particular, recent and previous Enterprise Surveys are used for all countries, while the General Census for Population, Housing, and Establishments (1996, 2006, and 2017) and Survey of Economic Activities of Micro Enterprises (2016) are also employed for Egypt and Tunisia, respectively.

Administrative, regulatory, and tax data. The study draws on several sources of administrative data to analyze the institutions, laws, and policies that govern firm and worker relations (Realm 1), including contributory and noncontributory social insurance programs:

- For Morocco, this includes data from the National Social Security Fund (Caisse nationale de sécurité sociale) and the National Fund of Social Provident Organizations (Caisse Nationale des Organismes de Prévoyance Sociale).
- For Tunisia, this comprises annual reports based on National Business Registry data from 2000 to 2019 and other data from the database maintained by the Center for Research and Social Studies (Centre de Recherches et d'Etudes Sociales) in 2019, 2021, and 2022.
- For Egypt, the institutional analysis (Realm 2) relies on secondary sources, owing to limited access to equivalent data sources.

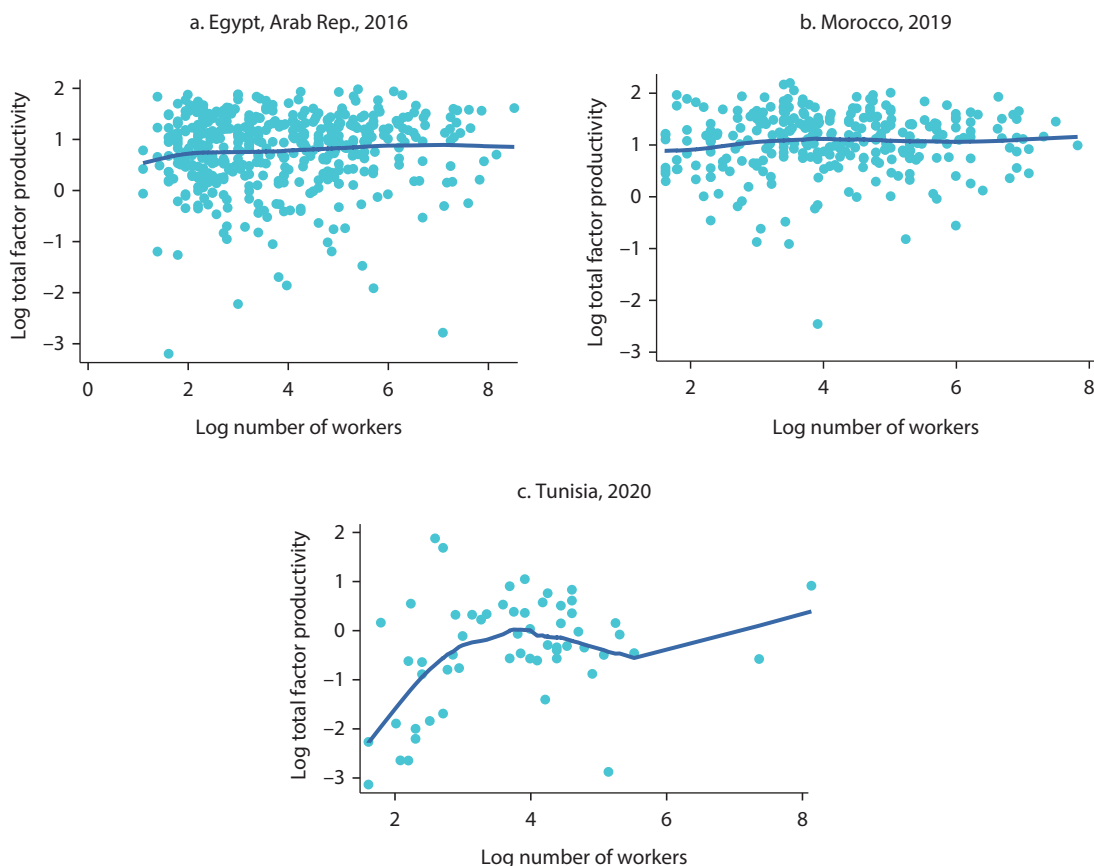
For all the countries, the tax analyses (Realm 2) use International Monetary Fund and Organisation for Economic Co-operation and Development data repositories, which provided important information related to each country's tax revenue composition and enabled international comparisons. More granular information on tax schedules and collections by income tax regime are from ministries of finance and central banks.

Although firm data on the ease of doing business and market conditions are scant in MENA, especially for informal firms, the World Bank's Doing Business repository and Enterprise Surveys are used for the pilot countries as measures of business regulations and enforcement quality. Additional market contestability inputs are from several secondary sources, most of which were written by governmental or intergovernmental organizations, such as the International Monetary Fund, Organisation for Economic Co-operation and Development, and World Bank.

ANNEX 1A: CORRELATION BETWEEN FIRM SIZE AND TOTAL FACTOR PRODUCTIVITY

FIGURE 1A.1

Correlation between Firm Size and Total Factor Productivity, by Pilot Country, Latest Year



Source: Based on data from Enterprise Surveys (dashboard), World Bank (<https://www.enterprisesurveys.org/>).

Note: The figures above used a Lowess smoother and a bandwidth of 0.8. Observations with productivity below the 5th and above the 95th percentile were dropped from the sample.

NOTES

1. TFP refers to the value added produced by a firm with US\$1 of capital and labor and is the result of the interaction between the physical efficiency of production and the price the firm receives for its product.
2. Calculations based on data from the National Business Register (2019) for Tunisia, the Labor Force Survey (2017) for Morocco, and the General Census for Population, Housing, and Establishments (2017) for Egypt.

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MENA's Key Challenges to Boost Living Standards

KEY MESSAGES

- Since 2000, economic growth in the pilot countries has been subpar, largely driven by consumption, while investment is low—and in the Arab Republic of Egypt and Tunisia, it is declining.
- Despite subpar growth, better living standards have continued in Morocco and Tunisia—mostly driven by pro-poor growth and higher public outlays—but not in Egypt, where living standards have stagnated.
- Subpar growth was driven by labor productivity gains, associated with physical and human capital accumulation, while total factor productivity growth remained sluggish.
- Making matters worse, rising fiscal deficits and public debts, along with rising current account deficits, are a recipe for unsustainability.
- Labor markets feature low labor force participation rates, especially among youth and women.
- Informal employment is high, especially in Egypt and Morocco, and it is more common among workers with little education, youth and older workers, and poor workers—although the middle class and affluent households have not been spared.

INTRODUCTION

Over the past two decades, the economic performance of the Middle East and North Africa (MENA) Region, excluding high-income countries, has been subpar, and this report's three pilot countries (Arab Republic of Egypt, Morocco, and Tunisia) are not exceptions. As a result, the region and the pilot countries have lost ground. The modest economic growth has not only generated few jobs compared to the size of the working-age population but also few jobs of good quality—a serious problem for a region with low labor force participation and high unemployment, especially among youth and women. Despite the modest growth, improvements in living standards have continued in Morocco, driven by pro-poor growth and investments in health and education, and in Tunisia, driven by an increase in public transfers.

As chapter 1 points out, the institutional forces that shape informal employment also feed through to productivity, growth, jobs, poverty, and inequality. This chapter looks at the key challenges that MENA countries must tackle to lay the groundwork for steady, sustainable, and inclusive growth. It begins with a look at the growth context in MENA and the pilot countries—in which labor market outcomes, including sizable informal employment, are embedded—before zeroing in on the labor markets and informality.

GROWTH, JOB CREATION, AND POVERTY REDUCTION

During 2000–19, economic growth averaged 1.7 percent per year in MENA, which was higher than growth in Latin America and the Caribbean (LAC) (1.6 percent) and Europe and Central Asia (ECA) (1.4 percent), but much lower than some other developing regions, such as East Asia and Pacific (EAP) (3.9 percent) and South Asia (SAS) (3.3 percent) (table 2.1). MENA's growth rate started to lose steam amid the Arab Spring—which contributed to a drop in average growth from 2.5 percent in 2000–04 to 0.5 percent in 2010–14. Although average growth doubled to 1.0 percent in 2015–19, disruptions in global supply value chains, capital flows, and COVID-19 confinement measures led to MENA's negative per capita growth rate of –4.3 percent in 2020.

Although growth in the pilot countries outperformed MENA's 1.7 percent average, their economic performance has been weaker compared to their income group peers. Among the three pilot countries, Morocco and Egypt had the highest average economic growth over 2000–19, about 2.8 and 2.3 percent, respectively; Tunisia's growth was slightly lower, at 2.1 percent. These rates are well below the

TABLE 2.1**Average Annual GDP per Capita Growth Rate, by Region and Pilot Countries, 2000–20***Percent*

| Region/country | 2000–04 | 2005–09 | 2010–14 | 2015–19 | 2020 | 2000–19 |
|---|---------|---------|---------|---------|-------|---------|
| Middle East and North Africa (excluding high-income) | 2.5 | 2.7 | 0.5 | 1.0 | –4.3 | 1.7 |
| Egypt, Arab Rep. | 2.0 | 4.2 | 0.6 | 2.6 | 1.6 | 2.3 |
| Morocco | 3.4 | 3.7 | 2.4 | 1.8 | –7.4 | 2.8 |
| Tunisia | 3.3 | 3.5 | 1.1 | 0.5 | –10.1 | 2.1 |
| Lower-middle-income | 3.8 | 4.3 | 4.8 | 4.4 | 4.0 | 6.9 |
| East Asia and Pacific (excluding high-income) | 6.7 | 8.5 | 6.9 | 5.6 | 0.4 | 3.9 |
| Europe and Central Asia (excluding high-income) | 6.4 | 4.0 | 3.3 | 1.8 | –2.1 | 1.4 |
| Latin America and the Caribbean (excluding high-income) | 1.0 | 2.0 | 2.5 | 0.0 | –7.7 | 1.6 |
| Sub-Saharan Africa (excluding high-income) | 2.1 | 2.5 | 2.0 | –0.1 | –4.4 | 4.6 |
| South Asia | 3.5 | 4.9 | 4.8 | 5.1 | –6.9 | 3.3 |

Source: Based on data from World Development Indicators, World Bank.

Note: GDP = gross domestic product; MENA = Middle East and North Africa.

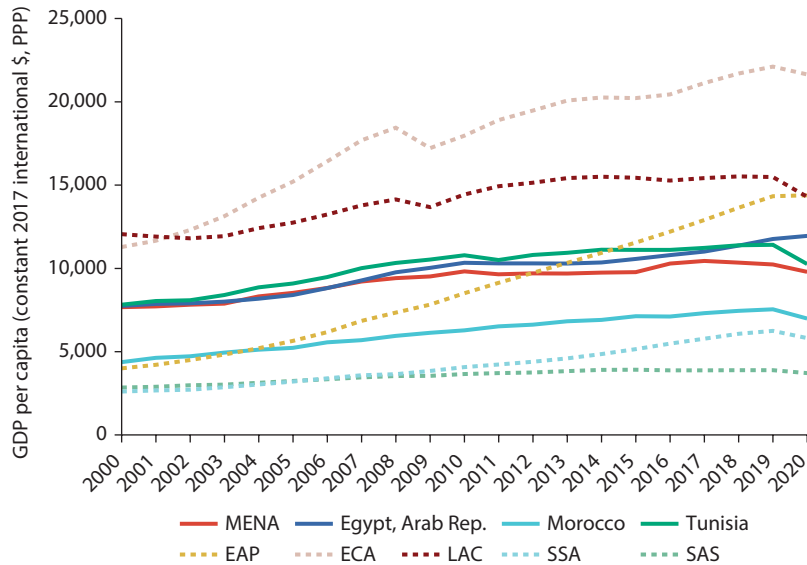
average 6.9 percent for the lower-middle-income group. Moreover, the COVID-19 pandemic and ensuing economic downturn worsened the economic outlook of the pilot countries, albeit to differing degrees. In 2020, gross domestic product (GDP) per capita in Tunisia and Morocco contracted by 10.1 and 7.4 percent, respectively, while it increased by 1.6 percent in Egypt (table 2.1). Glimmers of economic recovery have emerged in Tunisia, with 2021 GDP per capita growth starting to rebound, at 2.3 percent, while in Egypt it has remained at a tepid 1.4 percent.¹

Another commonly used measure—the level of GDP per capita—also shows MENA and the pilot countries at a low level compared to other developing regions (excluding Sub-Saharan Africa [SSA] and SAS). In 2020, for instance, MENA's estimated GDP per capita of US\$9,790 (measured in 2017 purchasing power parity) was 32 percent less than that of LAC (US\$14,295), the region's nearest (upward) regional comparator. Egypt and Tunisia have historically enjoyed higher GDP per capita than MENA's average, while Morocco's economic situation has compared less favorably (figure 2.1). Tunisia had the highest estimated GDP per capita among the pilot countries until the COVID-19-induced economic contraction, when it fell to US\$10,260 in 2020, making Egypt the group leader with GDP per capita at US\$11,951. In Morocco, by contrast, GDP per capita has been markedly lower than the MENA and regional comparator averages, standing at US\$6,986 in 2020, which was similar to the EAP average in 2007.

These economic growth trends should be viewed against MENA's changing demographic trends. Indeed, MENA, including Egypt and

FIGURE 2.1

GDP per Capita, by Region, 2000–20



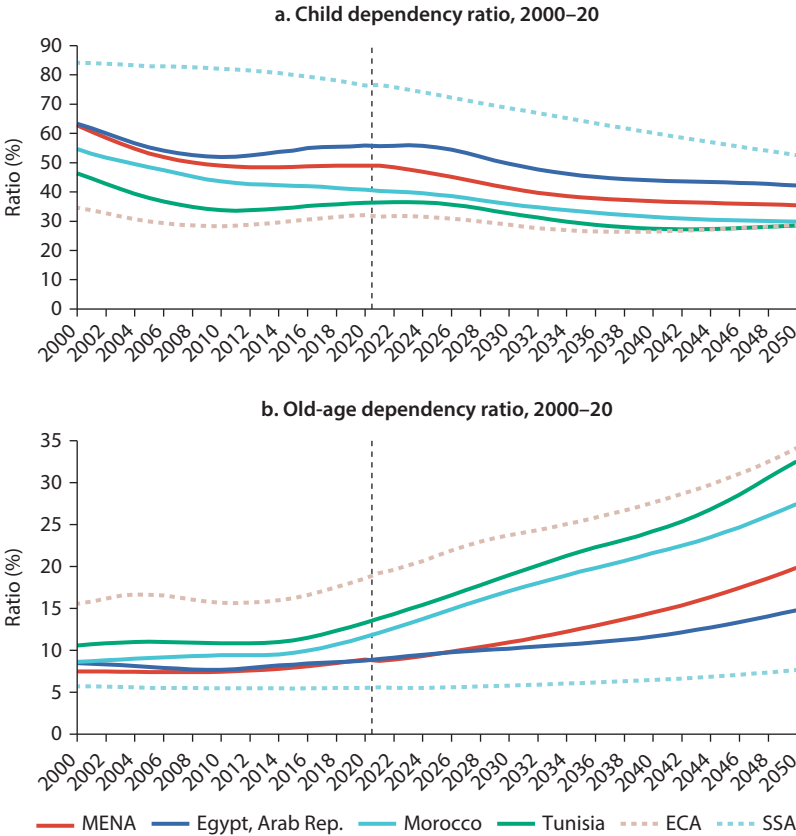
Source: Based on data from World Development Indicators, World Bank.
 Note: EAP = East Asia and Pacific; ECA = Europe and Central Asia; GDP = gross domestic product; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; PPP = purchasing power parity; SAS = South Asia; SSA = Sub-Saharan Africa.

Tunisia, is experiencing a reversal in its demographic transition—that is, the historical shift away from high birth rates and high death rates to low birth rates and low death rates as countries move up the economic development curve. Currently, most regions—except MENA and SSA—are seeing reductions in the fertility rate and the relative size of the young population (those under age 15) compared to the working-age population (those age 15–64). The year 2011 marked a turning point, with MENA’s fertility trends rising after a period of steady decline, as shown by a higher child dependency ratio (the dependence of youth on the working-age population), which is now about 49 percent. For the pilot countries, projections suggest that the child dependency ratio will resume its decline until 2025, with that of Morocco converging to a similar level as Tunisia’s by 2050 (at 29 percent) (figure 2.2, panel a).

However, MENA’s old-age dependency ratio (the dependence of those over age 64 on the working-age population) has remained low—at around 8 percent. In the pilot countries, the ratio ranges from 8.8 percent in Egypt, to 12 percent in Morocco, to 13.3 percent in Tunisia, but it is increasing rapidly. By 2050, Tunisia is expected to reach 32.5 percent; Morocco, 27.4 percent; and Egypt, 14.7 percent (figure 2.2, panel b).

FIGURE 2.2

Demographic Transition, Selected Regions and Pilot Countries, 2000–20



Source: Based on data from the United Nations Population Division.
Note: Data for 2000–2021 are actual and modeled, while estimates for 2022–2050 are projections, as indicated by the dashed vertical lines. ECA = Europe and Central Asia; MENA = Middle East and North Africa; SSA = Sub-Saharan Africa.

The current period—with the working-age population still growing faster than the total population in MENA—offers the region an opportunity to take advantage of this “demographic dividend” by creating enough decent jobs for the growing working-age populations.

How is MENA doing in terms of creating jobs from economic growth? One way to measure this is through employment elasticity (the percentage change in the number of employed persons in an economy associated with a percentage change in GDP). Although this effect is on average larger in high-income economies compared to emerging economies, in most countries, 1 percentage point of GDP growth can boost employment between 0.3 and 0.8 percentage point (Furceri, Crivelli, and Toujas-Bernate 2012). In the MENA

Region, these elasticities tend to be near or below the lower end of this range—and they contrast with the high elasticities registered in Tunisia and Egypt:

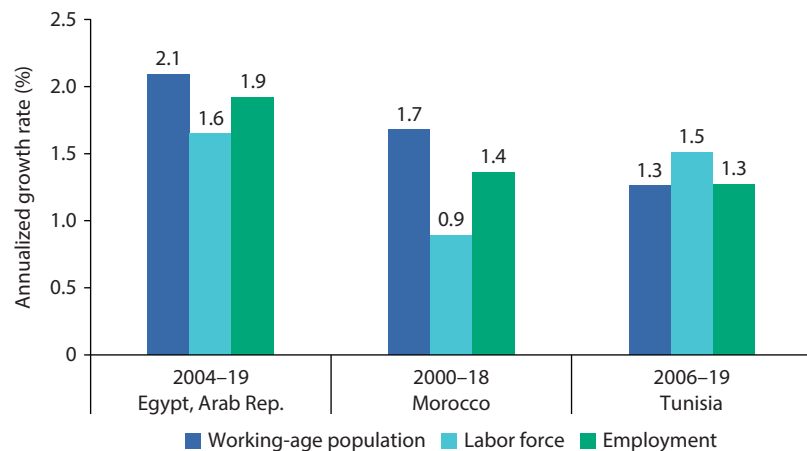
- In Tunisia, the employment-to-growth elasticity has picked up since the revolution, from 0.28 in 2006–11 to 0.89 in 2011–17 (World Bank 2022).
- In Egypt, the elasticity hovered at 0.88 from 2004 to 2019.
- In Morocco, the elasticity fell from 0.37 in 2000–9 to 0.12 in 2010–18.²

The next step is to see how these elasticities compare to not only the expansion of each country’s labor force but also its working-age population. Except Tunisia, the pilot countries have created enough jobs to keep up with their growing labor force but not with their expanding working-age population (figure 2.3).

- In Egypt and Morocco, where employment creation reached 1.9 percent (2004–19) and 1.4 percent (2000–18), respectively, this was higher than the increase in the labor force, which averaged 1.6 and 0.9 percent, respectively.
- In Tunisia, the average 1.5 percent increase in the labor force per year was higher than the rate of employment growth, contributing to a net employment deficit of about 15,500 jobs per year.

FIGURE 2.3

Annualized Growth Rate, Arab Republic of Egypt, Morocco, and Tunisia, 2000–19



Source: Based on data from national statistical offices.

In contrast, the working-age population increased at an average annual rate of 0.2 percent higher than the rate of employment growth in Egypt, 0.3 percent in Morocco, and at the same rate in Tunisia.

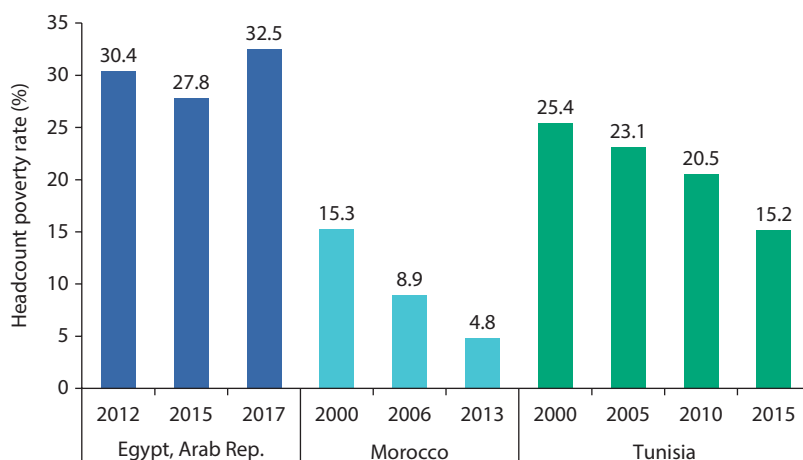
Against this backdrop of low economic growth and not enough job creation in MENA, extreme poverty (those living on less than US\$2.15 per day, 2017 purchasing power parity) was lower than in other regions from 2000 to 2012 (see figure 2A.1, in annex 2A).

It increased by around 56 percent between 2015 and 2018, from 4.8 to 7.5 percent, due in large part to conflicts in the Syrian Arab Republic and the Republic of Yemen—making MENA the only region where poverty has been increasing in recent years.

In the pilot countries, the poverty picture has been mixed. In Morocco, the poverty headcount rate at the national poverty lines declined considerably (from 15.3 percent in 2000 to 4.8 percent in 2013) (figure 2.4). The main driver was “pro-poor” economic growth, coupled with investments in education, health, and other social services, whereas transfers and subsidies were largely regressive (World Bank 2018). A similar decline in the poverty headcount was seen in Tunisia (from 25.4 percent in 2000 to 15.2 percent in 2015). The impetus between 2010 and 2015 was associated with more public transfers, upon which low-income households rely, and to some extent an employment shift from agriculture to wage employment among the poorest households (World Bank 2022). In contrast, progress has been limited in Egypt: the

FIGURE 2.4

Headcount Poverty Rate, Arab Republic of Egypt, Morocco, and Tunisia, 2000–17



Source: Based on data from national household budget surveys.
 Note: The headcount poverty rates are measured using national poverty lines.

reduction in the poverty headcount from 30.4 to 27.8 percent between 2012 and 2015 was followed by an increase to 32.5 percent in 2017. In the first period (2012–15), poverty reduction followed increases in social spending after the 2011 revolution, whereas double-digit inflation eroded purchasing power and led to the increase in poverty between 2015 and 2017 (World Bank 2021).

On inequality (as measured by the Gini index, where 0 means perfect equality and 100 means perfect inequality), the pilot countries have seen an improvement over time, albeit to different degrees. Egypt has the lowest inequality (31.5 in 2017), followed by Tunisia (32.8 in 2015) and Morocco (39.5 in 2014). While Tunisia's Gini index fell by 3 points and Morocco's by 1.2 points, Egypt's dropped only by 0.3 point. High inequality is the by-product of noninclusive growth that fails to create decent jobs for all and may also signal the limited effectiveness of fiscal redistribution.

SOURCES OF MENA'S GROWTH AND ECONOMIC TRANSFORMATION

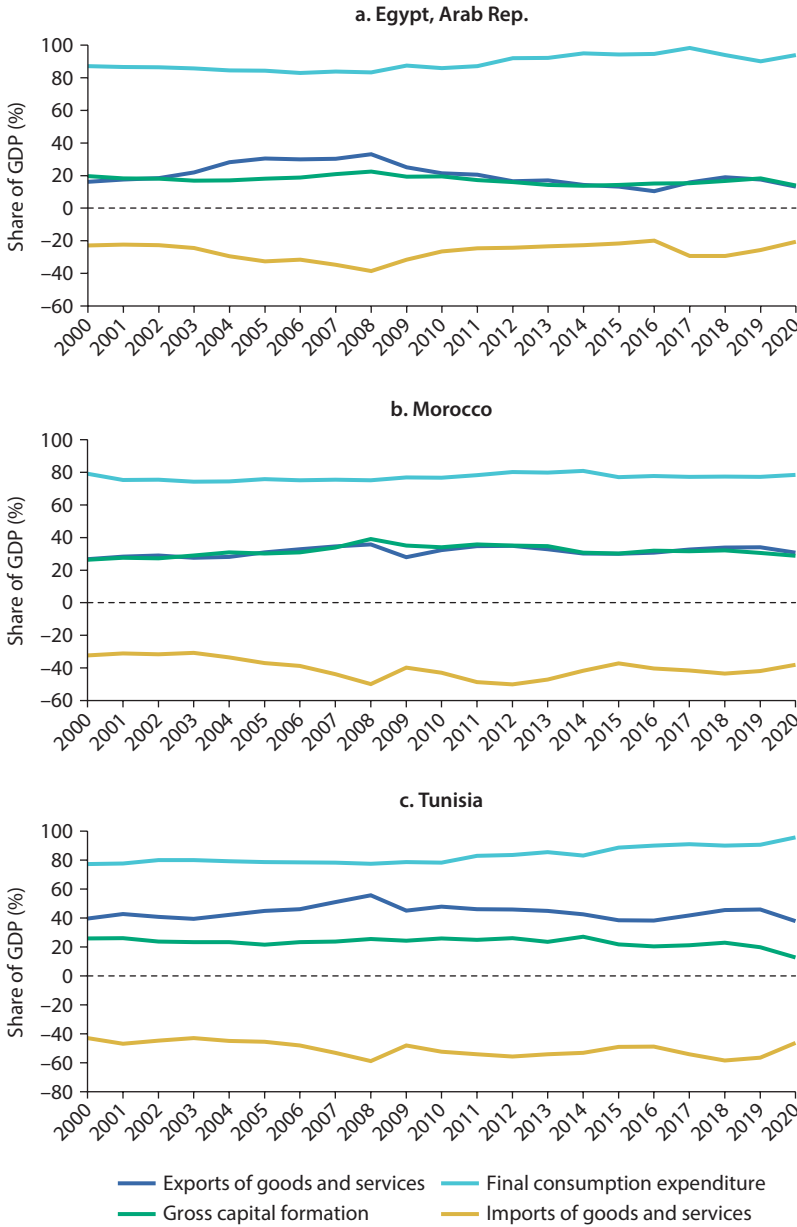
What are the key drivers of economic growth in MENA and the pilot countries? One way to answer this is by looking at the final users—households, businesses, and the government—of the goods and services produced by a country's economy during a specific period. As figure 2.5 shows, consumption is the clear leader among the pilot countries. In Egypt, Morocco, and Tunisia, final consumption averaged 87.0, 93.0, and 78.0 percent of GDP, respectively, between 2011 and 2019. Moreover, consumption's share of final demand gained relevance compared to the 2000–10 average, especially in Tunisia and Egypt. At the same time, the roles of investment and trade faded in the region, implying an economic shift to less sustainable sources of growth.

Investment as a share of GDP is low and declining. Underpinning recent weak economic performance, MENA countries have had low levels of investment as a share of GDP. Until 2011, MENA's gross fixed capital formation as a proportion of GDP was below the average for other developing regions; thereafter, it caught up, and its investment rates have been on a similar path as those of other developing regions (figure 2.6). Even so, MENA is significantly below its aspirational regional comparators in terms of investment per capita. In 2018, MENA's investment per capita was US\$2,811, markedly less than EAP (at US\$5,661) and ECA (at US\$5,267).

In Egypt and Tunisia, fixed capital formation as a proportion of GDP has been below the averages for MENA and other developing regions,

FIGURE 2.5

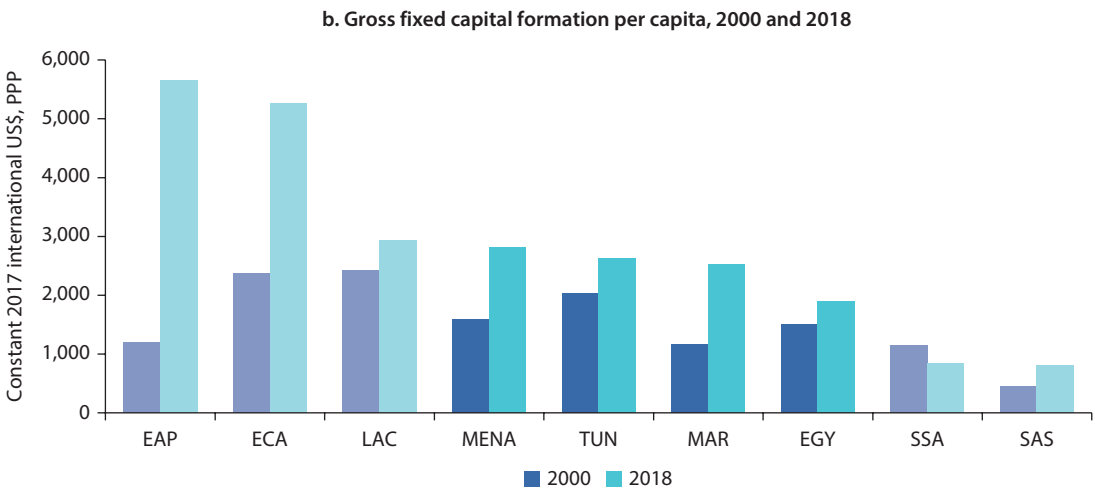
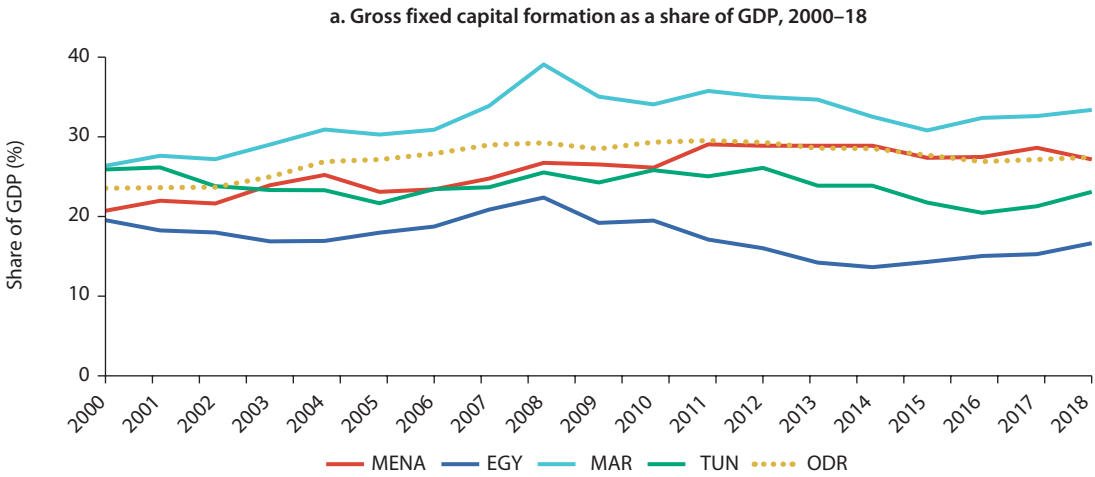
Consumption, Investment, Exports, and Imports as a Share of GDP, Arab Republic of Egypt, Morocco, and Tunisia, 2000–20



Source: Based on data from World Development Indicators, World Bank.
Note: GDP = gross domestic product.

FIGURE 2.6

Gross Fixed Capital Formation in MENA and Arab Republic of Egypt, Morocco, and Tunisia



Source: Based on data from World Development Indicators, World Bank.
 Note: EAP = East Asia and Pacific; ECA = Europe and Central Asia; EGY = Egypt, Arab Rep.; GDP = gross domestic product; LAC = Latin America and the Caribbean; MAR = Morocco; MENA = Middle East and North Africa; ODR = other developing regions; PPP = purchasing power parity; SAS = South Asia; SSA = Sub-Saharan Africa; TUN = Tunisia.

exhibiting a downward trend over time. In Morocco—given public efforts to incentivize capital-intensive industries—investments as a share of GDP reached 33.5 percent in 2018, exceeding the average for the other developing regions. Per capita investments increased in the pilot countries from 2000 to 2018, more than doubling in Morocco, while increasing more modestly in Tunisia and Egypt. Of the three pilot countries, Tunisia exhibited the highest investment per capita in 2000 and 2018.

The external sector, particularly exports, has also been subpar. In MENA, exports have historically outweighed imports, with the external trade surplus increasing from 3.9 percent of GDP in 2000 to 5.5 percent of GDP in 2008. Following the 2008/09 financial crisis, however, MENA's trade balance underwent a steep downturn, which led to an external trade deficit, worsening from -2.3 percent of GDP in 2009 to -5.6 percent of GDP in 2019. Remittances and international tourism receipts, meanwhile, modestly bolstered their relevance in MENA, increasing their GDP shares from 2.4 and 4.2 percent in 2000 to 4.1 and 4.5 percent in 2019, respectively.

In the pilot countries, imports have consistently outweighed exports over the past two decades, causing an external trade deficit. In Morocco, the difference between imports and exports was widest in 2012 amid the Arab Spring, at -15.3 percent of GDP. In Egypt and Morocco, the differences were -13.5 and -13.0 percent in 2017 and 2018, respectively. Tourism receipts, which are important contributors to GDP, stood at an average 8.9 percent in Morocco, 6.9 percent in Tunisia, and 4.6 percent in Egypt from 2000 to 2020—although they have been declining since the 2011 Arab Spring. Another contributor, remittances (as a share of GDP), have remained relatively stable over the past two decades in Morocco (7 percent) and Tunisia (4.5 percent), but have been steadily increasing in Egypt (from 2.9 percent in 2000 to 8.1 percent in 2020).

Foreign direct investment (FDI) inflows remain weak. MENA has had lower average rates of FDI as a proportion of GDP (1.6 percent) in the past two decades than other developing regions (2.5 percent) (table 2.2). However, the pilot countries have exhibited higher FDI inflows than MENA and other developing region averages. From 2000 to 2019, average FDI inflows as a share of GDP in Egypt and Tunisia were 2.9 percent, with Morocco at 2.8 percent. In all cases, these inflows increased from 2000–04 to 2005–09 but fell in the wake of the 2009 global recession and the 2020 COVID-19 restrictions.

TABLE 2.2

Foreign Direct Net Inflows as a Share of GDP, by Pilot Country, Region, and Subperiod, 2000–20

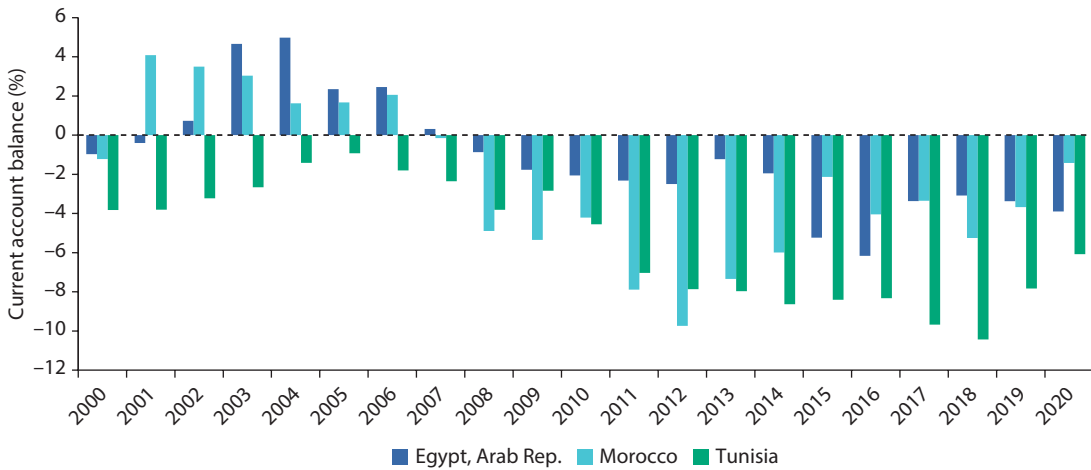
| Region/country | 2000–04 | 2005–09 | 2010–14 | 2015–19 | 2020 | 2000–19 |
|--|---------|---------|---------|---------|------|---------|
| Middle East and North Africa (excluding high income) | 1.5 | 2.6 | 1.1 | 1.0 | 1.0 | 1.6 |
| Egypt, Arab Rep. | 0.9 | 6.7 | 1.3 | 2.8 | 1.6 | 2.9 |
| Morocco | 3.1 | 2.9 | 2.6 | 2.4 | 1.5 | 2.8 |
| Tunisia | 2.6 | 5.0 | 2.3 | 1.9 | 1.4 | 2.9 |
| Other developing regions | 2.3 | 3.1 | 2.6 | 2.2 | 1.8 | 2.5 |

Source: Based on data from World Development Indicators, World Bank.

Note: FDI = foreign direct investment; GDP = gross domestic product.

FIGURE 2.7

Account Deficits, Arab Republic of Egypt, Morocco, and Tunisia, 2000–20



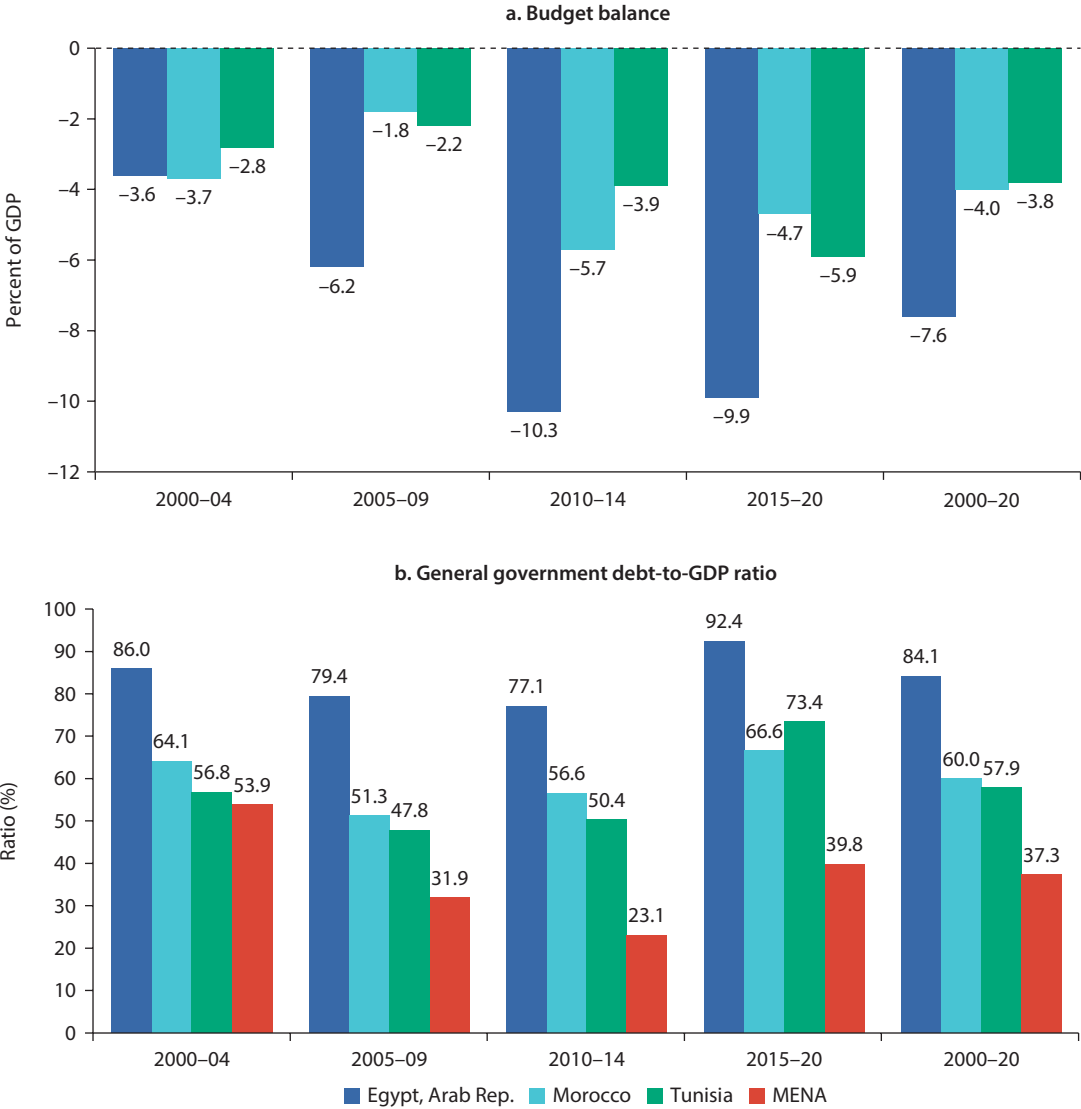
Source: Based on data from World Development Indicators, World Bank.

Current account deficits are still in the red. Although Tunisia has persistently run deficits over the past two decades, the global collapse of trade in late 2008 had a strong impact on Egypt and Morocco, which both suffered from the ensuing sluggish global growth and turned to negative balances in the past decade (figure 2.7). These deficits have now peaked in all three countries but remain sizable. The annualized average current account deficit since 2008 has been –3 percent in Egypt, which compares favorably to Morocco’s –5 percent and Tunisia’s –7.2 percent. Current account deficits mirror net inflows of foreign capital and indicate that sustained external debt accumulation has accompanied a decade of sluggish economic growth. The COVID-19 pandemic and global economic contraction played a role in temporarily narrowing deficits in Tunisia and Morocco, due to decreased import demand and resilient remittance inflows, despite a strong decrease in exports and collapsing tourism receipts (IMF 2022).

Budget and debt imbalances worsen the fiscal burden. Making matters worse, fiscal deficits and public debt have increased in MENA, including the pilot countries—with the most prominent increase in Egypt, whose deficits increased from an average of –3.6 percent in 2000–04 to –9.9 percent in 2015–20 (figure 2.8, panel a). Morocco and Tunisia exhibited average fiscal deficits of –4.0 and –3.8 percent, respectively, over the 2000–20 period. In large part, sustained deficits are attributable to high recurrent public expenditures for wages, energy, and food subsidies, as well as transfers to state-owned enterprises. Rising fiscal deficits imply higher general government debt-to-GDP ratios, which exceeded the MENA average (37.3 percent)

FIGURE 2.8

Share of Public Debt, Arab Republic of Egypt, Morocco, and Tunisia, 2000–20



Source: Based on data from World Development Indicators, World Bank.
Note: GDP = gross domestic product; MENA = Middle East and North Africa.

in all three countries (figure 2.8, panel b). Egypt exhibited the highest and most volatile debt-to-GDP ratio from 2000 to 2020. Its debt-to-GDP ratio was 84.1 percent, far above Tunisia’s 57.9 percent and Morocco’s 60.0 percent. Further, the pandemic-triggered recession and the fiscal response increased both fiscal and public deficits in 2020.

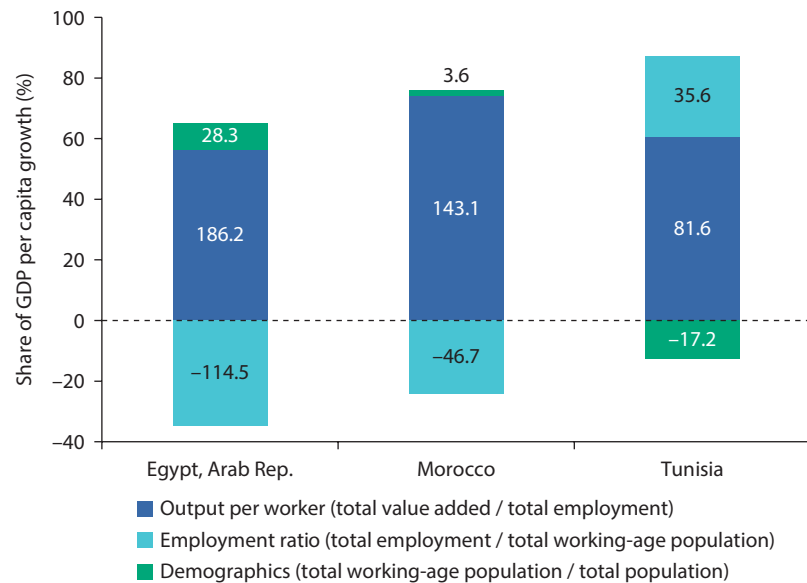
Labor Productivity: A Driver of Recent Growth, Despite Lackluster Total Factor Productivity

What can MENA countries do to boost economic growth, in addition to encouraging more investment (domestic and foreign) and securing technological progress? The pathway centers on better labor productivity. Here, labor productivity is defined as aggregate output per worker, which represents a measure of efficiency in the use of labor in production and is also correlated with changes in living standards via its relationship to the wages paid to workers.

For the pilot countries, a look at the 2012–18 period shows that higher labor productivity explains most of the increases in GDP per capita (figure 2.9)—although overall total factor productivity (TFP) has been weak (box 2.1). GDP per capita can be decomposed into three components: (1) GDP per employed person (a measure of labor productivity); (2) the employment-to-population ratio, that is, the share of employed persons in the working-age population (a measure of the employment rate of all working-age people); and (3) the share of the working-age population (age 15 years and older) in the total population

FIGURE 2.9

Labor Productivity, Arab Republic of Egypt, Morocco, and Tunisia, 2012–18



Sources: Based on data from national offices of statistics and labor force surveys.

Note: The figure shows the decomposition of GDP per capita growth over 2012–18. GDP = gross domestic product.

BOX 2.1

Total Factor Productivity Is Stuck at Weak

The growth of labor productivity that drove economic growth in per capita terms in the pilot countries between 2012 and 2018 was largely due to “extensive growth”—that is, more physical capital and human capital. In contrast, “intensive growth,” or total factor productivity (TFP)—that is, changes in both the efficiency with which inputs are used and technology—was weak (figure B2.1.1):

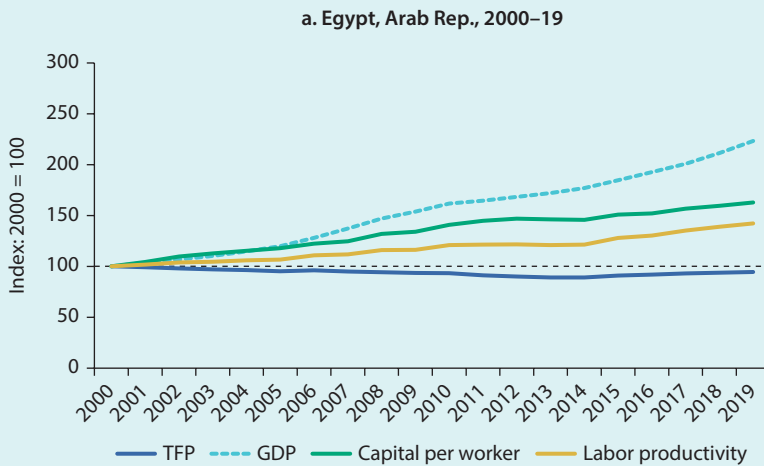
- In the Arab Republic of Egypt, the average annual rate of growth of TFP decreased by 0.3 percent.
- In Tunisia, TFP increased by only 0.3 percent per year.
- In Morocco, TFP increased by only 1.3 percent per year.

This matters because if TFP had been higher, labor productivity—which has been driving growth in the Middle East and North Africa and the pilot countries—would have been higher.

Why is TFP so low? There are several possible explanations: (1) allocative inefficiency, with capital flowing to unproductive sectors; (2) technical inefficiency and weak capacity to convert inputs into outputs; and (3) factors such as barriers to firms’ market entry or exit, regulatory failures, or probably a combination of factors. As the World Bank (2022) argues, lack of market contestability is likely the main culprit.

FIGURE B2.1.1

Total Factor Productivity, Arab Republic of Egypt, Morocco, and Tunisia, 2000–19



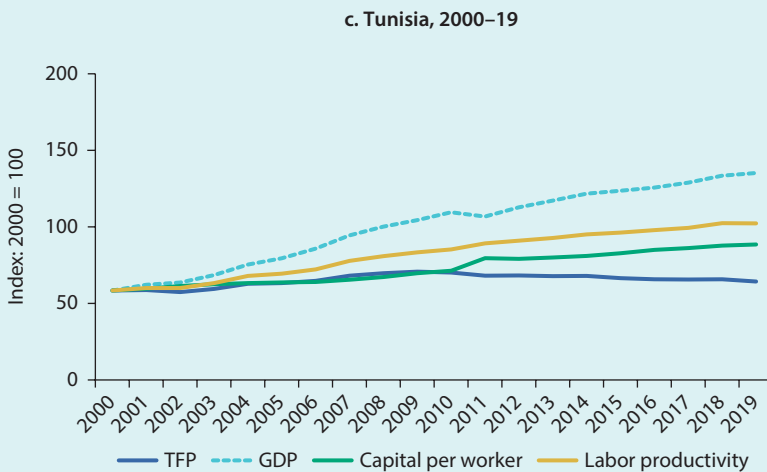
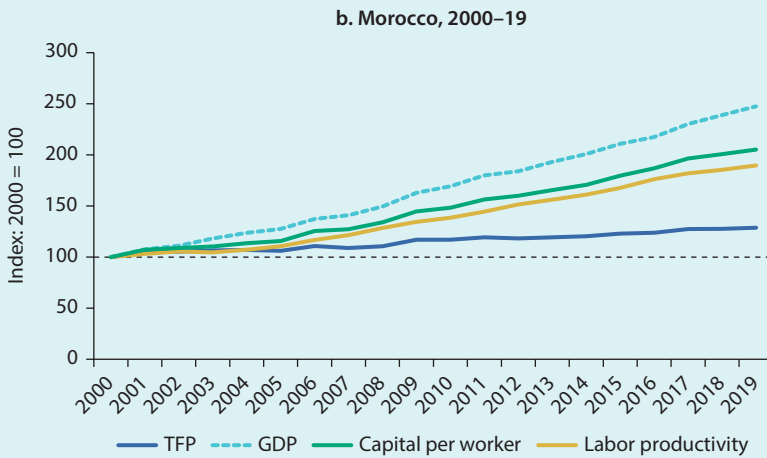
(continued)

BOX 1.2

Total Factor Productivity Is Stuck at Weak (*continued*)

FIGURE B2.1.1

Total Factor Productivity Remains Weak, Particularly in Morocco and Tunisia (*continued*)



Source: Based on data from the Penn World Table.
 Note: GDP = gross domestic product; TFP = total factor productivity.

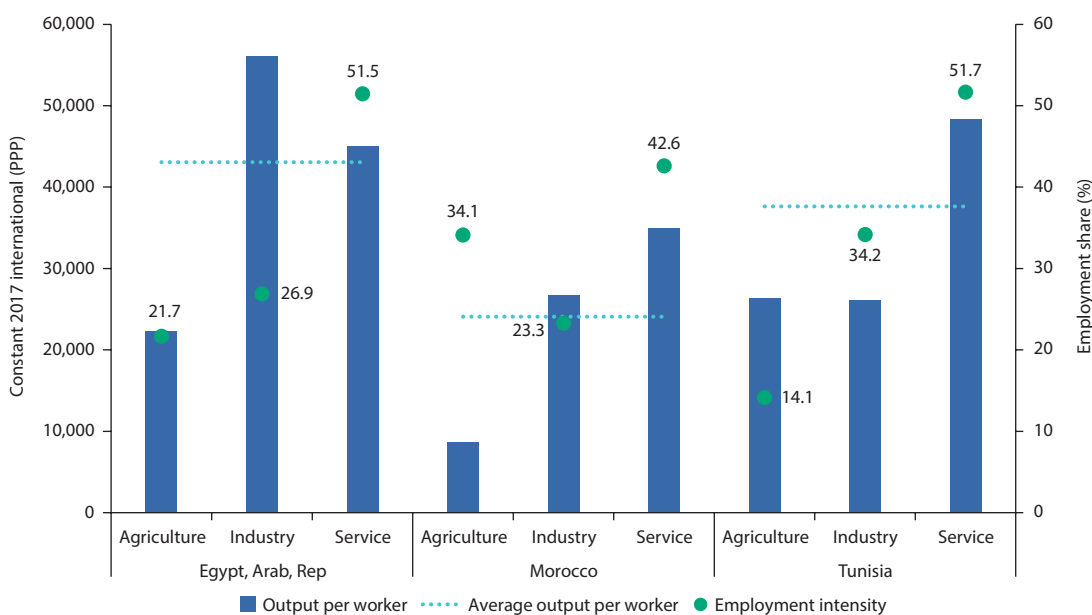
(a demographic measure that reflects the economic burden on the workforce) (see annex 2B).

However, there are significant differences in labor productivity across countries, with Egypt and Tunisia having higher labor productivity than Morocco (figure 2.10). There are sizable shares of workers still employed in sectors with below average labor productivity: 48.3 percent in Tunisia, 34.1 percent in Morocco, and 21.7 percent in Egypt. Further, there are big differences within countries across sectors, producing notable intersectoral differences in wages and living standards:

- In Tunisia, the sectors with below-average productivity are agriculture and industry. Output per worker in the service sector (which accounts for about half of employment) is significantly higher than in agriculture and industry (which account for 14 and 34 percent of total employment, respectively).
- In Morocco, agriculture is the sector with below-average productivity. Output per worker in the service sector (which accounts for about 43 percent of employment) is four times higher than in agriculture.

FIGURE 2.10

Labor Productivity, by Sector, Arab Republic of Egypt, Morocco, and Tunisia, 2018



Sources: Based on data from national statistical offices for the pilot countries; data from ILOstat, International Labour Organization.
 Note: PPP = purchasing power parity.

- In Egypt, the only low-productivity sector is agriculture. Output per worker in industry (which accounts for only 27 percent of employment) is significantly higher than in agriculture and somewhat higher than in the service sector (which accounts for around half of employment).

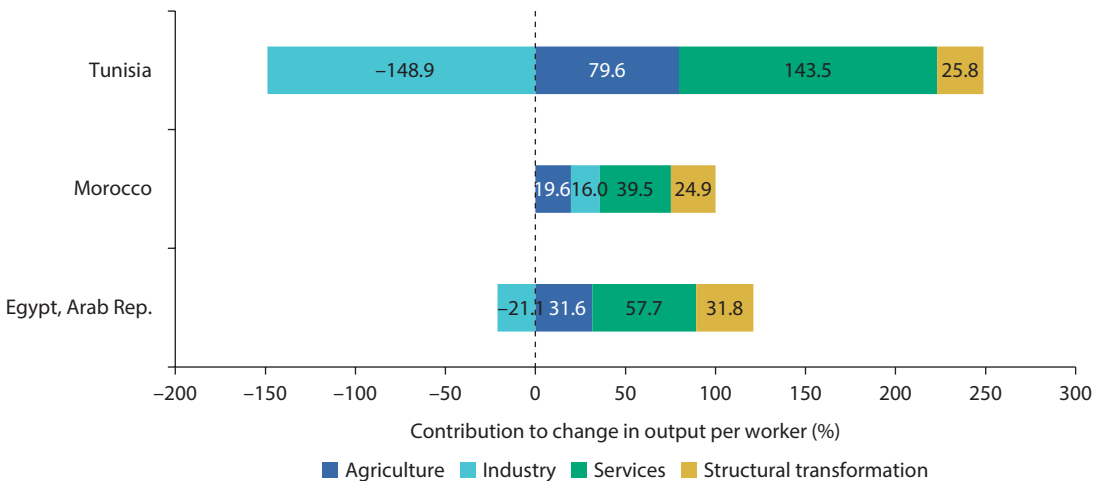
Workers have an incentive to move from lower to higher labor productivity sectors as long as labor productivity gaps persist across sectors and such gaps are reflected in the wages paid to workers. However, markets are not always competitive, labor productivity can differ from wages within sectors, and workers might face barriers to mobility across sectors—for example, getting a job in a different sector might require moving to a different location or having a different skill set.

These big differences in labor productivity across sectors within a country raise the question of whether each country’s labor productivity gains have come from within or across sectors. To answer this, a further decomposition is needed: breaking down labor productivity growth into (1) changes in output per worker within sectors; and (2) changes in output per worker due to shifts of labor between sectors (see figure 2B.1, in annex 2B).

The within-sector component explains most of the net labor productivity gains over 2012–18: Morocco, 75.1 percent; Tunisia, 74.2 percent; and Egypt, 68.2 percent. The across-sector component (also known as structural transformation) explains the remaining 25 to 30 percent (figure 2.11). This means that growth of labor productivity

FIGURE 2.11

Labor Productivity Gains within Sectors, Arab Republic of Egypt, Morocco, and Tunisia, 2012–18



Source: Based on data from national offices of statistics and labor force surveys.

has been driven mostly by improvements in the use of labor to produce a unit of output within each sector, as opposed to gains due to labor movements from less productive toward more productive sectors. However, considering the still sizable gaps in average labor productivity across sectors, there is space for structural transformation to play a bigger role and contribute more to economic growth going forward, particularly in Morocco, where the share of employment in agriculture is still sizable.

AN OVERVIEW OF LABOR MARKETS IN EGYPT, MOROCCO, AND TUNISIA

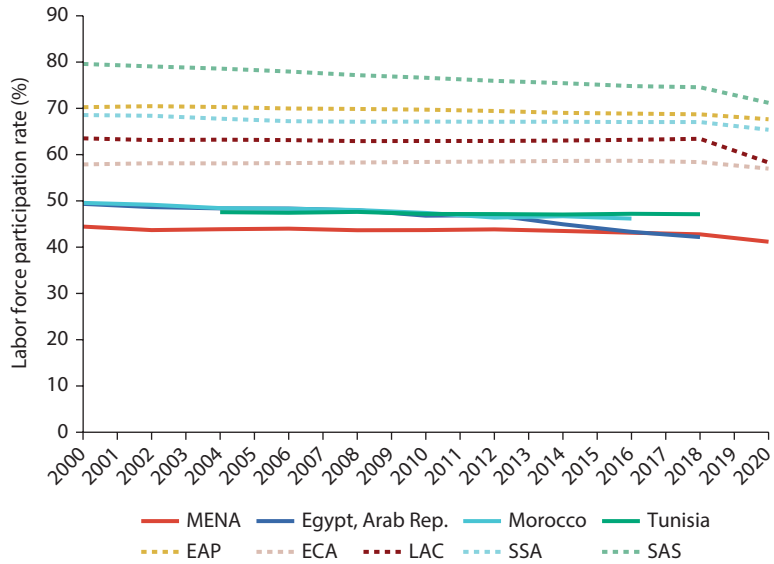
Countries' labor markets are intricately linked to their markets for capital, goods, and services—and thus the overall economic context in which they operate. A close look at the labor markets in MENA and the pilot countries raises concerns about (1) labor market participation, (2) unemployment, (3) workers' employment relationships, and (4) the relevance of the public sector as an employer. All these factors, and especially employment relationships, are key for understanding the size of informal employment together with a country's legal labor market framework.

Labor force participation rate (LFPR). The LFPR provides an estimate of a country's active workforce. As of 2019, MENA's LFPR rate was 42.8 percent, significantly lower than the rates in EAP (68.7 percent), SSA (67.0 percent), and LAC (58.4 percent) (figure 2.12). Moreover, MENA's LFPR has been declining, dropping by almost 2.0 percentage points from 2010 to 2019. The pilot countries had remarkably similar LFPRs (46.8–49.5 percent) from 2010 to 2016, which slowly decreased over time. After 2016, the rate was unchanged in Tunisia and Morocco, but it fell to 41.1 percent in Egypt in 2019. Then, with the COVID-19-induced economic contraction, which set back economic activity around the world, MENA's LFPR fell by 1.6 percentage points from 2019 to 2020—which was much less than the declines in other developing regions (such as LAC, at 5.2 percentage points, or SAS, at 3.4 points).

A worrisome aspect of MENA's LFPR is the low level of female labor force participation. Indeed, at 19.5 percent, MENA's female LFPR is the lowest among all regions and is on the decline in the pilot countries other than Tunisia (figure 2.13, panel a). As of 2019, although female LFPR was higher in Tunisia (26.8 percent) and Morocco (22.2 percent) compared to MENA's regional average, it was lower in Egypt (15.6) percent. Still, the female LFPRs are all

FIGURE 2.12

Labor Force Participation Rate, by Region and Pilot Countries, 2010–20



Source: Calculations based on data from ILOstat for regional aggregates.

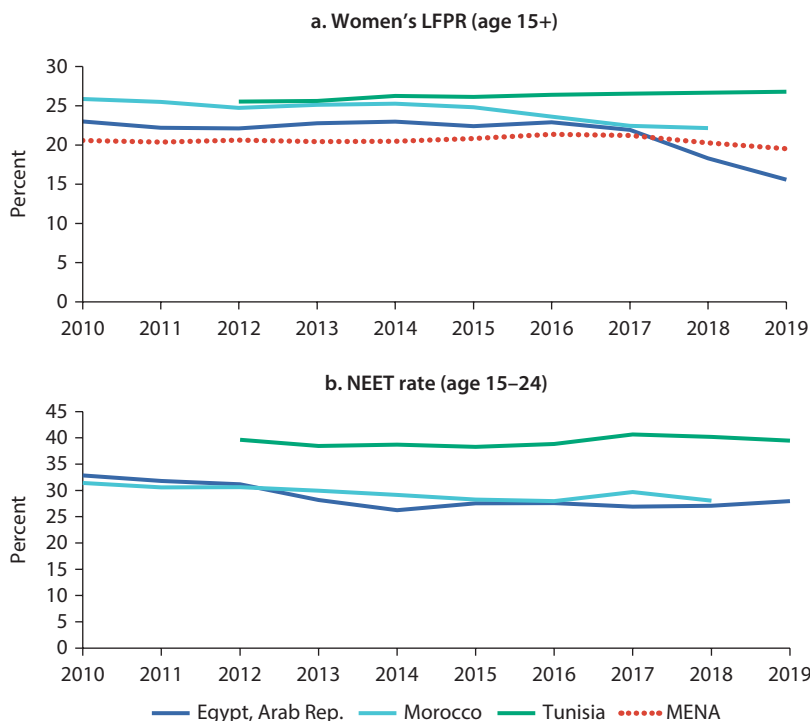
Note: The labor force participation rate is the number of people age 15 and older who are employed or actively seeking employment, divided by the total noninstitutionalized, civilian working-age population (age 15 and older). EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAS = South Asia; SSA = Sub-Saharan Africa.

lower than the lower-middle-income country average (33.1 percent). Another worrisome aspect is the high level of young people who are not in education, employment, or training (NEET) in the pilot countries, particularly in Tunisia, where the situation is getting worse (figure 2.13, panel b). Although the high level can be partly attributed to increases in secondary and tertiary school enrollments, NEET rates remain strikingly high.

Unemployment rates. In MENA, unemployment rates are significantly higher than in other developing regions—and have been so for decades (figure 2.14). Between 2010 and 2019, for instance, MENA’s average unemployment rate was 11.6 percent, well above the rates in ECA (7.4 percent), LAC (7.0 percent), SSA (6.1 percent), SAS (5.0 percent), and EAP (4.0 percent). In the pilot countries, Tunisia, at about 16.0 percent between 2012 and 2019, stands out with the highest average unemployment rate of all developing regions and the three pilot countries (figure 2.15). Egypt registered a comparable average unemployment rate as the MENA average, at 11.4 percent,

FIGURE 2.13

Share of Youth and Women Participating in the Labor Market, Pilot Countries and MENA, 2019

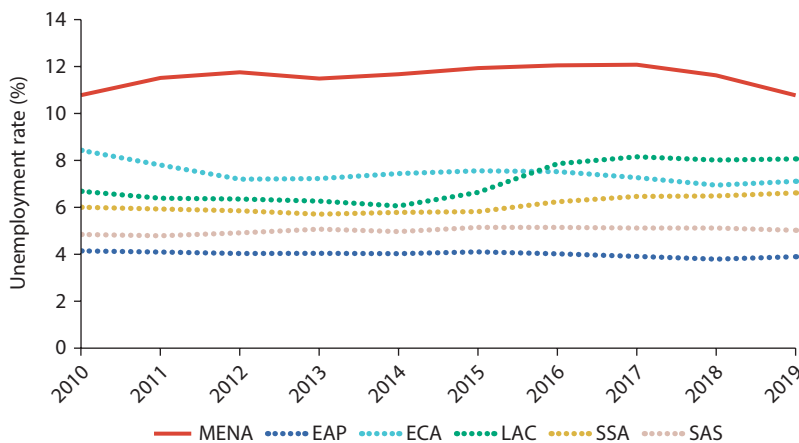


Source: Based on data from national statistical offices for the pilot countries.

Note: LFPR = labor force participation rate; MENA = Middle East and North Africa; NEET = not in education, employment, or training.

FIGURE 2.14

Unemployment Rate, by Region, 2010-19



Source: Based on data from World Development Indicators, World Bank.

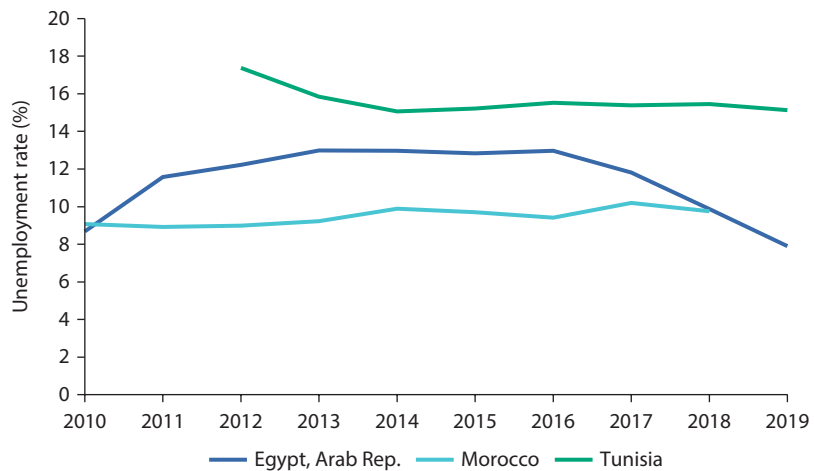
Note: EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAS = South Asia; SSA = Sub-Saharan Africa.

and Morocco stood at 9.5 percent. Between 2010 and 2019, Egypt exhibited the largest differentials in average unemployment by sex, with women being 1.8 times more likely to be unemployed than men (22.9 and 8.0 percent, respectively).

Worker status by type of employment. The four main types of worker status are (1) employees, (2) employers, (3) own-account workers, and (4) contributing family workers. In developing countries, often own-account and contributing family members make up a large share of workers, while in developed economies, employees represent the largest share of employment. After ECA, MENA has the largest share of employees in total employment among developing regions (figure 2.16). As of 2019, employees accounted for close to 63.0 percent of total employment, while their employment shares in SAS and SSA were 28.4 and 25.0 percent, respectively. The share of own-account workers and contributing family workers is low in MENA, at 31.4 percent, compared to other developing regions, such as EAP’s 44.6 percent. The MENA Region has the largest share of employers, at 6.0 percent.

In the pilot countries, employees account for most employment in Tunisia (74.7 percent) and Egypt (71.1 percent); in Morocco, workers were equally split between wage and nonwage employment as of 2019 (figure 2.17).³ Own-account workers are relatively more prevalent in Morocco (31.4 percent) compared to Tunisia (15.9 percent)

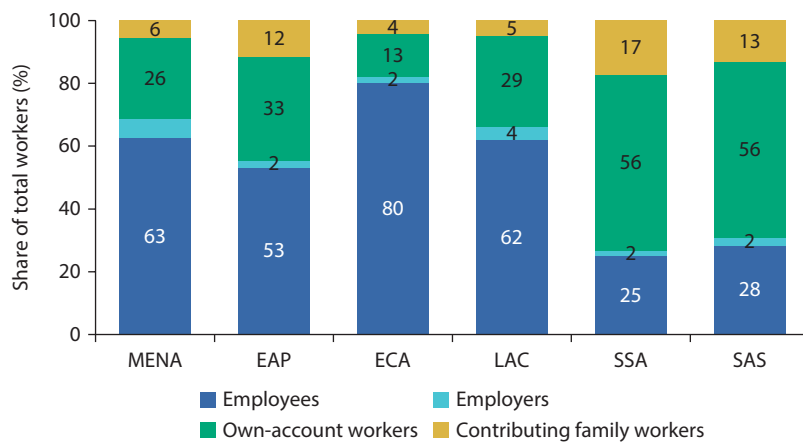
FIGURE 2.15
Unemployment Rate, Pilot Countries, 2010–19



Sources: Based on data from ILOstat for regional aggregates; data from national statistical offices for the pilot countries.

FIGURE 2.16

Share of Total Workers, by Type of Work and by Region, 2019

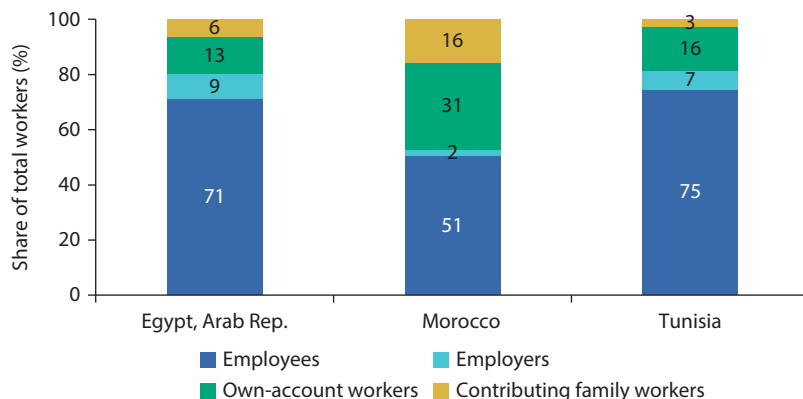


Source: Based on data from ILOstat for regional aggregates.

Note: EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAS = South Asia; SSA = Sub-Saharan Africa.

FIGURE 2.17

Share of Total Workers, by Type of Work, Arab Republic of Egypt, Morocco, and Tunisia, 2019

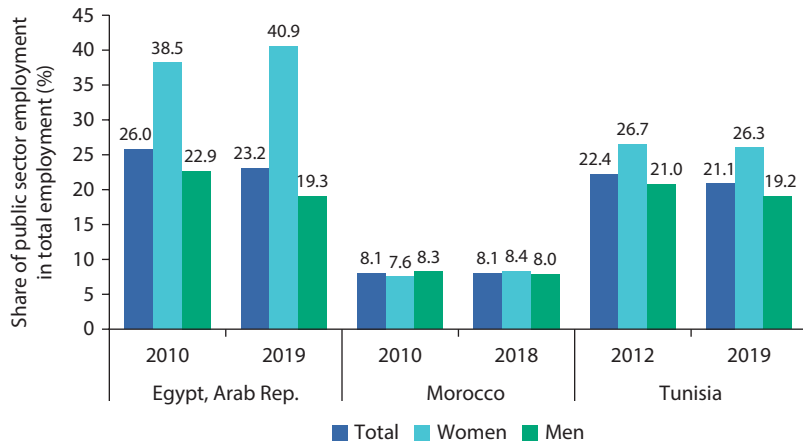


Sources: Based on data from ILOstat for regional aggregates; data from national statistical offices for the pilot countries.

and Egypt (13.1 percent). Contributing family workers account for 15.8 percent of employment in Morocco, which is more than in Tunisia (2.8 percent) and Egypt (6.4 percent). Employers are most abundant in Egypt (9.4 percent), followed by Tunisia (6.6 percent) and Morocco (2.3 percent).

FIGURE 2.18

Public Sector Employment as a Share of Total Employment, Arab Republic of Egypt, Morocco, and Tunisia, circa 2010 and 2018–19



Source: Based on data from national statistical offices for the pilot countries.

Public sector. The MENA Region has, on average, high levels of public sector employment, representing about 25 percent of total employment. Public sector salaries account for about 32 percent of total government spending—higher, on average, than any other region.

In the pilot countries, the public sector—with about 20 percent of workers—is a key employer in Egypt and Tunisia (figure 2.18). In Egypt, public sector employment is high, but it decreased from 26.0 percent in 2010 to 23.2 percent in 2019. Moreover, women are markedly more likely than men to hold a public sector job in Egypt; as of 2019, 40.9 percent of female employment was in the public sector compared to 19.3 of male employment. Likewise, in Tunisia, women (26.3 percent) are more likely than men (19.2 percent) to work in the public sector. By contrast, Morocco’s public sector wage bill is significantly less than Egypt’s and Morocco’s, representing only around 8.1 percent of employment in 2010 and 2018.

HIGH RATES OF INFORMAL EMPLOYMENT

Informal employment, measured as the share of workers not covered by social insurance, is pervasive in MENA, representing about 68 percent of total employment—far higher than the 59.6 percent in middle-income countries, 37 percent in ECA, and 54 percent in LAC, but lower than in the 89 percent in SSA (WIEGO 2018; ILO, forthcoming).

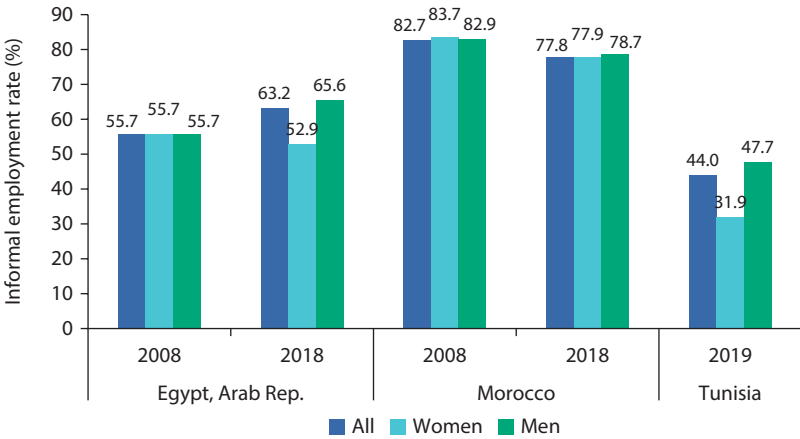
In the pilot countries, informality is extensive. Morocco has the highest informality rate among the three countries, at 77.8 percent in 2018, which was a decrease from 82.7 percent in 2008 (figure 2.19). Informality in Egypt increased from 55.7 to 63.2 percent over the same period. In Tunisia, for which there is only one data point, the rate of informality is significantly lower than the others (44.0 percent in 2019). Despite the variations among the three countries, some stylized facts stand out that paint a picture of informality in MENA.

Informal employment rates are mostly higher among men than women. In 2008, informal employment rates in Egypt were almost identical for both sexes; in 2018, the rates started to diverge—with informality among Egyptian women dropping to 52.9 percent and among men increasing to 65.6 percent. In Tunisia, as of 2019, the informal employment rate was 16 percentage points higher for men than women (47.7 percent versus 31.9 percent). Still, women more often work in the most vulnerable segments of the informal economy—for example, as domestic workers, home-workers engaged on a piece rate basis at the lower tiers of the global supply chain, or contributing family workers. In Morocco, women are more than four times more likely than men to be a contributing family worker.

Nonwage workers have a higher likelihood of being informal than wage workers. In Egypt, as of 2019, the informal employment rate of employees was 51.1 percent, while the rates were 85.2 and 84.4 percent for employers and own-account workers, respectively, and 98.8 percent for contributing family workers (figure 2.20, panel a). In Tunisia,

FIGURE 2.19

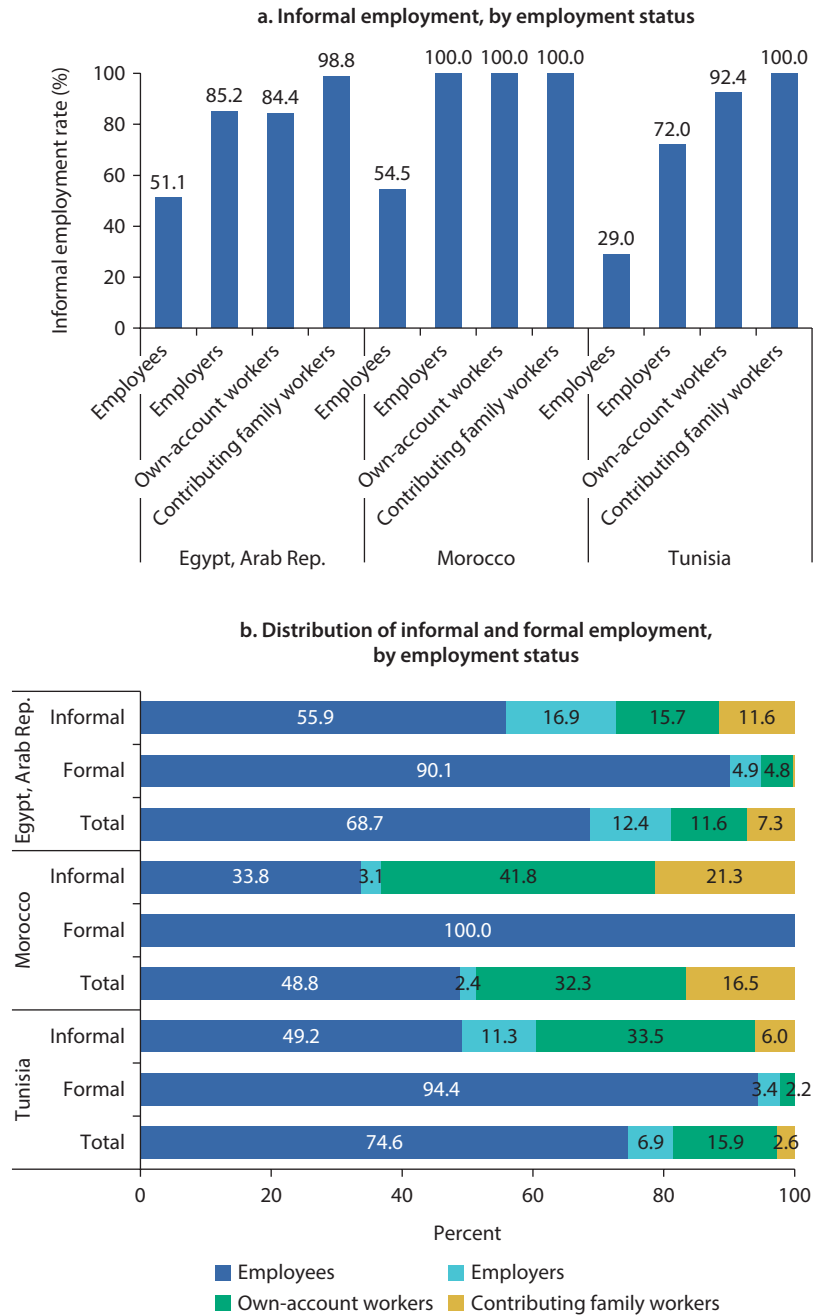
Informal Employment Rate, Arab Republic of Egypt, Morocco, and Tunisia, circa 2008 and 2018–19



Source: Based on data from national statistical offices.
 Note: The informal employment estimates for the Arab Republic of Egypt and Morocco are for 2018; for Tunisia, they are for 2019.

FIGURE 2.20

Informal Employment Rate, by Employment Status, Arab Republic of Egypt, Morocco, and Tunisia, 2018–19



Source: Based on data from national statistical offices.
 Note: The informal employment estimates for the Arab Republic of Egypt and Morocco are for 2018; for Tunisia, they are for 2019. Panel a shows the percentage of informal employment within each employment status (for example, 100 percent for own-account workers in Morocco). Panel b shows the distribution of informal employment across employment statuses (for example, own-account workers account for 41.8 percent of informal employment in Morocco).

as of 2018, 29.0 percent of wage earners were classified as being in informal employment, a fraction of the proportion among employers (72.0 percent), own-account workers (92.4 percent), and contributing family workers (100 percent). In Morocco, whereas 54.4 percent of wage workers were informal, 100 percent of nonwage workers were informal. In figure 2.20, panel a shows the percentage of informal employment within each employment status, and panel b shows the distribution of informal employment across employment statuses. For example, in Morocco, whereas all contributing family workers are informal—that is, 100 percent—they represent only 21.3 percent of national informal employment because of their small share in total employment.

Wage workers are the largest contributor to informal employment in Tunisia and Egypt due to their overall large employment share. While wage workers represented 55.9 and 49.2 percent of total informal employment in Egypt and Tunisia, respectively, they only accounted for 33.8 percent in Morocco (figure 2.20, panel b). Moreover, in Morocco, own-account workers are the largest contributor to informal employment (41.8 percent), followed by contributing family workers (21.3 percent). In contrast, employees in the pilot countries are the largest contributor to formal employment.

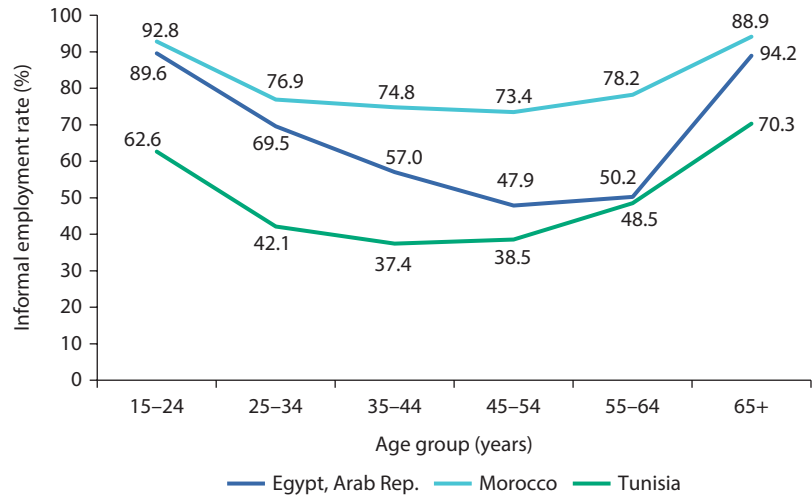
Youth and older workers are most likely to be employed informally, but all age groups are deeply affected.

In Egypt, about 90 percent of younger (age 15–24) and older (65+) workers are informally employed, compared to an average of 56.0 percent of those age 25–64 (figure 2.21). A similar picture emerges in Tunisia, where 62.6 percent of younger workers and 70.3 percent of older workers are informally employed, compared to 37.4–48.5 percent of prime-age workers (age 25–65). In Morocco, too, formal employment is particularly rare among younger (7.2 percent) and older workers (5.8 percent), and it is more common for those age 25–64, with an average formal employment rate of 24.2 percent. Compared to Egypt and Tunisia, informal employment in Morocco is persistent over workers' lifecycle, with informal employment rates remaining higher than in the other two countries across age groups. This is because of the prevalence of self-employment in Morocco, which often leads to fewer formal employment opportunities.

Workers with low levels of education are more likely than those with tertiary education to be informal. In the pilot countries, the effect of education on formality is strongest in Morocco—where the informal employment rate drops from 91.4 percent among those with no education to 32.3 percent

FIGURE 2.21

Informal Employment Rate as a Share of Total Employment, Arab Republic of Egypt, Morocco, and Tunisia, circa 2018–19



Source: Based on data from national statistical offices.

Note: The informal employment estimates for the Arab Republic of Egypt and Morocco are for 2018; for Tunisia, they are for 2019.

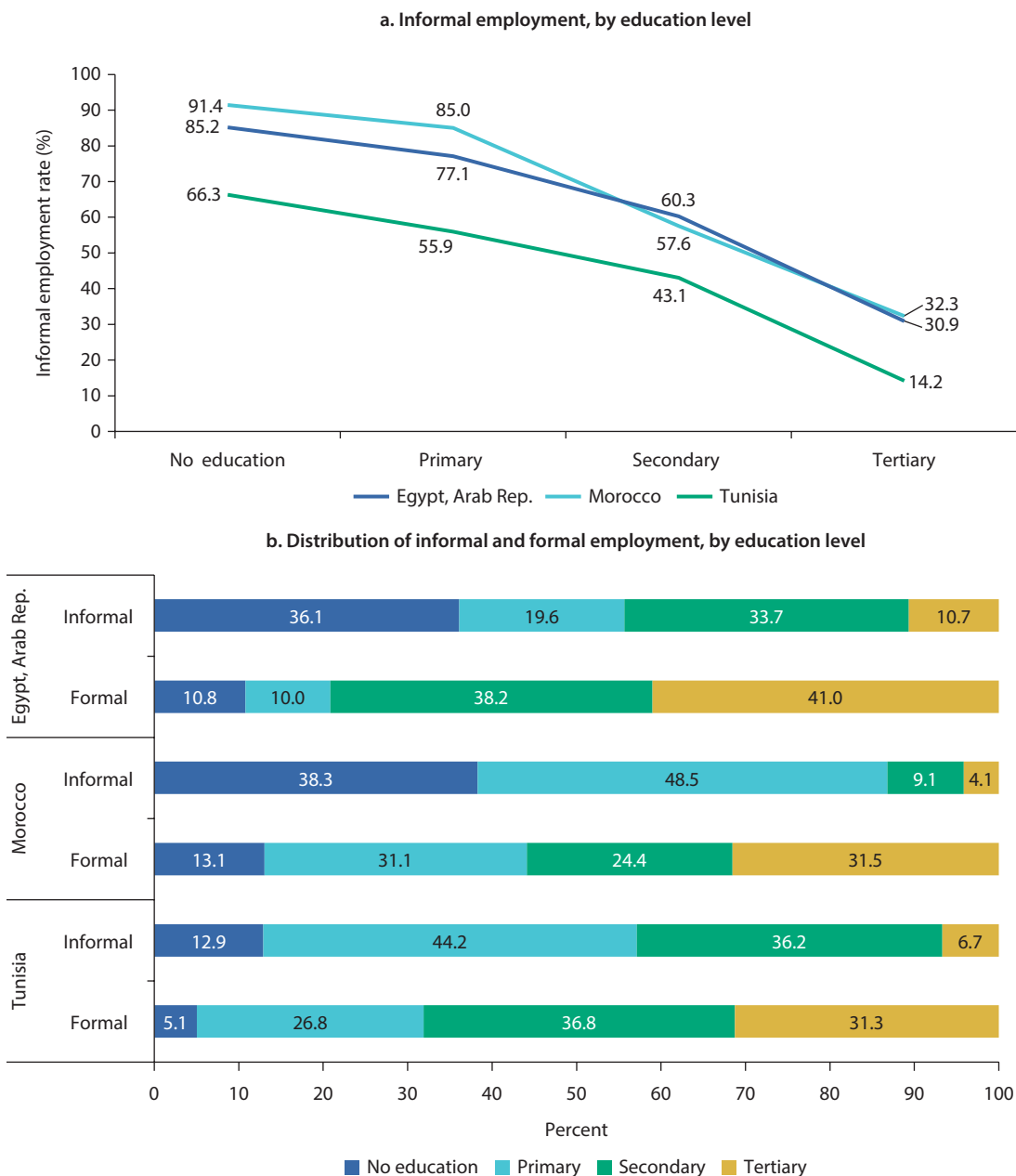
among those with tertiary education (figure 2.22, panel a). This effect is also pertinent in Egypt and Tunisia, where 85.2 and 66.3 percent of workers with no schooling were informally employed, respectively, compared to 30.9 and 14.2 percent of workers with tertiary education.

Informal employment absorbs the largest share of workers with no or little education. In Morocco, Egypt, and Tunisia, 86.8, 55.7, and 57.1 percent of all informal workers, respectively, have at most a primary education, as opposed to the proportions with a tertiary-level education (4.1, 10.7, and 6.7 percent, respectively) (figure 2.22, panel b). The education profile of formal workers differs significantly, insofar as the majority have achieved at least a secondary education. In Egypt, Morocco, and Tunisia, for instance, 79.2, 55.9, and 68.1 percent of formal workers, respectively, have secondary education or higher.

Informality is most prevalent among workers in poor households. In Egypt and Tunisia, as of 2019, the average informal employment rates among workers in the bottom 50 percent of the household welfare distribution were 77.6 and 55.3 percent, respectively—significantly less than Morocco’s 94.7 percent in 2018 (figure 2.23, panel a). Informal employment was still sizable among richer workers, with the average informal employment rates among workers in

FIGURE 2.22

Informal Employment Rate, by Education Level, Arab Republic of Egypt, Morocco, and Tunisia, circa 2018–19

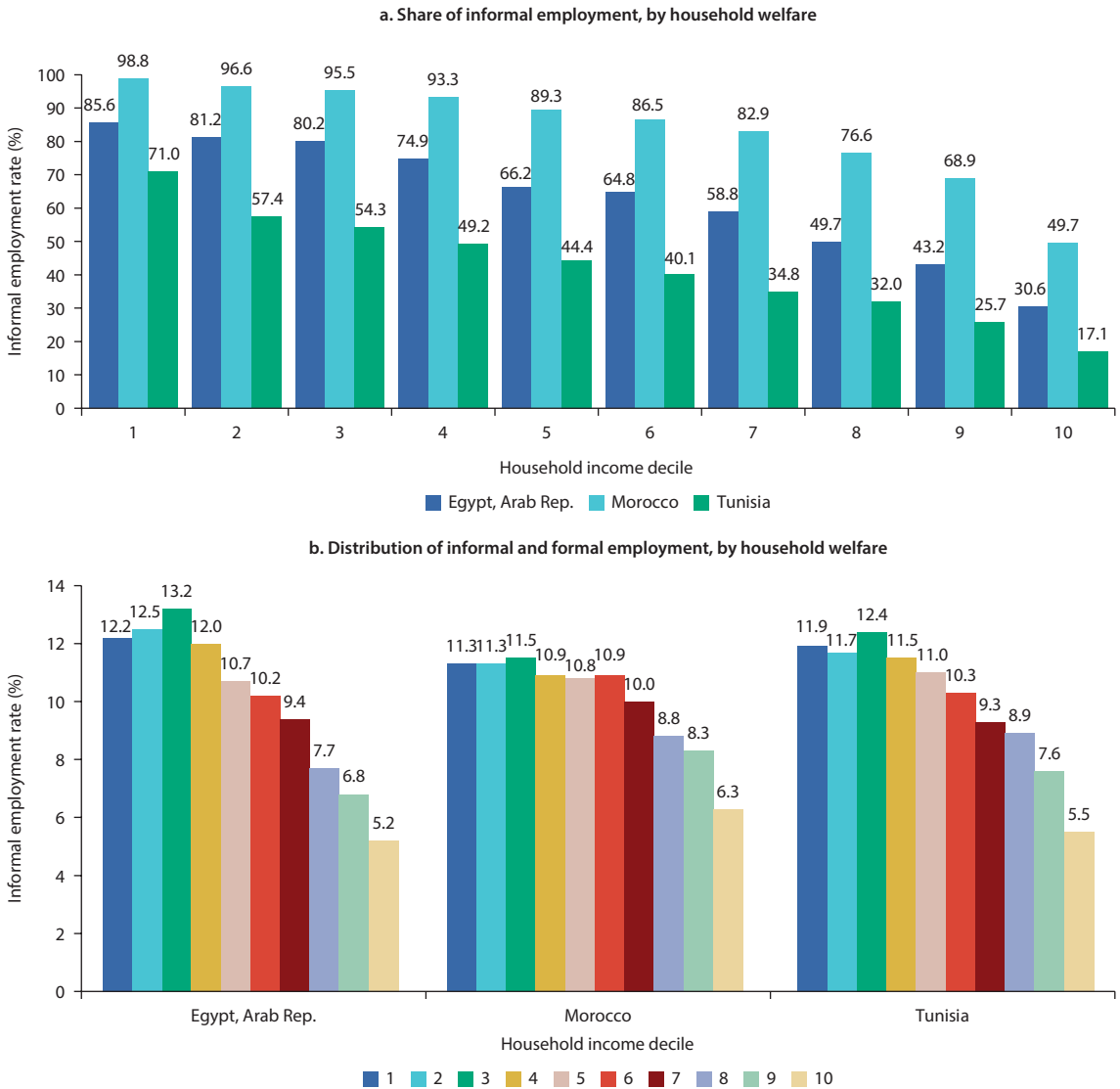


Source: Based on data from national statistical offices.

Note: The informal employment estimates for the Arab Republic of Egypt and Morocco are for 2018; for Tunisia, they are for 2019.

FIGURE 2.23

Informal Employment Rate, by Household Welfare, Arab Republic of Egypt, Morocco, and Tunisia, Most Recent Year



Sources: Based on data from CAPMAS 2018 for the Arab Republic of Egypt; HCP 2013 for Morocco; NIS 2015 for Tunisia.

Note: Due to data limitations in the case of Egypt, it was not possible to use deciles of per capita household expenditures. Alternatively, however, wealth deciles were constructed based on a factor analysis approach using household ownership, durable assets, and housing conditions.

the top 30 percent estimated at 41.2, 65.0, and 25.0 percent in Egypt, Morocco, and Tunisia, respectively. This extensive spread might signal that informal employment is not always a matter of exclusion or a last-resort option.

Workers who are informally employed largely belong to households in the bottom 40 percent of the welfare distribution—50 percent of informal workers in Egypt, 45 percent in Morocco, and 47.5 percent in Tunisia (figure 2.23, panel b). In other words, about one in two informal workers belongs to a household in the bottom 40 percent in the pilot countries.

CONCLUSION

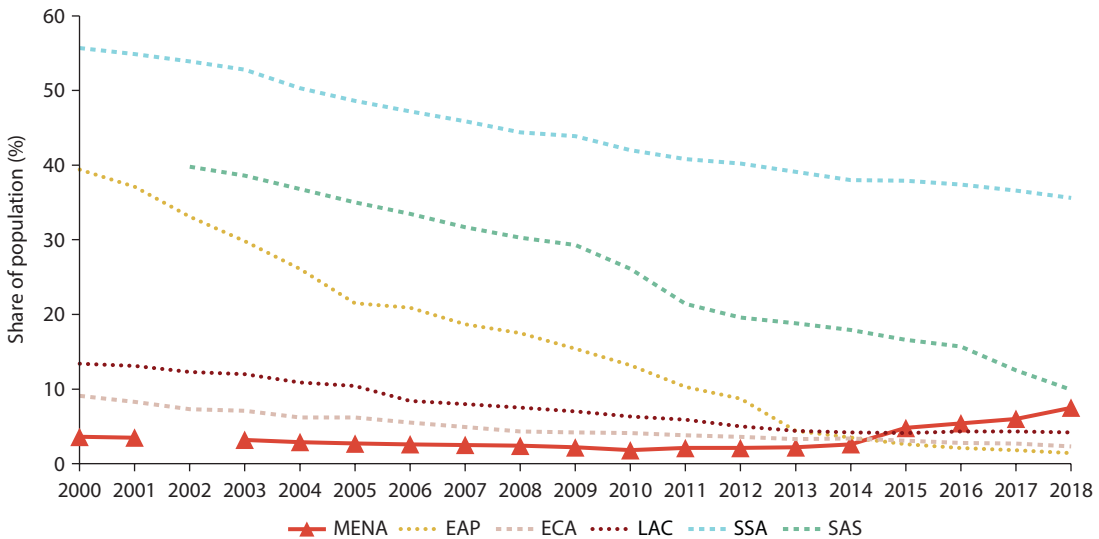
Over the past two decades, Egypt, Morocco, and Tunisia have posted sub-par growth relative to their income peers, and economic growth was mainly driven by consumption—with investments playing a secondary role together with trade. Fiscal and current account deficits have been a constant feature of the three economies, have recently deteriorated, and are not substantiable in the long term. Nonetheless, improvements in living standards have continued in Morocco and Tunisia, mainly driven by pro-poor economic growth in Morocco and increases in public transfers in Tunisia. In Egypt, little progress was observed in poverty reduction between 2012 and 2017.

On the labor front, except in Morocco, TFP growth has been anemic (possibly due to resources not flowing to the most productive sectors and firms), as reflected in modest economic performance and weak employment creation, particularly in high-productivity sectors. The labor markets of the pilot countries suffer from low labor force participation—especially among women—and high unemployment, posing challenges for inclusive economic growth. In addition, pervasive informal employment leaves most workers in Egypt and Morocco and over two-fifths of workers in Tunisia uninsured against risks, while acting as a drag on economic growth and hurting development prospects at the aggregate level.

ANNEX 2A: REGIONAL POVERTY ESTIMATES, 2000–18

FIGURE 2A.1

Poverty Headcount Ratio at US\$2.15 a Day, by Region



Source: Based on data from World Development Indicators, World Bank.

Note: In the figure, the poverty line is set at US\$2.15 a day, 2017 purchasing power parity. EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAS = South Asia; SSA = Sub-Saharan Africa.

ANNEX 2B: SHAPLEY DECOMPOSITION OF CHANGES IN VALUE ADDED PER CAPITA

The methodology decomposes value added per capita growth using several consecutive steps. In the first step, growth in value added per capita is decomposed into changes in the employment ratio, changes in output per worker (or labor productivity), and demographic changes, as follows:

$$\frac{Y}{N} = \frac{Y}{E} \times \frac{E}{A} \times \frac{A}{N} \tag{2B.1}$$

where Y = total value added; N = total population; E = total employment; A = total working-age population; $Y/E = \omega \rightarrow$ output per worker; $E/A = e \rightarrow$ share of working-age population that is employed; and $A/N = a \rightarrow$ share of the total working-age population.

In the second step, employment changes, Δe , are further decomposed into changes in employment by sector:

$$\Delta e = \sum_{i=1}^S \Delta e_i \tag{2B.2}$$

The third step decomposes changes in output per worker into changes linked to changes in output per worker within sectors and changes linked to structural transformation or the reallocation of workers across sectors, as follows:

$$\frac{Y}{E} = \sum_{s=1}^S \frac{Y_s}{E_s} \times \frac{E_s}{E} \text{ or } \omega = \sum_{s=1}^S \omega_s s_s, \quad (2B.3)$$

where $\left(\omega_i = \frac{Y_i}{E_i}\right)$ is output per worker in sector i and $\left(s_i = \frac{E_i}{E}\right)$ is employment share in sector i . Taking differences of equation 2B.3 between the final year (t) and the initial year ($t - \tau$) yields the following:

$$\Delta \omega_t = \underbrace{\sum_{i=1}^S \bar{s}_i \Delta \omega_{i,t}}_{\text{Within component}} + \underbrace{\sum_{i=1}^S \bar{\omega}_i \Delta s_{i,t}}_{\text{Structural transformation}}, \quad (2B.4)$$

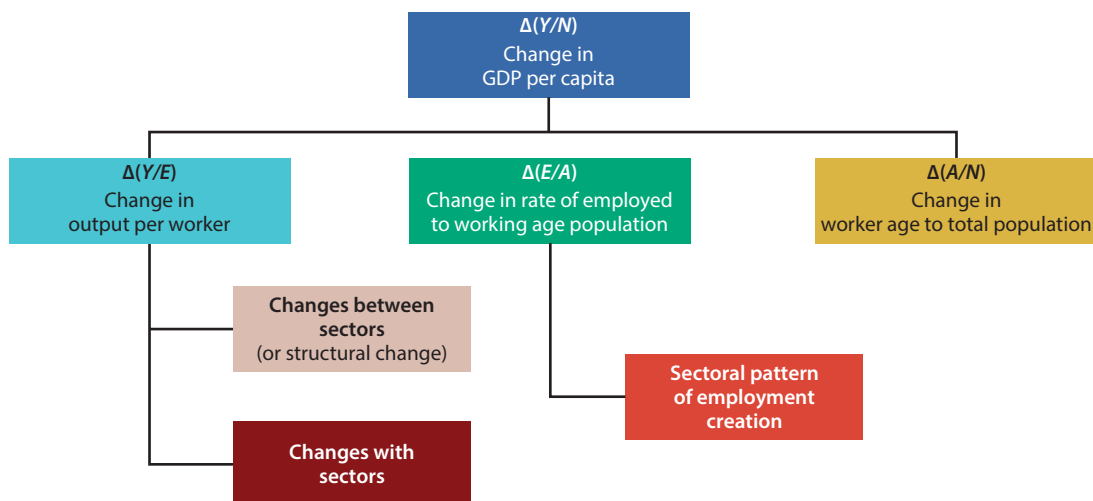
where $\Delta \omega_{i,t}$ and $\Delta s_{i,t}$ are the changes between periods t and $t - \tau$ in output per worker and employment share in sector i , respectively. Thus, changes in output per worker are the weighted sum of changes in output per worker in all sectors, where the weights are the employment shares of each sector. The weights of each sector are calculated as averages over the two periods of the shares in employment and the shares in output per worker in each sector.

The fourth step goes further in understanding the role played by each sector in the aggregate effect of employment shifts across sectors. Increases in the share of employment in sectors with above average productivity will increase overall productivity and contribute positively to the structural transformation term. By contrast, movements of labor out of sectors with above-average productivity will have the opposite effect. Similarly, increases in the share of employment in sectors with below-average productivity will reduce growth, while reductions in their share will contribute positively to growth. If a sector has productivity below average and its employment share shrinks, then its contribution will be positive. Thus, outflows of workers from this low-productivity sector will contribute positively to the increase in output per worker. If the same sector sees an increase in its employment share, such inflows of workers into this low-productivity sector will contribute negatively to output per worker and thus have a negative effect on the structural transformation term. The magnitude of the effect will be proportional to (1) the difference in the sector's productivity with respect to the average and (2) the size of the employment shift.

The last step combines all the elements together to calculate how much each factor contributes to growth of gross domestic product per capita (figure 2B.1).

FIGURE 2B.1

Decomposition of per Capita GDP Growth



Source: Original figure for this publication.

NOTES

1. In the case of Morocco, GDP per capita growth data are currently unavailable for 2021.
2. For more information, see Morocco's Job Diagnostic (Lopez-Acevedo et al. 2021).
3. Estimates for Morocco are for 2018.

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The Case of Tunisia

KEY MESSAGES

- The social protection system—combined with the minimum wage and collective agreements; lengthy, costly, and complicated dismissal procedures; and weak enforcement of labor regulations—incentivizes informality and hampers productivity growth.
- The interaction between contributory and noncontributory social insurance does not encourage formal employment—and leads to erratic coverage and poverty traps.
- Special tax regimes for individual enterprises that operate below certain sales thresholds—coupled with advantages from value added tax exemptions and weak tax enforcement—discourage firms' growth, productivity, and creation of formal jobs.
- Setting up a business is simple and inexpensive, but laws protecting borrowers and lenders are weakly enforced, and competition is hampered by a heavy state-owned enterprise footprint and cronyism—severely limiting market entry, firms' growth, and potentially formal job creation.

INTRODUCTION

On December 17, 2010, a Tunisian street vendor set himself alight to protest his harassment by Tunisian authorities, which triggered a popular uprising, known thereafter as the Jasmine Revolution, and led to the ousting of longtime president and dictator Ben Ali. At issue were the country's declining living standards, as evidenced by high unemployment, food price inflation, corruption, and lack of political freedoms. The revolution opened the path to a complex political transition, which is today threatened by the outcome of a recent referendum, and brought about a change in economic policy to accommodate social demands, paving the way for higher public sector employment and wages, stepped-up cash transfers, and better access to subsidized health insurance. However, in parallel, economic growth weakened, the business environment deteriorated, and the fiscal deficit and public debt rose together with a worsening of the current account deficit—raising concerns about the sustainability of the country's economic development model. Then, in 2020, the COVID-19 pandemic worsened the economic outlook and exacerbated existing imbalances.

Today, Tunisia struggles with limited economic growth, high fiscal and current account deficits, and labor market outcomes that are unsatisfactory for a majority of the population and thus nurture a sense of frustration. These challenges include low labor force participation rates (particularly among women), subpar employment creation, high unemployment, and a large share of informal workers.

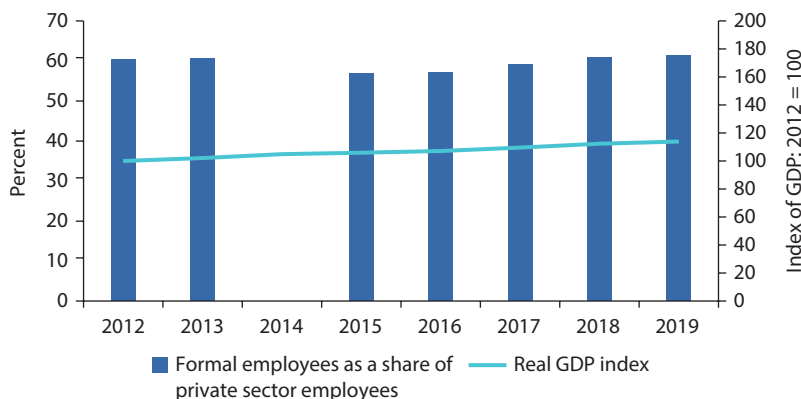
As Tunisia weighs the best way forward to sustainable, inclusive growth, an in-depth analysis of the country's high level of informality—in particular, through an institutional lens (see chapter 1)—can shed light on how the design of the social protection system, the tax system, and market conditions—as well as their interaction—might contribute to limited social insurance coverage, thereby dampening productivity growth and, ultimately, overall economic growth.

OVERVIEW OF THE TUNISIAN LABOR MARKET

In the aftermath of the Jasmine Revolution, Tunisia's economic growth has weakened. Between 2012 and 2019, real gross domestic product (GDP) increased cumulatively by less than 14 percent (figure 3.1), and real GDP per capita growth averaged only 1.1 percent per year. At the same time, the share of formal employees in the private sector increased by only 1 percentage point, or 0.2 percent per year—from 60.3 percent in 2012 to 61.3 percent in 2019. This means that if the relationship between

FIGURE 3.1

GDP Growth and Formal Employees in the Private Sector, 2012–19



Sources: Based on data from the World Development Indicators, World Bank; National Business Register, National Institute of Statistics.

Note: Data on the number of formal employees are not available for 2014. GDP = gross domestic product.

growth and formal employment stays the same, a high rate of growth would be needed to increase formal employment significantly going forward. If GDP growth remains constant, it would take almost two centuries to make a significant dent in the incidence of informal employment.

Given that growth alone has not significantly reduced the informal employment rate, how else might policy makers further increase formal employment? This chapter applies the framework put forward by Levy and Cruces (2021), described in chapter 1, to investigate how the institutional landscape influences informality in Tunisia. In this framework, the institutional landscape is composed of three broad realms: Realm 1, entrepreneur-worker relations; Realm 2, taxes and transfers; and Realm 3, market conditions.

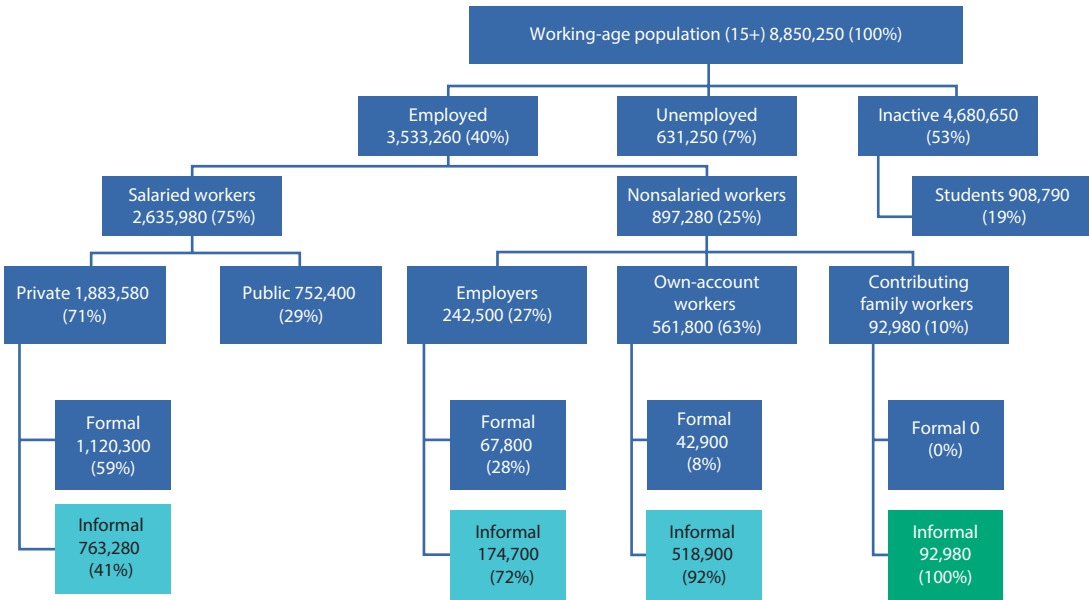
Before delving into the three realms, it is helpful to take a snapshot of Tunisia's labor market. Figure 3.2 decomposes the working-age population (age 15 and older) into employed, unemployed, and inactive; and then drills down into whether those who are employed work for wages or not, which categories nonwage workers fall into (such as employers or own-account workers), where the public sector fits in, and the shares of informal and formal workers (see box 3.1).

The following key labor market trends stand out.

Labor market participation is low, especially among women. The working-age population comprises 8.8 million people who can contribute

FIGURE 3.2

Overview of the Tunisian Labor Market, 2019



Source: Based on data from the Labor Force Survey.

Note: Informal employment—defined as workers not covered by contributory social insurance—is by law illegal for virtually all workers, with contributing family workers being the only exception. The light blue boxes indicate illegal informal employment; the green box indicates legal informal employment.

BOX 3.1

Defining Informal Workers

Informal employment includes workers who do not contribute to social insurance or, in the case of employees, workers whose employers do not contribute to social insurance on their behalf.

Workers are legally informal if the law does not require them to contribute to social

insurance. In Tunisia, except for contributing family workers, all workers, salaried and nonsalaried, who are not covered by contributory social insurance are illegally informal.

productively to the economy. About 47 percent of this group (4.1 million) is active in the labor market, and 53 percent (4.7 million) is neither employed nor looking for work. Among the inactive, more than 8 in 10 are also not in school. Women, particularly, participate in the labor market in very low numbers: fewer than 30 percent are employed or

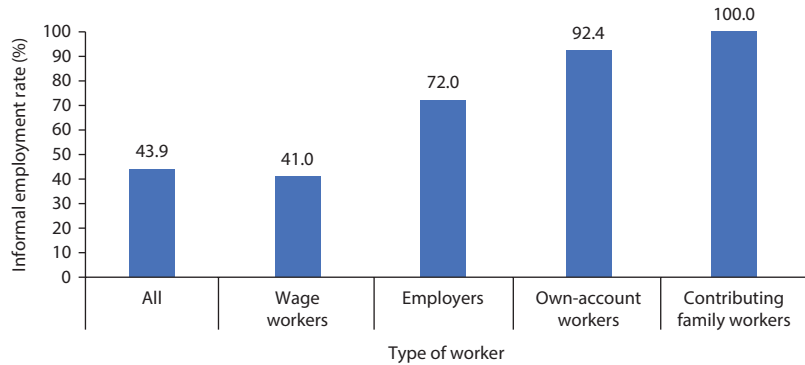
unemployed, despite considerable improvements in educational outcomes. This compares to an average rate of 52.9 percent (2019) among Organisation for Economic Co-operation and Development (OECD) countries, 45.4 percent (2019) among middle-income countries, and about 17.9 percent in the Middle East and North Africa (MENA) (excluding high-income countries, 2017).

Most workers receive a wage, and the public sector remains a large employer. Both before and since the 2011 revolution, there has been a steady increase in the share of the employed working for a wage, which is now at about 75 percent of the total employed population—above the average for middle-income countries (47.6 percent) and MENA (62.6 percent, excluding high-income countries). Further, while the share of wage workers employed in the public sector has decreased since 2012, it is now estimated at 29 percent, from 31.5 percent in 2012. The size of the public sector workforce increased from about 725,000 to 752,400 workers over the same period (up 3.1 percent). There were also shifts in the shares of the three types of nonwage workers from 2012 to 2019: the share of employers fell from 7.1 to 6.9 percent; own-account workers, from 17.3 to 15.9 percent; and contributing family workers, from 4.4 to 2.6 percent.

Informal employment is highest among nonwage workers and not limited to workers from poor households. Although the informal employment rate is about 44 percent overall, there are large differences among employment categories (figure 3.3). While 41 percent of wage workers are informal, the rate is much higher for nonwage workers—such as employers (72 percent) and own-account workers (92 percent). Moreover, informal employment is very high among workers in the poorest households, but not all informal workers are poor. The rate of informal employment remains high (17.1 percent) among workers in households at the top of the welfare distribution—an indication that informal employment might be a choice for some and not always due to socioeconomic exclusion or lack of formal job opportunities.

Formal workers typically earn more than informal workers, especially those in the public sector. For example, in Tunisian dinars, while the median monthly public sector wage is about TD 1,000 (equivalent to US\$358), that for formal private sector workers is TD 540 (US\$194), and for informal private sector workers, it is TD 435 (US\$156). Nonetheless, all types of workers can be found throughout the wage distribution, and the wage distributions of the three groups of wage workers overlap substantially. In addition, on average, public sector wage workers earn more than twice as much per hour as wage workers in the private sector, even after accounting for differences in workers' characteristics (such as age, education, and occupation) (World Bank 2022). Most of the difference

FIGURE 3.3

Informal Employment Rate, by Employment Type, Tunisia, 2019

Sources: Based on data from the Labor Force Survey; National Social Security Fund 2020.

in average wages between formal and informal workers employed in the private sector is due to differences in workers' characteristics (World Bank 2022).

*Almost all firms are micro and small ones, accounting for almost 65 percent of total employment.*¹ At about 1 million in 2019, the estimated total number of enterprises is low for a population of around 12 million people. The distribution of firms by size is heavily skewed toward micro and small enterprises (with fewer than 10 employees), accounting for about 97 percent of all firms. Moreover, 65 percent of firms do not have employees (one-person firms) and the same share operates informally. However, micro and small firms account for only about 40 percent of all employees, whereas medium-size and large firms (10 employees or more), which represent a small share of production units, account for about 46 percent of all employees. This pattern—with most firms being micro and small but medium-size and large firms contributing a sizable share of employment—is not unique to Tunisia (Merotto, Weber, and Aterido 2018). Further, medium-size and large firms are more likely to hire workers formally, as almost 90 percent of their workforce is formal—underscoring their importance in creating jobs, especially formal ones.

The entry of small firms drives job creation, but smaller firms are the ones most likely to fail. Evidence from recent data from the National Register of Enterprises shows that (1) the share of entering firms is significantly larger among micro firms (fewer than six formal employees) than small, medium-size, and large firms; and (2) the share of firms exiting the market is much larger among micro firms than larger ones. This matters because aggregate job creation in Tunisia has long been driven by firm

entry, especially that of one-person firms (own-account workers). For example, a study by Rijkers et al. (2014) finds that this was the case in 1997–2010. However, the study also finds that smaller firms were more likely to fail: on average, about 7–8 percent of firms with fewer than six workers exited the market after one year, compared to 1.6–3.8 percent of medium-size and large firms during 1996–2010.

REALM 1: ENTREPRENEUR-WORKER RELATIONS

The “entrepreneur and worker relations” realm comprises a complex set of dimensions that directly affect the incentives of firms and workers to operate formally and therefore contribute to the social protection, poverty, and inequality outcomes of individuals and households. The interactions of these elements with Realms 2 and 3 affect the number, size, and productivity of firms. In Tunisia, the social protection system, which is complex in terms of legislation and governance (see box 3.2), is composed of two main pillars: a contributory component (social insurance) and a noncontributory component (social assistance to the poor and vulnerable) (figure 3.4).

BOX 3.2

Legal Framework for Labor Relations and Social Security in Tunisia

In Tunisia, labor relations are governed by the Constitution, the Labor Code, and the Social Security Code:

- The Constitution contains general provisions concerning the right to health (article 38), the right to work (article 40), the right to organize, and the right to strike, without distinguishing between salaried and nonsalaried workers.
- The Labor Code presents general provisions that regulate employment relations in the public and private sectors—including remuneration, minimum wage, paid leave, promotions, trade union rights, working conditions, and hiring and dismissal rules. The vast majority of provisions apply to salaried workers in all sectors (agriculture and nonagriculture).
- The Social Security Code provides for mandatory social security contributions to cover mainly the health and pensions of all workers (salaried and nonsalaried). This means that informal employment—defined as employment not covered by social insurance—is by law illegal for virtually all workers in Tunisia, with contributing or unpaid family workers being the only exception (figure B3.2.1).

(continued)

BOX 3.2

Legal Framework for Labor Relations and Social Security in Tunisia (continued)

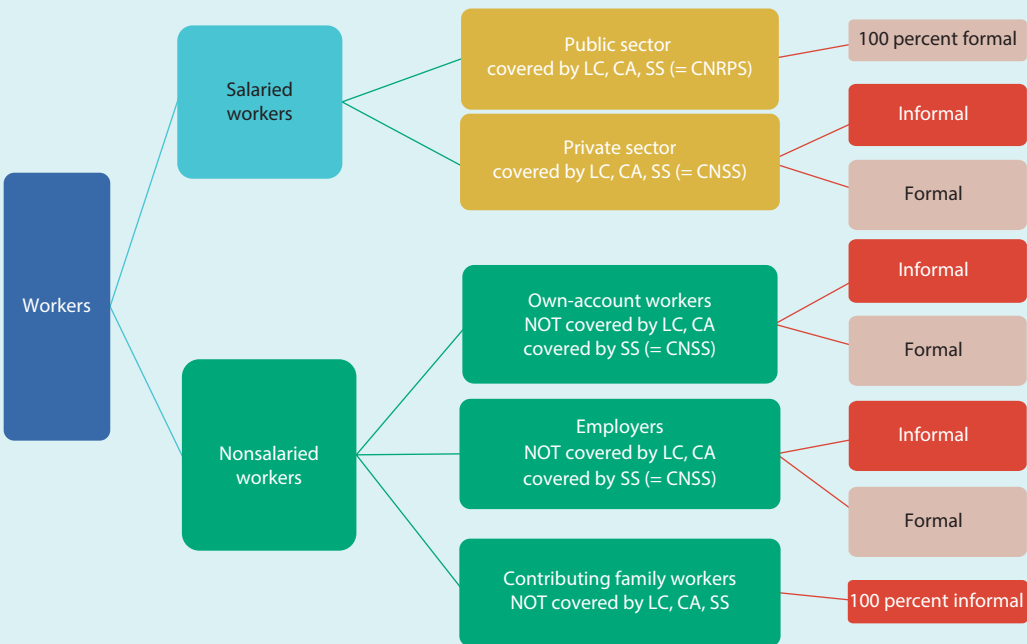
Social security contributions and benefits are separately regulated by sector (private/public, agriculture/nonagriculture) and by employment type (salaried worker, self-employed) across various specific regimes. The regulation of social security is managed by the National Social Security Fund (Caisse Nationale de Sécurité Sociale) for private sector workers and by the National Pension and Social Insurance Fund (Caisse Nationale de Retraite et de Prévoyance

Sociale) for public sector workers. The general status of the civil service (Law 83-112, 1983) governs public administration and local administrative authorities and covers working conditions, wages, and holidays, among other things, ensuring full coverage of public sector workers.

In addition, collective sectoral agreements covering salaried workers play an important role in the organization and regulation of working conditions and wage setting.

FIGURE B3.2.1

Overview of Legislation and Regulations Covering Workers, by Type of Employment, Tunisia

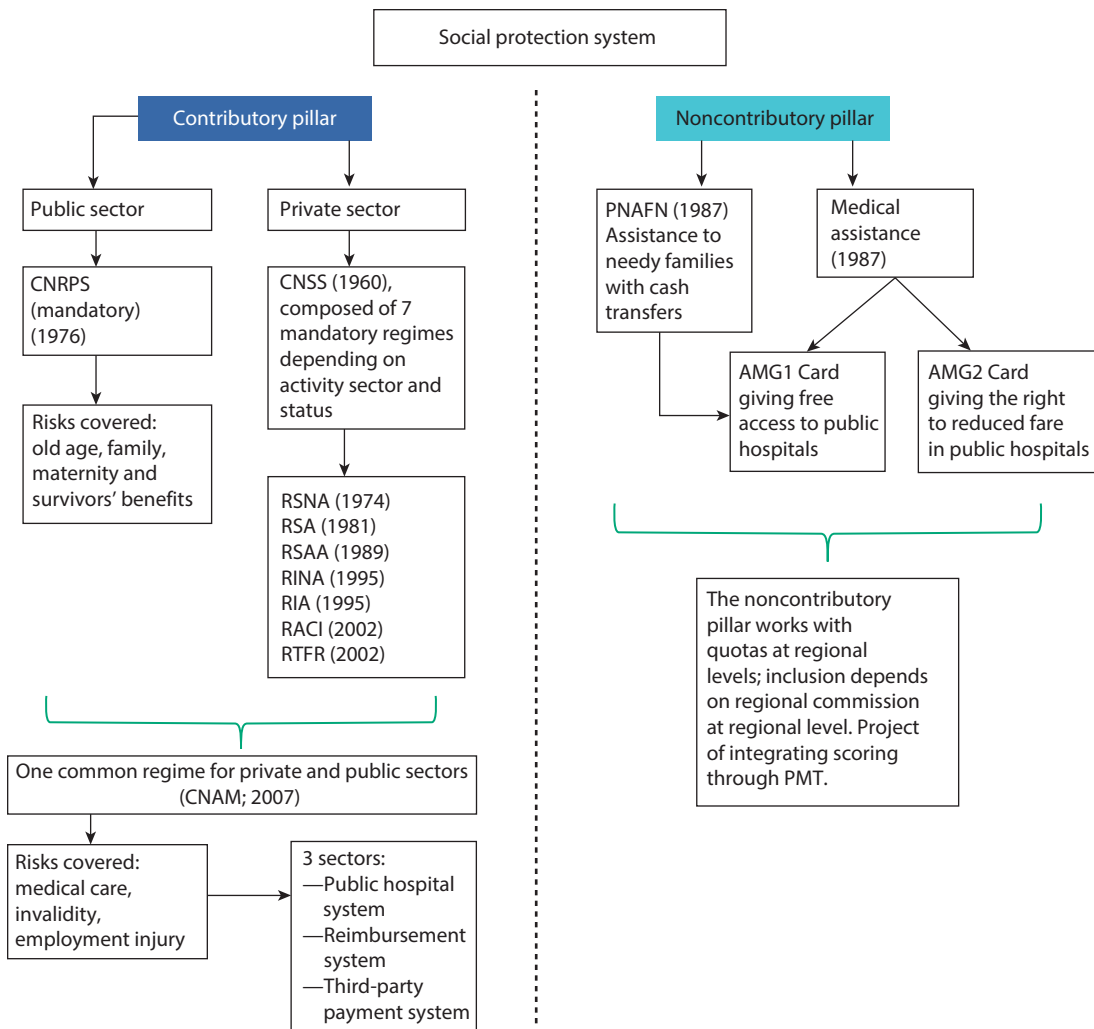


Source: Original figure for this publication.

Note: CA = collective agreement; CNRPS = National Pension and Social Insurance Fund; CNSS = National Social Security Fund; LC = Labor Code; SS = Social Security Code.

FIGURE 3.4

Tunisia’s Social Protection System



Source: Original figure for this publication.

Note: AMG = free medical assistance program for the vulnerable population; CNAM = National Health Insurance Fund; CNRPS = National Pension and Social Insurance Fund; CNSS = National Social Security Fund; PMT = proxy means test; PNAFN = National Program of Assistance to Needy Families; RACI = social insurance for artists and intellectuals in the private sector; RIA = general scheme for agricultural employees in the private sector; RINA = general scheme for nonagricultural self-employed workers in the private sector; RSA = expansion of the general scheme for agriculture and forestry workers; RSAA = general scheme for agricultural employees in the private sector; RSNA = general scheme for nonagricultural employees in the private sector; RTFR = social security insurance for low-income salaried workers in the private sector.

CONTRIBUTORY SOCIAL INSURANCE REGIMES

The contributory pillar distinguishes between workers in the public and private sectors. The main fund for the public sector is the National Pension and Social Insurance Fund (Caisse Nationale de Retraite et de

Prévoyance Sociale [CNRPS]); the main one for the private sector is the National Social Security Fund (Caisse Nationale de Sécurité Sociale [CNSS]). For the private sector, the schemes cover workers depending on whether they are employees or self-employed, and whether they work in the nonagriculture sector or the agriculture sector.² Other schemes that were created in the early 2000s for employees and the self-employed provide social insurance to specific categories of precarious workers who were not previously covered by the other schemes. The following are the social insurance schemes for private sector workers:

RACI: social insurance for artists and intellectuals

RIA: general scheme for agricultural employees

RINA: general scheme for nonagricultural self-employed workers

RSA: expansion of the general scheme for agriculture and forestry workers

RSAA: general scheme for agricultural employees

RSNA: general scheme for nonagricultural employees

RTFR: social security insurance for low-income salaried workers.

The contributory pillar covers all social risks (as defined by International Labour Organization Convention No. 102 of 1952), except job loss, which is partially covered under only one scheme (RSNA). The National Health Insurance Fund (Caisse Nationale d'Assurance Maladie [CNAM]) covers the health risk of all formal workers, whether in the public or private sector. The CNRPS and the CNSS collect contributions for CNAM. However, since retirement pension funding has faced hardships over the past decade, they have not reimbursed contributions paid to CNAM—creating a sizable debt and pushing CNAM into financial uncertainty.

The presence of several schemes that do not provide the same coverage in terms of the number of risks or quality makes the system complex and prone to arbitrage of firms and workers. This also raises questions about the system's ability to provide incentives to pay social security contributions and provide adequate coverage for different categories of workers.

A big problem for Tunisia is that the social insurance system segments private and public sector salaried employees, which might contribute to incentivizing informal employment. The public sector is an important employer, responsible for about 21 percent of all workers, and provides better and more generous working conditions than the private sector. For example, workers in the public sector are entitled to higher pensions, shorter working hours, longer paid leave, and more secure and stable jobs. It is no wonder that Tunisians prefer public sector jobs: 78.5 percent of individuals in the labor force would choose a job in the public sector (Assaad and Boughzala 2018).

Differences in working conditions generate labor market distortions, with a high share of private sector workers as well as unemployed and inactive (particularly graduates) individuals searching for an attractive public sector job. Given the preferential treatment of the unemployed in the public selection process, youth often opt for an informal private sector job while queuing for preferred employment in the public sector (OECD 2015).³ Further, rising fiscal deficits due to greater public sector recruitment have led to a hiring freeze, thus adding pressure on the struggling private sector, further limiting formal employment opportunities, and pushing many to accept informality by necessity (Yassin and Langot 2018).

CONTRIBUTORY REGIMES FOR SALARIED WORKERS

Contributory social insurance covers multiple risks that are bundled and offered as a package, which differs depending on the scheme. All components of the package have costs that depend linearly on workers' salaries.

In the private sector, the RSNA scheme—managed by the CNSS—covers Tunisian nonagricultural workers, while the RSAA provides coverage to agricultural wage workers. The benefits of these schemes include (1) retirement, invalid, and survivors' pensions; (2) family allowances; (3) employee death benefits; (4) health insurance, workplace accidents, maternity, and sick leave benefits provided by CNAM; and (5) supplementary pensions for nonagricultural workers with remuneration exceeding six times the minimum wage (the guaranteed minimum interprofessional wage [SMIG]).⁴ With nearly 1.3 million members, the RSNA is the largest plan in terms of contributors, covering 72 percent of CNSS contributors (about 44 percent are women). The overall contribution rate of the scheme is 28.75 percent, with the highest rates for retirement pensions (12.5 percent) and health (6.75 percent) risks, followed by family allowances (3.10 percent) (table 3.1).

For public sector workers, the CNRPS covers all risks covered under the RSNA scheme, with the same type of coverage for health insurance, family allowances, and death benefits (table 3.2).

Retirement pensions. In the private sector, pensions can be obtained at 60 years of age with a minimum of 10 years of contributions. The pension benefit represents 4 percent of the reference wage for each of the first 10 years of contributions, and subsequently 2 percent per year to reach a maximum benefit equal to 80 percent of the reference wage. The minimum benefit for those contributing 10 years equals two-thirds of the minimum wage. The reference salary is the average salary received

TABLE 3.1**Contribution Rates, by Type of Benefit and Separately for Employers and Employees, under the RSNA Regime, Tunisia***Percent*

| Benefit | Employer | Employee | Total |
|---|--------------|-------------|--------------|
| Retirement pension | 7.76 | 4.74 | 12.50 |
| Health insurance | 4.00 | 2.75 | 6.75 |
| Family allowance | 2.21 | 0.89 | 3.10 |
| Workplace accident and occupational disease | 0.72 | 0.28 | 1.00 |
| Sickness and maternity benefits | 0.61 | 0.24 | 0.85 |
| Lump sum death benefit | 0.47 | 0.18 | 0.65 |
| State special fund | 0.50 | n.a. | 0.50 |
| Employee social protection | 0.29 | 0.11 | 0.40 |
| Vocational training tax | 2.00 | n.a. | 2.00 |
| Housing fund | 1.00 | n.a. | 1.00 |
| Total | 19.56 | 9.19 | 28.75 |

Source: Original table for this publication.

Note: n.a. = not applicable; RSNA = general scheme for nonagricultural employees in the private sector.

TABLE 3.2**Contribution Rates, by Type of Benefit and Separately for Employers and Employees, under the CNRPS Regime, Tunisia***Percent*

| Benefit | Employer | Employee | Total |
|------------------------|--------------|--------------|--------------|
| Retirement pension | 14.50 | 9.20 | 23.70 |
| Health insurance | 4.00 | 2.75 | 6.75 |
| Lump sum death benefit | n.a. | 1.00 | 1.00 |
| FOPROLS (housing fund) | 1.00 | n.a. | 1.00 |
| Total | 19.50 | 12.95 | 32.45 |

Source: Original table for this publication.

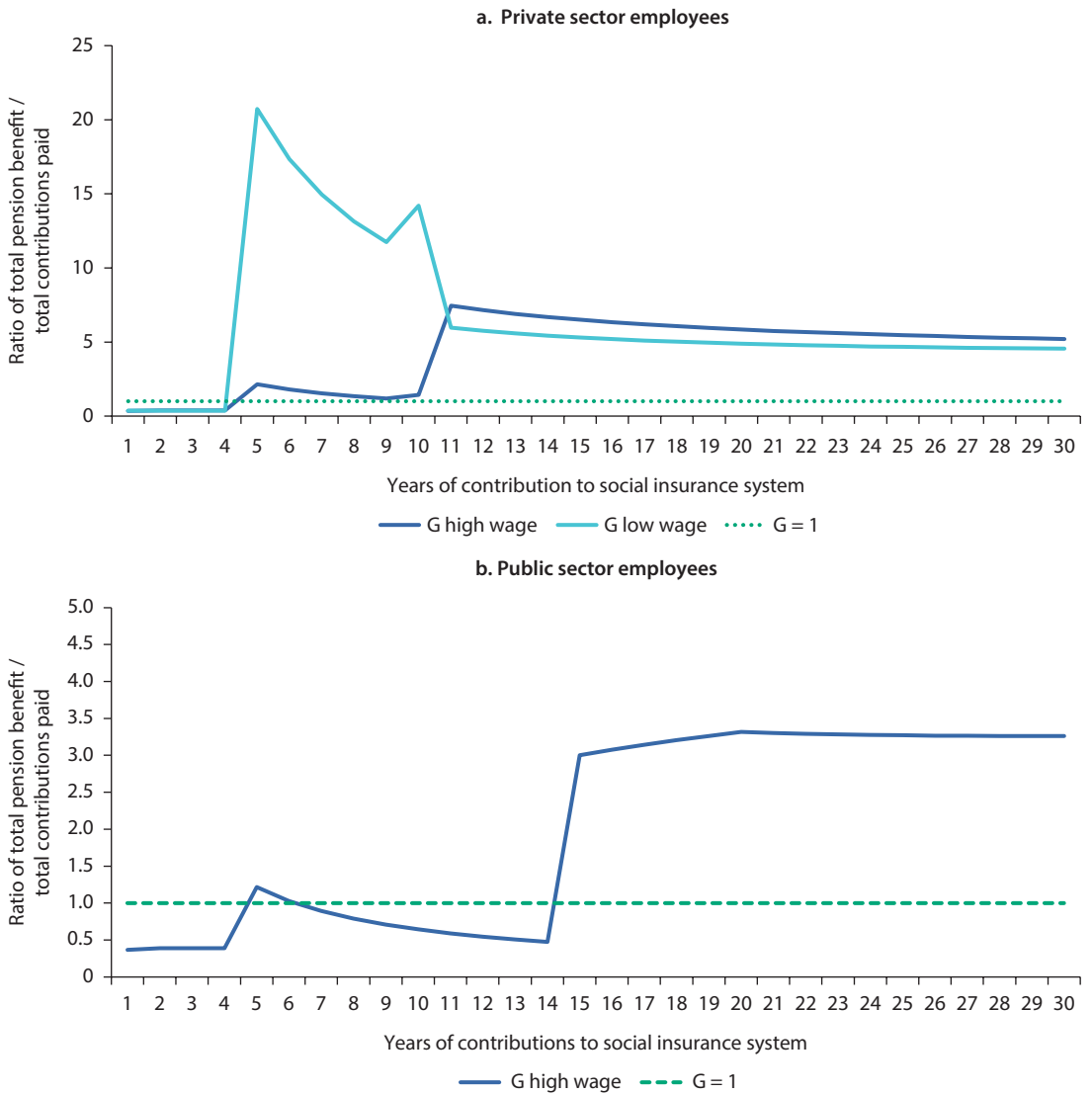
Note: CNRPS = National Pension and Social Insurance Fund; n.a. = not applicable.

over the past 10 years of contributions, capped at the SMIG level. What happens to workers who fall short of the 10-year minimum? If they have contributed 5–10 years, they can receive a benefit reduced by 50 percent, while workers who do not accrue 5 years can get a lump sum payment corresponding to the amount of contributions they paid, but not the two-thirds paid by employer contributions.

The pension system presents discontinuities that might play in favor of informal employment. The most evident one is between workers who contribute for 4 years and 11 months and do not have a right to a pension (thus bearing longevity risk, despite paying contributions) and those who contribute for 5 years and are entitled to a pension (although they must pay a penalty due to the low contribution density) (figure 3.5, panel a).

FIGURE 3.5

Ratio of Total Pension Benefits to Total Contributions Paid, Tunisia



Source: Original figure for this publication.

Note: Panel a shows the ratio of total retirement pension benefits to total contributions paid, by number of years of contributions for workers under the general scheme for nonagricultural employees in the private sector. Panel b shows the ratio for public sector employees. The following assumptions were used in the simulation: salary growth rate: 3 percent; pension growth rate: 2 percent; capitalization rate: 3 percent; life expectancy: 19 years at age 60; and salary capitalization scale for calculating the reference salary: official scale used by the National Social Security Fund (panel a) or the National Pension and Social Insurance Fund (panel b). G = ratio of benefits to contributions.

Further, workers paying into the system for just under 5 years are also denied the possibility of joining the public health insurance system during retirement, thus fully bearing health care costs when they are highest. Another discontinuity is that the size of the taxed population—that is,

those earning a pension less than proportional to their contributions or earning no pension at all despite contributing—could be sizable: in 2022, for instance, about 17.5 percent of RSNA contributors contributed less than two-thirds of the minimum wage, which is below the minimum benefit threshold (Center for Research and Social Studies 2022 data).

In addition, the system is somewhat regressive, as low-wage workers might subsidize high-wage workers given the low contribution densities of low-wage workers, and thus have a higher probability of not accruing enough years of contributions to receive a pension benefit. However, the system has some progressive elements. Given the SMIG cap on benefits, workers earning very high wages pay more into the system since there is no cap on contributions and they do not receive proportionally higher benefits. This creates another incentive problem: low-wage workers might not be incentivized to contribute to the system if they expect to have discontinuous careers, and high-wage workers benefit from not declaring all their salary to the CNSS, only exactly enough to maximize their returns from the pension system.

Nonetheless, the pension system is more than actuarially fair—the discounted sum of pension benefits is greater than the discounted sum of contributions paid (the ratio of benefits to contributions exceeds 1 [$G > 1$]). A simulation shows that there are significant differences in the value of G depending on the level of salary. Low-wage workers can obtain much higher returns than high-wage workers with the same number of years of contributions (fewer than 10). For workers with more than 10 years of contributions, the value of G hovers around 5, which means that workers who meet the eligibility criteria receive five times the amount they paid. In addition, it does not provide incentives to contribute more than the minimum number of years since the value of G tends to decline over the number of years of contributions paid. In other words, the system is not actuarially fair at the margin. This discourages working formally beyond the minimum number of years required to get a full pension. It also hurts the CNSS's financial stability, given that 90.6 percent of its revenue comes from the RSNA scheme. The financial deficit recorded by the pension component of CNSS in 2019 (TD 870 million, equivalent to US\$311.8 million) represents 66 percent of the overall deficit of the fund and 0.75 percent of the country's GDP.

In contrast, in the public sector, pensions can be obtained at age 62 with a minimum of 15 years of contributions. The pension benefit represents 2 percent of the reference wage (the last wage before retirement) for the first 10 years, 3 percent for an additional 10 years, and 2 percent for the remaining years of contributions paid. The replacement rate is capped at 90 percent of the last gross salary. Workers with fewer than 5 years of contributions get a lump sum payment that refunds

contributions paid; for those with more than 5 and up to 15 years, the benefit equals 50 percent of the minimum wage.

A simulation indicates that for a career of less than 14 years, workers are taxed as they receive less than what they paid (figure 3.5, panel b). With at least 15 years of contributions, public sector workers receive three times the amount paid, and the benefit increases for up to 20 years of contributions. Such an incentive to pay contributions for a long period is associated with stable and secure employment of civil servants who enjoy open-ended contracts and high average salaries, in addition to bonuses and allowances. At 23.7 percent, the CNRPS collects much higher contribution rates for retirement pensions. Together with higher average salaries and longer and continuous careers, this leads to higher average pension benefits for public sector workers.

Family allowances. These do not create a large incentive to contribute to social security. Family allowances are paid to all contributing workers for the first three children under age 16, between 16 and 21 years of age if the child is enrolled in school, and without an age limit in the case of a handicapped or invalid child. The quarterly amount is calculated as a percentage of the total quarterly remuneration of the employee, capped at TD 122,000, or US\$43,728, in the following amounts for each additional child:

- First child, 18 percent, maximum of TD 21,960, or US\$7,871
- Second child, 16 percent, maximum of TD 19,520, or US\$6,996
- Third child, 14 percent, maximum of TD 17,080, or US\$6,122.

Workers with a nonemployed spouse are entitled to a higher allowance. The benefit has a progressive component built in as all workers pay the same percentage, which means that high-wage workers end up contributing more to the system relative to low-wage workers, and receive the same benefit conditional on the numbers and ages of their children. Thus, high-wage workers might have a further incentive to declare a lower salary. However, the benefits are low compared to the cost of living; and even among low-wage workers, family allowances do not represent a big incentive to contribute to social security.

Unemployment benefit. Job loss risk is only covered under the RSNA regime. The conditionalities are strict: (1) three years of contributions with the same employer with an open-ended contract; (2) job loss due to firm closure for economic or technological reasons, or unexpected closure of the firm and failure to meet dismissal procedures (as certified by a labor inspector or court); and (3) dismissed workers must be registered with the National Agency for Employment and Independent Work for at least one month and must not have received

any job offers. Unemployment benefits are low, as the maximum amount corresponds to the minimum wage, and are provided for up to one year.

Health insurance. The health insurance system—which is managed by CNAM—covers health risk (along with workplace accidents and sick leave benefits) for all workers covered by social insurance, whether in the public or private sector and regardless of the contribution scheme.⁵ CNAM (created in 2007) has helped reduce out-of-pocket health expenditures and improve social security coverage. However, at close to 39.0 percent of GDP in 2018, the share of these health expenditures remains much higher than the OECD's 13.8 percent. There are also significant differences in access, depending on where workers live (Ministry of Health 2019). Households in rural areas far from facilities equipped to provide certain medical specialties must incur significant travel costs and forgo earnings because they cannot work. Despite its complexity, CNAM remains an essential player in the management of chronic diseases, and many workers contribute irregularly to the system to maintain a valid card that lasts six months.

The overall contribution rate for health insurance for both public and private workers is 6.75 percent, of which employers pay 4 percent. There is no ceiling on taxable wages, which means that high-wage workers pay much more than low-wage workers for the same service, thus creating an incentive to declare a lower wage when possible and pay for a private health insurance plan. Moreover, the system might partially redistribute from workers with continuous formal employment to those with short formal employment spells.⁶ The system provides three options:

- The private channel offers access to private health care providers by referral from a primary care physician, with payment of 30 percent of treatment cost (selected by about 20 percent of CNAM contributors).
- The public channel offers access to public health providers and CNSS polyclinics, with copayment fees (selected by about 55 percent of CNAM contributors).
- The reimbursement channel offers access to public providers, as well as agreed-on private providers, with CNAM reimbursement of the legal tariff (selected by about 25 percent of CNAM contributors).⁷

The most common health plan provides limited coverage for ordinary illnesses and shifts a large part of the costs to workers—in the form of long waiting lines and low-quality services or low reimbursement rates if private providers are used.

Most contributors opt for the public channel, given the low coverage of the other regimes and high costs of medical treatments in the private sector. Although chronic diseases are fully covered, for ordinary illnesses, there is a reimbursement ceiling at TD 300 (US\$107) per year for the insured worker, plus TD 75 (US\$27) per year for each additional dependent, with a household cap at TD 600 (US\$215) per year. In both cases, the amount refunded is the rate negotiated between the health insurance fund and doctors, which is typically below the private sector price. Some workers supplement the public health scheme with a private mutual system organized at the sectoral level, which offers higher benefits and prompt reimbursement. However, this partially undermines the system's ability to share risks to the extent that workers who opt for additional health insurance tend to have higher salaries and declare lower wages to the CNSS.

Contributory Regimes for Nonsalaried Workers

The self-employed benefit from a separate contributory social insurance scheme and a certain degree of flexibility. Contributory social insurance covering the self-employed is composed of three schemes: (1) the RINA scheme (created in 1995) for the self-employed in the nonagriculture sector, (2) the RIA scheme (created in 1995) for the self-employed in the agriculture sector, and (3) the RACI scheme (created in 2002) for artists and intellectuals. The RIA and RINA schemes operate under the same legislation, and the health insurance benefits (under the RSNA regime) are the same. The RACI scheme features a few differences for pension benefit calculations. With more than 429,000 members, the RIA scheme is the second-largest CNSS scheme in terms of the number of affiliates, and the RINA has fewer than 140,000 members. However, there is a significant gap between the number of affiliates and the number of active contributors in a year—in the case of RINA, fewer than 6 in 10 affiliates contributed in 2019 (table 3.3).

TABLE 3.3

Number of Affiliates and Contributors to the RINA and RIA Regimes, Tunisia, 2019

| Category | RINA | RIA |
|---------------------------------|---------|---------|
| Affiliates (number) | 429,063 | 137,229 |
| Contributors (number) | 243,036 | 70,851 |
| Contributor/affiliate ratio (%) | 56.6 | 51.6 |

Source: Center for Research and Social Studies 2021 data.

Note: RIA = general scheme for agricultural employees in the private sector; RINA = general scheme for nonagricultural self-employed workers in the private sector.

The retirement age for self-employed workers is 65 years, which is higher than that for wage workers (60 years), and a minimum of 10 years of contributions is required. The self-employed contribute according to 10 income classes, ranging from 1 (less than 2 times the minimum wage) to 10 (18 times the minimum wage). Workers who do not meet the minimum number of years of contributions are entitled to a lump sum payment equal to the contributions they paid. The total contribution rate for the three schemes is 14.71 percent and is mainly composed of contributions to retirement pensions (7 percent) and health insurance (6.75 percent). The other risks covered, namely, sickness and maternity benefits and the lump sum death benefit, have low contribution rates, at 0.55 and 0.41 percent, respectively. The schemes do not provide family allowances for the self-employed.

The pension benefit is calculated as 3 percent of the reference wage for each of the first 10 years of contributions, and subsequently 2 percent per year to reach a maximum benefit equal to 80 percent of the reference wage. This is less generous compared with wage workers for the first 10 years. The minimum benefit for those contributing 10 years equals 30 percent of the minimum wage. The vast majority of the self-employed under the three schemes pay contributions in the lowest income brackets: 88 percent of RINA contributors and 96 percent of RIA contributors were in the lowest income category in 2019. The evidence whereby most of the self-employed pay contributions based on the minimum income level allowed by the system might be the by-product of two factors: (1) the self-employed might try to benefit from the contributory social insurance system (notably, health insurance) while paying the minimum allowed by law, or (2) this behavior might signal the low value that they place on the retirement pension benefit.

In addition, the self-employed with very low incomes can contribute under the RTFR—the social security insurance for low-income salaried workers—if they declare an income equivalent to two-thirds of the minimum wage (SMIG or guaranteed minimum agricultural wage [SMAG], depending on the sector). This scheme (introduced in 2002) covers low-income workers (like domestic and construction workers, fishers, and agricultural workers). It has relatively low coverage, due to a combination of the strict legislative requirements and the socioeconomic conditions of the reference population. The number of contributors remains low, reflecting the inability of the scheme to attract this category of workers.

The self-employed can opt to contribute for some fraction of their working life and still be able to regularize their social security contributions at any subsequent time to benefit from the system (such as for a retirement pension). Those who contribute pay a total contribution rate (health insurance and pension contributions) of only 7.5 percent,

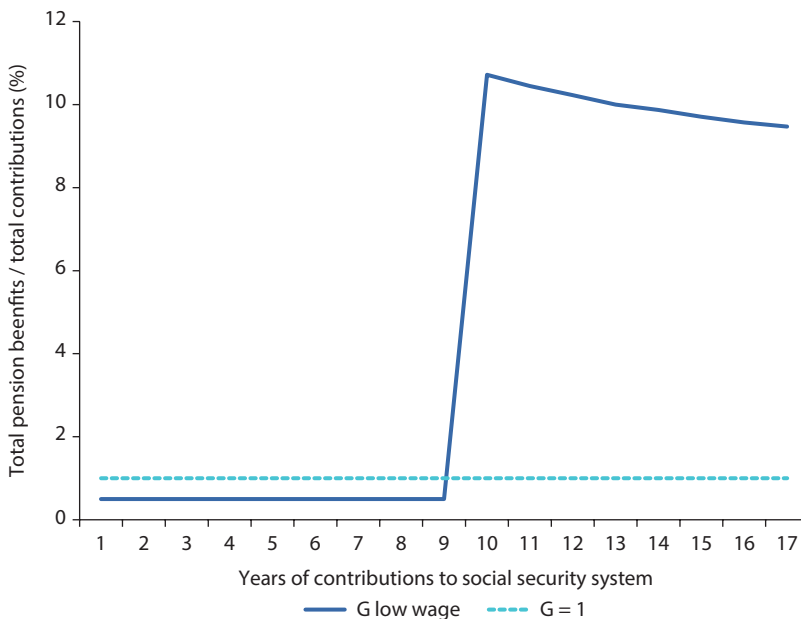
but the benefits are relatively limited. The maximum retirement pension benefit is low, at 80 percent of two-thirds of the minimum wage, and the minimum retirement age is 65. Figure 3.6 shows that people who contribute for fewer than 10 years are taxed, although beyond the minimum number of years of contributions, the system is more than actuarially fair. However, it is unlikely that many contributors will meet the eligibility requirement—and even if the benefit is much higher than the cost, the amount of the pension benefit would not allow retirees to have a decent standard of living.

Labor Regulations

Minimum wage. Over the past decade, the minimum wage has remained roughly constant in real terms. The Tunisian system operates with two minimum wages: the Guaranteed Minimum Wage for nonagriculture sector workers (SMIG), and the Guaranteed Minimum Wage for agricultural workers (SMAG). They are applied to all employees with open-ended and fixed-term contracts (article 134 of the Labor Code).

FIGURE 3.6

Ratio of Total Retirement Pension Benefits to Total Contributions Paid, Tunisia



Source: Original figure for this publication.

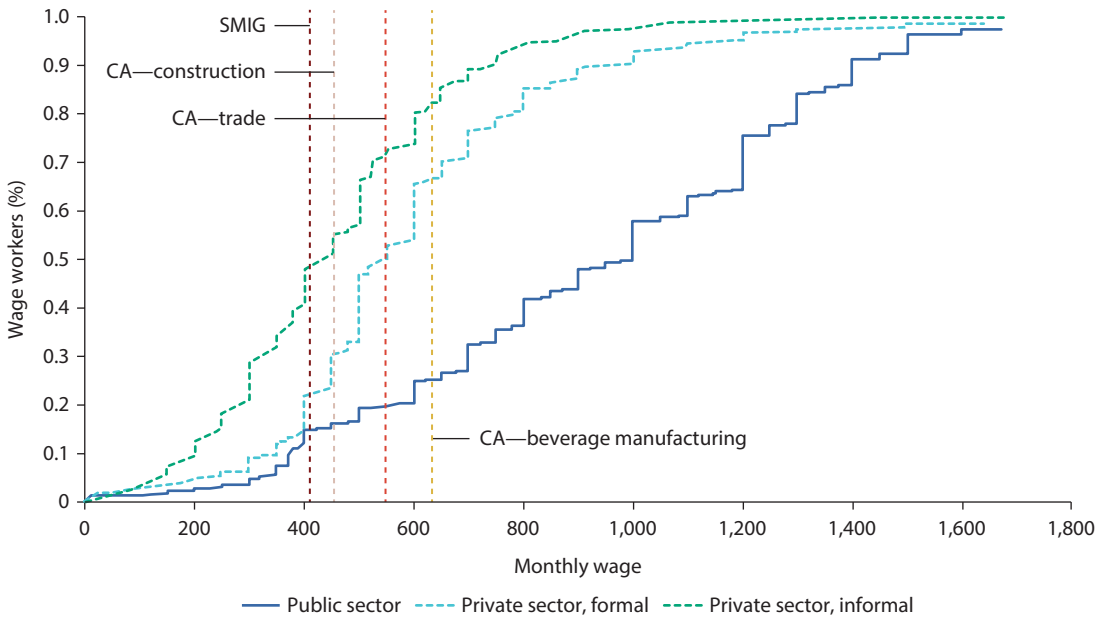
Note: The figure shows the ratio of total retirement pension benefits to total contributions paid, by number of years of contributions for workers under the social security insurance for low-income salaried workers in the private sector regime.

Minimum wage levels are revised every year after consultation with social partners, to keep up with price changes. They are also a reference for the negotiation and adjustment of wages under collective agreements. The increase in the minimum wage is often used as a reference for wage increases provided through sector-level agreements. In 2019, the SMIG was around TD 403 (US\$144) per month and the SMAG was around TD 372 (US\$133) per month. Since 2010, the minimum wage has been revised upward in nominal terms at nearly the same rate as inflation, keeping it roughly constant in real terms.

Minimum wages are set at a relatively high level and might be a barrier to formally hiring workers with a low productivity level. In 2019, the minimum wage for nonagriculture sector workers was about 67 percent of the average wage and 79 percent of the median wage. Around 45 percent of informal workers earned less than the SMIG (figure 3.7). In addition, collective agreements set sectoral minimum wages higher than the SMIG, which might further discourage formal hiring of workers with very low or unknown productivity levels (youth with no previous work experience, for example). For example, the minimum wage set by the collective agreement for the beverage industry is 152 percent of

FIGURE 3.7

Minimum Monthly Wages, by Sector, Tunisia, 2019



Source: World Bank 2022.

Note: The figure shows the cumulative distribution function of monthly wages of private (by formality status) and public sector wage workers in 2019. Monthly wages are expressed in TD (2019 prices). CA = collective agreement; SMIG = minimum monthly wage for nonagricultural workers, set at TD 403 in 2019.

the SMIG. As of 2020, the ratio of the minimum wage to value added per worker in Tunisia is 0.58, which is higher than the MENA average (0.47) and the world average (0.45) (World Bank 2021).

Collective agreements. These play a key role in the organization and regulation of working conditions and wage setting. Sectoral agreements complement the Labor Code by introducing specific provisions on working conditions, recruitment, remuneration, severance payment, and conflict management. By law, collective agreements cannot provide less favorable conditions with respect to those defined in the Labor Code. They cover mainly permanent workers and, to a lesser extent, workers with fixed-term contracts.⁸ About 54 collective agreements currently exist in the private sector, covering a majority of sectors. Although the Labor Code allows different levels of negotiation (article 44), since 2011, collective bargaining has been carried out at the national and inter-professional level—rarely at the sectoral level and even more rarely at the company level. Centralized negotiations, most often focusing on wage increases, lead to a national agreement on wage adjustment. Branches and companies have a legal obligation to comply with the national agreement. This protects formal salaried workers while introducing a degree of rigidity since nationally agreed-on wage increases do not account for sector- or company-specific conditions.

The base salary, collectively agreed on within a sector, is the minimum wage firms pay to salaried workers in the sector and is considerably higher than the SMIG. For example, firms in the construction sector must pay a minimum salary that is 114 percent higher than the SMIG. Moreover, collective agreements can provide for bonuses and allowances in fixed amounts by professional categories that account for up to 98 percent of workers' regular pay. Bonuses and allowances include transportation and lunch allowances, allowances for workers exposed to dangerous products, allowances paid to managers in positions of high responsibility, child allowances, and bonuses on religious holidays. On average, less than 2 percent of remuneration is variable and indexed to personal performance. Remuneration grids contained in collective agreements reveal a glaring weakness in the share of merit pay—which implies that companies end up paying a quasi-fixed remuneration to all workers (within a category), regardless of performance and productivity. Firms are also required to provide workers centrally agreed-on wage increases, regardless of the firms' economic and financial conditions.

Hiring and firing regulations. The most common job contracts in Tunisia are open-ended in nature, and as of 2019, they applied to over half of all employees. The prevalence of these contracts varies significantly by institutional sector and formality status—while 85.7 percent of public sector employees had a permanent contract, the shares were

lower in the private sector, at 57.5 percent for formal employees and 20.1 percent for informal ones. Meanwhile, 20.3 percent of employees worked under fixed-term contracts. These contracts are allowed for nonpermanent tasks in specific cases prescribed by the Labor Code (such as seasonal work, temporary replacement of a permanent worker, and maintenance work). Firms hiring workers with a fixed-term contract have significant flexibility in managing human resources, particularly in terms of simplified dismissal procedures. However, fixed-term contracts must be converted into open-ended ones after four years, leading some employers to dismiss workers before reaching the four-year term (Assaad and Boughzala 2018).

Workers with open-ended contracts can be fired under specific conditions, with limited dismissal costs.² Dismissing workers is authorized in the case of an established and proved misconduct or/and fault (article 14 of the Labor Code; for instance, continuous absence without justification, theft, violence, or disclosure of a professional secret) or in the case of economic (such as demand contraction or shrinking markets) or technological reasons. No compensation is due to employees in the case of serious misconduct or fault. In the event of termination of a fixed-term contract due to economic or technological reasons, an amount equal to the salary corresponding to the remaining duration of the contract must be paid. Redundancy pay is provided only to employees with permanent contracts who are dismissed for proven economic or technical reasons (article 21 of the Labor Code). Article 22 of the Labor Code mandates compensation corresponding to one day of salary per month of service with the firm. Sectoral agreements often require higher compensation, set at a minimum of 1.25 days of salary per month, and it can reach 2.5 days of salary per month. A simulation of the cost of redundancy (as a percentage of cumulated wages) finds that it is between 5 and 6 percent of cumulated wages, which is not very high, and it decreases with years of service.¹⁰

However, uncertainty about the length of the dismissal process might push firms to hire part of their workforce informally. Dismissal procedures are long and require several stages: from gathering evidence and a labor inspection one month before termination, to a possible intervention by a central commission (composed of representatives of unions, the company, and labor inspectors) or a court appeal. In the case of abusive dismissals or noncompliance with legal procedures, additional damages (between one and two months of salary per year of service with the company, capped at three years of salary) must be paid to workers on top of a redundancy payment. However, the law does not envisage the possibility of nullifying the dismissal decision; thus, worker reinstatement is possible only in agreement with the employer. Such complex, uncertain, and

lengthy procedures lead to only a few redundancies—less than 1 percent of the total workforce, compared to an average over 10 percent in OECD countries (World Bank 2014).

In addition, the virtual lack of unemployment insurance makes dismissals even more complex and strongly opposed by workers and unions. Dismissed workers are generally left without income and social protection support until they find a new job. Only nonagricultural salaried workers under the RSNA scheme can receive, in the event of proven economic or technological redundancies and under strict conditions and complex procedures, a monthly allowance (not exceeding the minimum wage) and social protection for up to one year.

Enforcement. This is weak due to a lack of human and financial resources. The Ministry of Social Affairs (MoSA) enforces labor regulations with labor inspectors. However, the labor inspection department lacks sufficient human and financial resources to conduct its mission. According to a department report, in 2017 MoSA carried out 18,297 inspections, resulting in 3,144 written warnings and 526 penalties in a labor market of 3.5 million people (labor inspection report, 2018). The small number of controllers (about 300 in 2021) cannot ensure effective enforcement of paying social security contributions. There is also an overlap of control functions between labor inspectors and social security controllers, which makes governance of the control system complicated and inefficient. Further, derisory and nondissuasive sanctions make the control particularly ineffective and lead to rare recourse to justice. However, complicated and lengthy judicial procedures, lack of transparency, judicial misconduct, and uncertainty discourage recourse to justice. According to a 2019 survey by the Observatoire national de l'emploi et des qualifications and the National Institute of Statistics on informal workers, 97 percent of them declare that they have never been contacted by the public control services (labor inspection, social security controllers, or others). In a context of weak law enforcement, many employers do not comply with regulations and choose to operate fully or partially informally to limit labor costs and benefit from more flexibility in workforce management.

Noncontributory Regimes

The noncontributory pillar is composed of two key elements: a cash transfer program, the National Programme of Assistance to Needy Families (Programme national d'aide aux familles nécessiteuses [PNAFN]), and free or subsidized access to health care. The economic and social crisis that followed the Jasmine Revolution was largely

mitigated by scaling up the social response. This included more public sector hiring and increases in the number of social assistance beneficiaries and the amount of cash transfers, which helped improve living standards, but at a high cost. Since 2019, the government has engaged in a reform program to set up a new integrated social safety net program—known as the AMEN Social program—to address multidimensional poverty by reducing fragmentation, increasing coverage, and creating a Social Registry of beneficiaries.

Cash transfer program. The PNAFN, which is implemented by the MoSA, consists mainly of an unconditional permanent cash transfer to households that lack financial and family support (such as the elderly poor and individuals with disabilities). Program management is based on identification through social surveys of families living in poverty and eligible for aid. Most beneficiaries are household heads age 60 or older. Even for working-age beneficiaries, the program does not foresee a graduation from poverty. Among the beneficiaries, 55 percent have been in the program for at least 10 years, with some households having been in the program for more than 20 years. The program works with quotas at the regional level, and households must submit an official request to MoSA to receive benefits. Over the past decade, the coverage and budget of the cash transfer increased from 124,000 households in 2010 to 265,000 households in 2021. PNAFN beneficiaries receive a monthly cash transfer of TD 180 (US\$64.5) per family plus TD 10 (US\$3.5) per child (limited to three children per family) and free access to health care. Beneficiaries cannot benefit from social insurance through their job—which therefore favors informal work for workers living in poor households who would not receive a considerably higher wage by working formally.

Health programs. There are two key health programs:

- Free Medical Assistance 1 (médicale gratuite catégorie 1), which integrates free access to public health infrastructure for PNAFN beneficiaries (7.5 percent of the total population; 824,000 people; total outlay: TD 276 million, or US\$98.9 million).
- Free Medical Assistance 2 (médicale gratuite catégorie 2), which allows access to public health infrastructure at reduced rates for the vulnerable population, with payment of a symbolic price of TD 10 (US\$3.5) per year (17.5 percent of the total population; 1.9 million people; total outlay: TD 242 million, or US\$86.7 million).

Beneficiary selection is based on self-declared data, which are verified and completed by social workers with social surveys and manual cross-checks with some public administrations.¹¹ The health insurance benefits

from these programs are like those received from contributory programs under the public sector plan—a disincentive for low-wage workers from poor and vulnerable families to contribute to the CNSS and pay for the full package of bundled risks. This is particularly the case if the pool of workers who can benefit from free or subsidized health care does not place a high value on the benefits received to cover longevity risk and the family allowances. In addition, inclusion and exclusion errors have restricted access to health care among the poorest, while providing it for free or at a subsidized rate to middle-class and rich households.

SOCIAL PROTECTION, INFORMALITY, AND POVERTY

How many workers are both poor and vulnerable, not poor but vulnerable, or not poor or vulnerable? Table 3.4 maps out the distributions of workers according to (1) formality status (and separates public sector workers from private sector ones), and (2) household-level per capita expenditures. It shows that in 2015:

- Informal employment did not imply poverty or vulnerability, as more than 7 in 10 informal workers were neither poor nor vulnerable.
- A large number of workers who should contribute to social insurance do not do so. This limits the extent of risk pooling and implies that there is suboptimal coverage among formal workers in terms of risks of illness, death, or disability.

TABLE 3.4

Distribution of Workers According to Poverty and Formality Status, Tunisia, 2015

| Category | Public sector workers | Formal private workers | Informal private workers | Total |
|-------------------------------|-----------------------|------------------------|--------------------------|-----------|
| Nonpoor, nonvulnerable | | | | |
| Number | 717,247 | 1,157,014 | 887,663 | 2,761,924 |
| Percent | 93.1 | 91.5 | 70.6 | 83.9 |
| Nonpoor, vulnerable | | | | |
| Number | 8,492 | 8,254 | 152,936 | 169,682 |
| Percent | 1.1 | 0.7 | 12.1 | 5.2 |
| Poor | | | | |
| Number | 44,452 | 98,157 | 216,861 | 359,471 |
| Percent | 5.8 | 7.7 | 17.2 | 10.9 |
| Total | | | | |
| Number | 770,192 | 1,263,425 | 1,257,460 | 3,291,077 |
| Percent | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Based on data from the 2015 Household Budget Survey, National Institute of Statistics.

Note: The statistics refer to the employed population age 18 and older. Poverty is defined at the household level based on per capita expenditures and the official poverty lines. Households are classified as vulnerable if they report they have access to subsidized health care (they have a free medical assistance 2 card).

Firing regulations are a substitute for limited or lack of unemployment insurance. They are not a good substitute as they do not help dismissed workers but rather protect those who have a formal job, thereby shifting the risk to informal workers who are not protected from negative employment shocks. Informal workers do not save voluntarily in most cases, which contributes to lower aggregate savings and fewer resources available for investments. Moreover, coverage provided by noncontributory programs only concerns illness, which means that informal workers in Tunisia are not insured against disability, death or accidents at work, unemployment, and longevity. Although part of the cost might be covered by the cash transfer program, the rest of the risk is borne by households or networks of friends and family.

Against this backdrop, what incentives do workers have to move away from informality toward formality, or to stay in informality? Given how the contributory and noncontributory schemes interact, the following scenarios could emerge:

- *Poor workers* have incentives to remain informal, as they benefit from the cash transfer program and free access to health care. Being formal and paying social security contributions would imply the loss of free health care.
- *Informal, nonpoor vulnerable workers* might have little incentive to formalize, as they benefit from access to health care at a reduced price and might not value insurance against other risks. This is particularly the case with pension benefits if workers expect that they will not be able to contribute for a sufficient number of years to be eligible. Many workers switch between formality and informality within the course of a year, and they might be able to access some benefits that do not rely on a long contribution period (such as family allowances and health insurance).
- *Informal nonpoor and nonvulnerable workers* might opt for contributing to the system if the net value of contributory social insurance were sufficiently high. This is the largest group of workers, estimated at more than 1 million individuals in 2015. However, given the value and quality of benefits provided, the incentives to contribute to social insurance are mixed. Depending on their degree of bargaining power, some workers might be able to receive part of their employers' savings in the form of a higher wage, which derives from the employer not contributing to social insurance, along with more flexibility in workforce management.
- *Public sector workers* have no incentive to quit their job, as the average salaries and nonmonetary benefits are good, and they enjoy the highest level of job security available.

In addition, public expenditures on noncontributory programs are limited, with most resources going to contributory social insurance, particularly for public sector workers. The data available on expenditures are not sufficiently disaggregated to understand how much of the resources are devoted to each group of workers and their families depending on poverty and formality status. Expenditures on contributory social insurance for salaried workers (provided under the CNRPS and RSNA schemes) account for the largest share of expenditures—reaching 74 percent of all social protection expenditures (table 3.5). In 2016 and 2017, CNRPS received subsidies from the state budget in the amounts of TD 300 million (US\$107.5 million) and TD 500 million (US\$179.2 million), respectively. Expenditures on noncontributory schemes represent only TD 886.6 million, or about 0.76 percent of GDP, most of which was directed to the cash transfer for poor families (0.6 percent of GDP)—much lower than the 7.1 percent of GDP spent on contributory schemes.

REALM 2: TAXES AND TRANSFERS

The “taxation” realm is composed of various dimensions that directly influence whether economic agents adhere to their tax obligations or hide

TABLE 3.5

Public Expenditures by Poverty and Formality Status of Workers, Tunisia, 2019

TD millions and % of GDP

| Category | Public workers | Formal private workers | Informal private workers | Total |
|-------------------------------|---------------------------------|----------------------------------|--------------------------|---------|
| Nonpoor, nonvulnerable | | | | |
| Number | n.a. | n.a. | 0 | n.a. |
| Percent of GDP | | | | |
| Nonpoor, vulnerable | | | | |
| Number | n.a. | n.a. | 193.6 (AMG2) | n.a. |
| Percent of GDP | | | 0.16 | |
| Poor | | | | |
| Number | n.a. | 31.06 (RTFR) | 583 (PNAFN)+110 (AMG1) | n.a. |
| Percent of GDP | | 0.026 | 0.6 | |
| Total | | | | |
| Number | 4,764.15 (CNRPS) | 3,490.55 (CNSS) | 886.6 | 9,140.6 |
| Percent of GDP | 4.1 (of which 2,028 to CNAM) | 3.02 (of which 2,028 to CNAM) | 0.76 | 7.92 |

Source: Original table for this publication, based on 2019 data from the Ministry of Social Affairs.

Note: All figures are expressed in millions of Tunisian dinars. AMG1 = free medical assistance program for PNAFN beneficiaries; AMG2 = free medical assistance program for the vulnerable population; CNAM = National Health Insurance Fund; CNRPS = National Pension and Social Insurance Fund; CNSS = National Social Security Fund; GDP = gross domestic product; n.a. = not applicable; PNAFN = National Program of Assistance to Needy Families; RTFR = social security insurance for low-income salaried workers in the private sector.

under the radar; whether they opt for real or special tax regimes; and, often as a by-product, whether they operate informally or formally. The design of tax schedules, strength of tax enforcement, and existence of preferential tax regimes for firms are all important determinants of actual tax revenues and the overall tax burden. All these factors affect the productivity of firms, number of workers covered by contributory social insurance, and redistributive power of social protection systems, thereby affecting other social and economic outcomes, such as poverty and inequality. This section focuses on three core elements of overall tax revenue: (1) the personal income tax (PIT), (2) the corporate income tax (CIT), and (3) the value added tax (VAT).

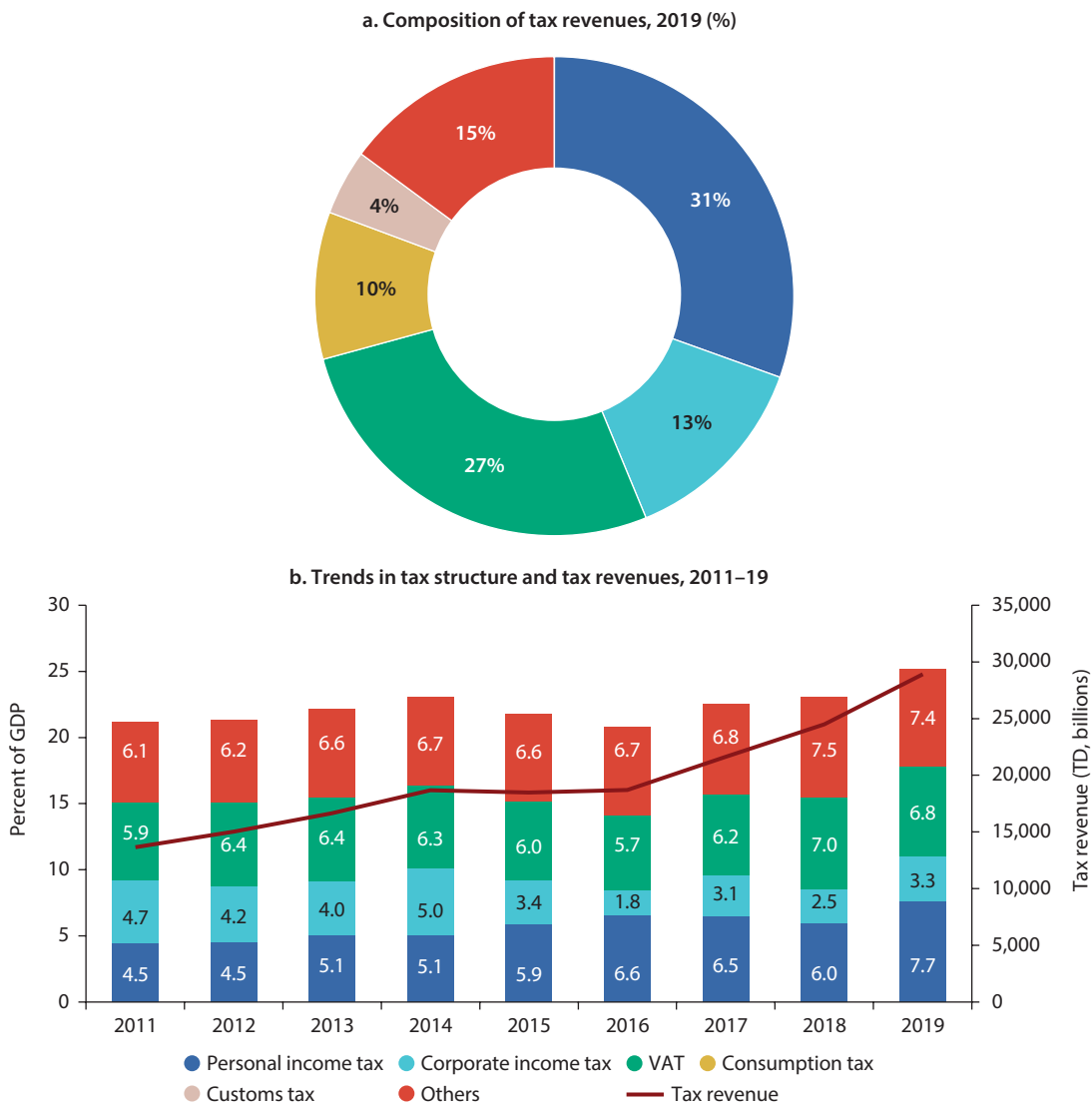
Direct taxes include the PIT and CIT, while indirect taxes include the VAT, consumption tax, customs tax, and other taxes (such as on registration, tax stamp, car ownership, and fines). More than US\$1 in US\$2 of tax revenues in Tunisia are derived from indirect taxes, particularly the VAT and consumption taxes. In 2019, indirect taxes accounted for 56.0 percent of tax revenues, with the VAT, consumption tax, customs tax, and other taxes representing 27, 10, 4, and 15 percent, respectively (figure 3.8, panel a). The remainder is attributable to the PIT (31.0 percent) and CIT (13.0 percent).

Over the past decade, tax revenues have risen sharply—about 115 percent—and now account for about 25 percent of GDP (figure 3.8, panel b). The most prominent change in the tax revenue structure is related to increases in the PIT, which has converged to a similar share of GDP as in the OECD. For instance, as a share of GDP, Tunisian PIT receipts increased from 4.5 percent in 2011 to 7.7 percent in 2019, compared to a rise from 7.2 to 8.0 percent in the OECD. Although this was partly driven by rising wage employment, especially the new hires in public administration in the aftermath of the Jasmine Revolution, the larger role of the PIT also reflects higher PIT rates and more individual firms paying the PIT. CIT receipts declined from 4.7 percent of GDP in 2011 to 3.3 percent in 2019, due to lower tax rates aimed at attracting domestic and foreign direct investment.

The overall tax burden is high compared to regional peers but lower than in the OECD. As of 2019, total tax revenue in Tunisia was 25.3 percent of GDP, less than in Algeria (26.7 percent) and the OECD (33.4 percent), but significantly more than in the Arab Republic of Egypt (13.8 percent), Jordan (15.5 percent), and Morocco (21.7 percent). The tax burden is also high for the formal sector, given that more than 4 in 10 workers and most enterprises are informal and, thus, do not pay taxes. In other words, the contributors are a small number of taxable formal private and public wage workers and mostly large firms. This, in turn, makes the informal-to-formal transition

FIGURE 3.8

Composition and Trends in Tax Revenues, Tunisia, 2011–19



Source: Based on data from the International Monetary Fund and the Central Bank of Tunisia.
 Note: GDP = gross domestic product; VAT = value added tax.

costly, which carries important implications for the appeal of formalization for workers and enterprises.

The Ministry of Finance (MoF) and the MoSA are in charge of collecting taxes and social security contributions, but coordination is weak. The MoF manages the design of the tax system and tax enforcement

and control through the Tax Directorate and the Directorate of Tax and Financial Incentives, while the MoSA is responsible for collecting and managing social security contributions. However, with limited communication and exchange of information between the two ministries, there is a greater likelihood of arbitrage, fraud, and evasion. As of 2019, tax fraud was estimated at US\$8.5 billion, which represented 24.0 percent of GDP and 85.0 percent of tax revenues (Bouzaiene 2021).

In addition, the lack of human and financial support weakens tax enforcement, facilitating tax underreporting, evasion, and informality. Although Tunisia has more than 700,000 taxpayers, the administration has only 1,632 tax control agents, and only 450 of them are trained as specialists (Bouzaiene 2021). On average, there are only three computers for every three agents, one car for every 16 agents, and an archaic and failing computer system. For example, in the regional office of Sfax, a large industrial city, 42.0 percent of the tax control agents lack access to a computer. In 2019, among the 692,308 taxable firms estimated by the MoF, only 59.0 percent filed their tax returns. Thus, in part, the wide tax gap and the large number of firms avoiding taxes reflect lack of resources and inefficient tax administration.

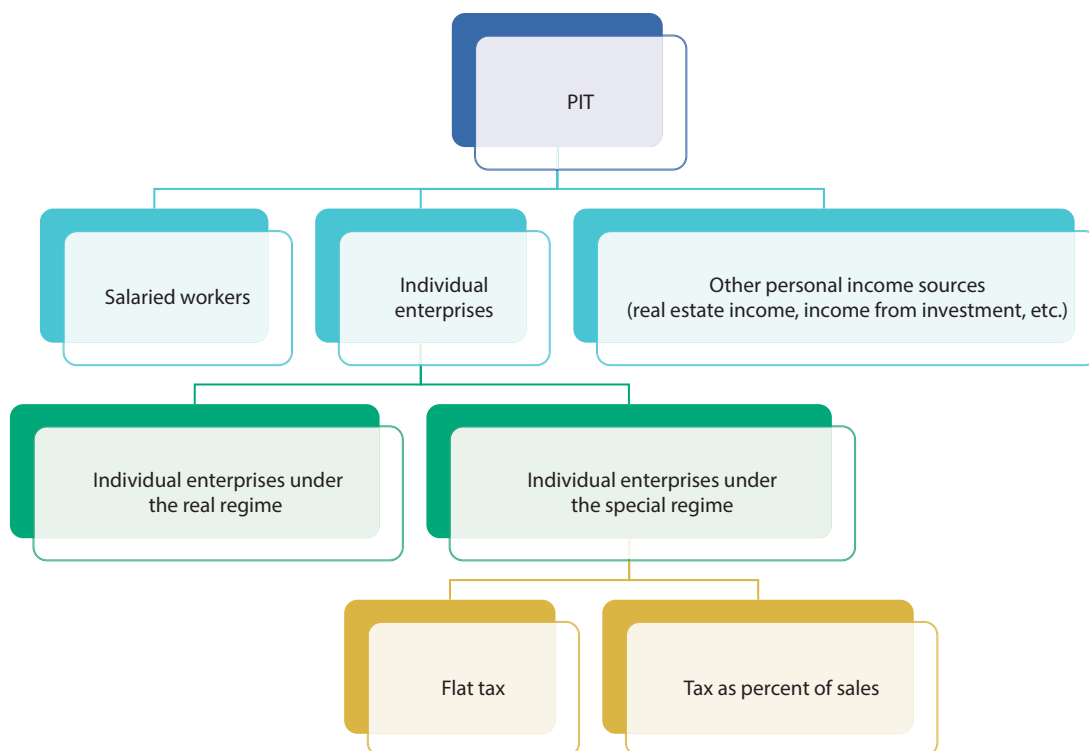
PERSONAL INCOME TAX

The PIT is levied on personal income and the profits of individual enterprises—defined as firms owned by a single person; that is, with only one shareholder, registered as a natural person regardless of the number of employees, and with no distinction and no separation between the assets of the owner and the assets of the enterprise. As shown in figure 3.9, the PIT is levied on paid income from wages, pensions, annuities, other sources of personal income derived from individual assets and returns on investments, and individual enterprise profits. Such enterprises can pay the PIT under the “real regime” or the “special regime,” as determined by the firm’s characteristics and performance (such as the sector in which it operates and annual sales).

For the tax burden, as of 2019, formal employees contributed the most, and taxes levied on wages represented 62.0 percent of PIT revenues; 19.0 percent of total tax revenues; and 4.7 percent of GDP, which was high compared to the average for developing countries (2.5 percent of GDP) (see IMF 2022). Other sources of personal income contributed around 33.8 percent to PIT tax revenues, with the remainder from individual enterprises (about 4.2 percent). Workers earning an annual income at or below the minimum wage of TD 5,000 (US\$1,792) are subject to a zero PIT rate (table 3.6). Thereafter, the marginal tax rate rises sharply to

FIGURE 3.9

Structure of the Personal Income Tax, Tunisia, 2019



Source: Based on data from the Ministry of Finance.

Note: PIT = personal income tax.

TABLE 3.6

Personal Income Tax Schedule for Wage Workers and Individual Enterprises under the Real Regime, and the Distribution of Wage Workers

| Annual income bracket (TD) | Marginal tax rate (%) | Effective tax rate at upper limit (%) | Wage workers paying each tax rate (an estimation) (%) |
|----------------------------|-----------------------|---------------------------------------|---|
| 0 to 5,000 | 0.0 | 0.0 | 31.0 |
| 5,001–20,000 | 26.0 | 19.5 | 66.4 |
| 20,001–30,000 | 28.0 | 22.3 | 2.1 |
| 30,001–50,000 | 32.0 | 26.2 | 0.0 |
| 50,001 and above | 35.0 | — | 0.0 |

Sources: Based on data from the Ministry of Finance; Labor Force Survey.

26 percent, with a progressive increase reaching 35 percent for incomes above TD 50,000 (US\$17,921) per year. The initial rise is an incentive to be informal among low-wage workers or to declare a monthly income at or below the minimum wage, and for individual enterprises under the real regime to remain small or informal.

The PIT burden among wage workers falls on just a few formal employees who earn above the minimum wage, while other wage workers are exempt or evade. As of 2019, as much as 31.0 percent of wage workers earned the minimum wage or less and thus did not pay taxes on labor income. At the same time, all the informal workers earning above the minimum wage did not pay the PIT. This means that more than 1 million workers—or 40.0 percent of wage workers—did not pay the PIT, which influences the informal/formal divide in several ways. First, around 45.0 percent of informal workers earned at or below the minimum, and thus might have decided to be informal due to the functioning of the social insurance system. Second, the remaining 55.0 percent of informal workers earned more than the minimum wage, which makes them liable to pay the PIT and their employer to pay contributions to social insurance. This, in turn, acts as an incentive for evasion and informality—and represents a significant share of the nonpoor proportion of informal wage earners in Tunisia. The inefficient and inequitable market outcome leads to a sizable proportion of high-earning wage workers opting for informality, not contributing to social security, and evading taxes, while potentially benefiting from inexpensive social protection under the noncontributory regime.

Individual enterprises can file their tax returns under the real regime or the special regime, and most opt for the latter. Of an estimated 550,000 individual enterprises, about 73.0 percent (400,000) were under the special regime, with the remaining 27.0 percent (149,277) under the real regime. Those using the special regime contributed little to the PIT (0.5 percent) and total tax revenues (0.2 percent) and paid about TD 100 (US\$35.8) per enterprise per year. While those using the real regime contributed more to the PIT (3.7 percent), with an approximate tax burden of TD 2,365 (US\$848) per enterprise, this pales in comparison to the tax burden paid by an average enterprise under the corporate tax regime (Bouzaïene 2021).¹² Most of the tax burden for individual enterprises under the real regime is paid by few contributors—as of 2019, about 41.0 percent of them did not declare any profits and paid no tax, and in 2015, only 20.0 percent of enterprises with sales greater than TD 100,000 (US\$35,842) accounted for 75 percent of taxes collected under the real regime (El-Haddad 2020).

Since individual enterprises under the real regime are subject to the same PIT schedule as salaried workers, there are no incentives for arbitrage between wage workers and the self-employed. However, arbitrage may arise because of differences in the cost, coverage, and quality of social security services offered under the wage and self-employment regimes. Since RSNA, the social security regime for formal salaried workers, is the most comprehensive in terms of insurance against risks,

it may encourage self-employed workers to self-select into this plan and disguise themselves as wage workers.

On top of taxes on sales, individual enterprises pay employee social security contributions, a cost that multiplies with each additional employee. Irrespective of whether the tax regime is “real” or “special,” individual enterprises must contribute to social security under one of the self-employment regimes—RINA for the nonagriculture sector and RIA for the agriculture sector, while “RTFR” is applicable to those with revenue below a certain threshold. Importantly, these costs are in addition to (1) social security payments to be paid for each formally hired employee, (2) other costs related to the minimum wage or wages negotiated by collective agreements, and (3) dismissal costs.

The special regime for individual enterprises provides two options that come with significant tax savings, conditional on firms meeting specific requirements.¹³ In the first option, enterprises are exempt from keeping accounts, but they must keep a register to record revenues and expenditures daily with supporting documents to present in case of tax audits. Eligible firms are those with annual sales less than TD 10,000 (US\$3,584)—and for a maximum of four years, with the possibility of renewal. They can pay a flat tax that depends on the geographical area where the enterprise is located: TD 100 (US\$35.8) per year for those located in communal areas and TD 200 (US\$71.6) per year for those in noncommunal areas. In the second option, which is available to firms with annual sales between TD 10,000 and TD 100,000 (US\$3,584 and US\$35,842, respectively), the tax is 3 percent of sales. However, the firms cannot operate in certain sectors (alcohol or freight transportation, for instance) and cannot import any goods or services used in production.¹⁴ Firms using this option will have a significantly lower tax burden compared to their counterparts under the real regime, paying, on average, between TD 100 (US\$35.8) and TD 3,758 (US\$1,346) per enterprise per year. Hence, there might be arbitrage opportunities and strategic behaviors of firms to declare—legally or illegally—sales of less than TD 10,000 (US\$3,584) (table 3.7).

TABLE 3.7

Tax Rates and Amounts for Individual Enterprises under the Special Regime, Tunisia

| Annual sales (TD) | Tax |
|-------------------|-------------------------------------|
| < 10,000 | TD 200 per year in communal area |
| | TD 100 per year in noncommunal area |
| 10,000–100,000 | 3% of sales |

Source: Based on data from the Ministry of Finance.

Special regimes were introduced with the intention not only to support micro and small firms and own-account workers but also to encourage compliance and, in turn, increase tax revenues. However, tax contributions have remained low. As of 2019, individual enterprises under the special regimes contributed 0.5 percent of tax revenues, with 40.0 percent of them not declaring any income. Among those that did pay the PIT, 90.0 percent declared income of less than TD 10,000 (US\$3,548), thereby minimizing their tax burden under the first option of the special regime, and the average amount of tax per firm was modest (TD 100 per year [US\$35.8]).

The bottom line is that special regimes are not conducive to growth and formalization in at least two ways. First, they do not generate incentives to expand the size of the business, and thus the amount of annual sales, above the thresholds defined in table 3.7, which would result in a higher tax burden. This also limits the possibility of firms under this regime, and more generally under the PIT regime, to take advantage of economies of scale, to increase the number of shareholders, diversify capital, and expand access to credit. Second, the special regimes help the survival of micro and small enterprises that operate at very low productivity, by lowering their tax burden, which distorts the natural process of firm selection, thus reducing total factor productivity, growth, and formal job creation. In essence, the flat PIT regime subsidizes small businesses at the cost of large, productive, and job-creating enterprises.

Corporate Income Tax

Companies that are registered as legal entities are liable to pay taxes on their profits at a significantly higher tax rate relative to the PIT regime. In 2019, the standard corporate tax rate was 25 percent, with a maximum of 35 percent for firms operating in certain industries (such as finance and insurance, oil, and telecommunications) and as low as 10 percent for enterprises operating in handicrafts, fisheries, and cooperatives. The annual tax burden for corporates was TD 51,561 (US\$18,480) per enterprise, which was significantly higher than that for firms under the PIT regimes (that is, TD2,365 [US\$847.6] and TD100 [US\$35.8] per enterprise under the real and special regimes, respectively).¹²

However, CIT contributes little to overall tax revenues—only 13 percent—meaning that few firms, typically large ones that are unable to hide under the radar, bear a very high tax burden. Although this is partly due to successive reductions in CIT rates to encourage investment (down to 25 percent in 2014 from 30 percent in 2013), it is also a result of high levels of fraud and tax evasion. For example, in 2019, only 52 percent of the 143,031 registered companies under the corporate tax regime reported their profits. The incentive to arbitrage between the PIT and CIT stems

from the large difference between the tax burdens of companies under the different regimes. In 2015, the 1,700 largest companies contributed 68 percent to total CIT revenues, while in 2017, 13 percent of companies with sales exceeding TD 1 million (US\$358,423) paid 75 percent of CIT (El-Haddad 2020). In essence, the system penalizes large companies that are often the most productive and efficient, and have a high potential for formal job creation, while subsidizing small, inefficient firms operating at low productivity.

Value Added Tax

As of 2019, VAT revenues, at 27.0 percent of tax revenue, represented the single largest contributor to overall tax revenue—equivalent to 6.7 percent of GDP. VAT collection uses a credit invoice method, whereby taxes paid on inputs and intermediate purchases are deductible from the VAT to be paid on sales. Although the general VAT rate is 18.0 percent, certain professions and goods are subject to different rates. The VAT rate is 12.0 percent on a small set of goods (such as oil and natural gas), as well as on services provided by certain professions (such as lawyers and architects). It is as low as 6 percent on some inputs for activities (such as renewable energy and medical services). Various other goods are exempt from the VAT altogether (such as agricultural and fishery products, primary goods, and equipment for people with disabilities).

The problem is that the individual enterprise exemption from the VAT under the special regime not only adds another incentive to opt for remaining small and paying lower taxes but also discourages firms in the real regime from exchanging with them. This is because goods and services purchased from a firm under the special regime cannot be included in the calculation of the deductible VAT in accordance with the VAT code, resulting in firms under the real regime avoiding purchasing intermediate inputs from them. As a consequence, firms under the special regime mostly trade with other informal firms under the special regime or sell to final consumers. The lack of exchange and competition between informal enterprises in the real and special regimes hinders connections between micro or small and medium-size or large enterprises, thus preventing technical and technological knowledge transfer and inhibiting economies of scale, growth, and the creation of formal jobs.

REALM 3: MARKET CONDITIONS

The “market conditions” realm comprises a complex set of dimensions that directly affect the number, size, and productivity of firms.¹⁶

The interactions of these dimensions with Realms 1 and 2 contribute to the social protection, poverty, and inequality outcomes of individuals and households. This section focuses on three areas that affect the entry, exit, and growth of private sector firms: (1) registration procedures and costs, (2) enforcement of credit and commercial contracts, and (3) competition in the product market—drawing on the World Bank’s Doing Business report, which covers 12 areas (“dimensions”) of business regulation (World Bank 2021).

REGISTRATION PROCEDURES AND COSTS

Tunisia mostly outperforms its regional peers on the procedure, time, and cost of starting a business. The Doing Business report shows that it was in the “starting a business” dimension that Tunisia achieved its highest score: 94.6 out of 100, ranking 19th in the world—higher than the MENA average (84.0) and even the OECD average (91.3). As of 2019, this process was made easier by the creation of a “one-stop shop,” which streamlined registration processes and reduced the overall time required. Starting a business is an efficient process that has fewer steps, takes less time, and is less expensive compared to the regional peers. It consists of 3.0 procedures, compared to 6.5 in MENA; takes an average of 9.0 days, compared to 20.3 days in MENA; costs about 2.9 percent of income per capita, compared to 16.7 percent in MENA; and has no minimum capital requirement, compared to almost 9.0 percent of income per capita in MENA.

By contrast, “registering a property,” especially land, can be cumbersome. On this dimension, Tunisia scored only 63.7 out of 100, which is slightly higher than MENA (63.4) but less than the OECD (77.0). To register a property, it takes an average 35.0 days, has five procedures, and costs 6.1 percent of the property value; in MENA, there are slightly more procedures (5.4), but it takes fewer days (26.6) and is cheaper (5.6 percent of the property value). Tunisia’s biggest downfall, however, is the quality of land administration—which is characterized by a lack of transparency, reliability, and geographic coverage. On this dimension, Tunisia scored 13.5 (out of 30), which was less than MENA’s 14.6 and the OECD’s 23.2.

Enforcement of Credit and Commercial Contracts

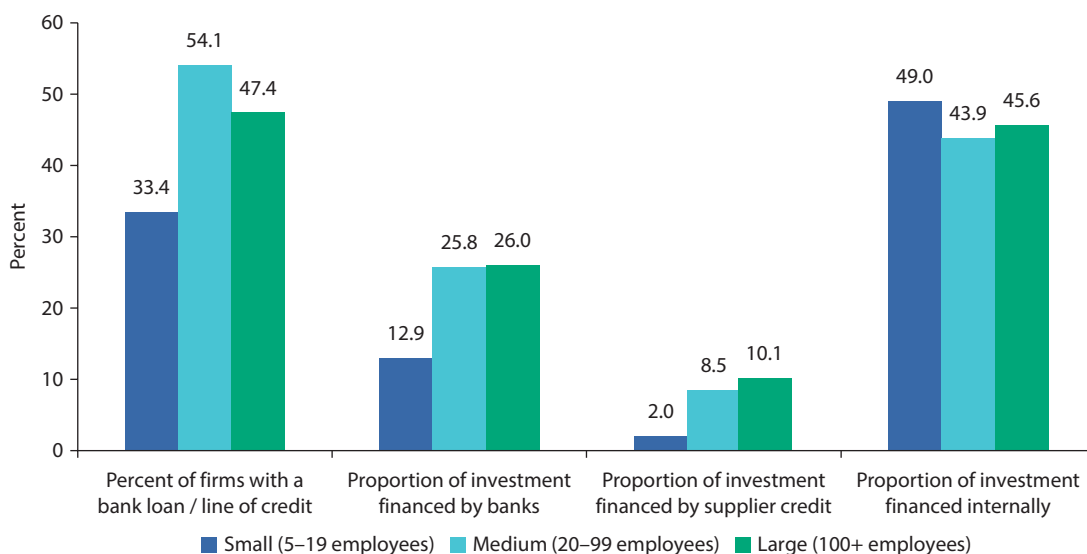
Tunisia’s financial system is underdeveloped, and accessing credit remains a primary challenge for firms. The 2019/20 Enterprise Survey reveals that around 40 percent of the interviewed firms said that obtaining finance as

the single most important business constraint in the private sector, and close to 70.0 percent of the firms are classified as credit constrained.¹⁷ Overall, medium and large firms have more access to credit thanks to commercial bank credit, while small firms mostly rely on internal sources of finance (figure 3.10). For the “getting credit” dimension, Tunisia scored 50.0 (out of 100.0), which is better than the MENA average (41.8) and Morocco’s score (45.0), but significantly worse than Egypt (65.0) and the OECD (64.3).¹⁸ The two metrics of this dimension on which Tunisia performed particularly poorly were “strength of legal rights index” and “credit bureau coverage (percent of adults).” For the former, Tunisia scored 3.0 (out of 12.0), while MENA scored 3.1, and the OECD, 6.1. For the latter, Tunisia scored 0.0 (percent of adult population), which was lower than MENA’s 16.3, and far lower than the OECD’s 66.7.

Although several factors discourage firms from applying for a loan, high interest rates and heavy collateral requirements are among the most prominent. In 2019, 96.0 percent of Tunisian firms were required to offer collateral, compared to 80.0 percent in MENA—and the value of collateral reached 319 percent of the loan amount, against 200 percent in MENA.¹⁹ These requirements reflect regulations that control lending rates for small and medium-size enterprises. Banks also place conditions on loans that impose far higher costs on most borrowers than interest rates alone. As a result, 51.0 percent of Tunisian firms with approved loan

FIGURE 3.10

Access to Credit, by Firm Size, Tunisia, 2019–20



Source: Based on data from the Enterprise Survey, World Bank.

applications choose not to invest (World Bank 2022). Moreover, beyond banks, there are few effective financing mechanisms available. Private equity remains underdeveloped, and capital markets are shallow, restricting access to long-term finance.

What happens when there are commercial disputes? Here, Tunisia scored similarly to its peers—58.4 out of 100.0 on the “enforcing contracts” dimension, a bit above MENA’s 56.0. It takes an average of 565.0 days to resolve a dispute in Tunisia, compared to 622.0 days in MENA and 589.9 days in the OECD. This process costs an average of 21.8 percent of the claim value, compared to 24.7 percent in MENA and 21.5 percent in the OECD (World Bank 2021). Tunisia is significantly more efficient than its regional peers in “resolving insolvency.” It scored 54.2 (out of 100), with MENA at 34.5, Egypt at 42.2, and Morocco at 52.9. It takes 1.3 years and costs 7.0 percent of the estate to resolve an insolvency in Tunisia, compared to 2.7 years and 14.0 percent in MENA. The most striking difference concerns the recovery rate—51.3 cents on the dollar in Tunisia, compared to an average 27.3 cents in MENA.²⁰

Although resolving disputes is relatively inexpensive and short in duration in Tunisia, the “quality of judicial processes” is low, reflecting a lack of automated court processes and poor case management. Tunisia’s “quality of judicial processes” score was 6.5 (out of 18), just below MENA (6.6) but much lower than the OECD (11.7).

COMPETITION IN THE PRODUCT MARKET

Tunisian state-owned enterprises (SOEs) are widespread, and they compete against private firms in commercial sectors with no economic rationale for their presence—often requiring bribes. According to the MoF, as of 2021, 110 SOEs accounted for around one-fifth of GDP.²¹ The Tunisian government controlled at least one firm in 40 of 44 sectors, compared to an average of 22 sectors in advanced economies and 26 sectors in other emerging markets and developing economies (World Bank, forthcoming). Tunisian SOEs produce goods and services that could be provided entirely by the private sector; for instance, 17 of the 31 largest SOEs are active in commercial sectors (like manufacturing, construction, or distribution).²²

In addition, SOEs in commercial sectors benefit from support in the form of subsidies that are not available to private competitors. In 2018, the state transferred more than TD 4 billion (around 4 percent of GDP) to eight SOEs, and the bulk of these payments were linked to energy and farm subsidies (Ministry of Economics, Finance, and Investments 2021 data). Several SOEs are legal monopolies in markets that are not

naturally prone to monopolization, such as the Tunisian Trade Broad, and are exempt from competition law. SOE commercial and noncommercial activities are not separated, making cross-subsidizing commercial activities with public funds possible. Corruption remains a major challenge for many private firms, especially those interacting with SOEs (see box 3.3).

BOX 3.3

Private Firms Cite Corruption as a Major Constraint

Cronyism and political connections remain a distinct feature of the Tunisian private sector landscape, further debilitating market contestability and contract enforcement. According to the Tunisian Institute of Competitiveness and Quantitative studies (ITCEQ 2019), 46 percent of interviewed companies considered corruption a major constraint on the performance of their business, and 23 percent were forced to pay bribes to obtain a building authorization from the public service. Moreover, this level of corruption is significantly higher than for regional peers or other middle-income countries. The Enterprise Survey (2020) reports that about 28.0 percent of Tunisian formal firms declared that they use direct political connections to gain political access, while the equivalent figure in MENA is 9.0 percent, and in Europe and Central Asia, 4.2 percent.^a

Political connections undermine market contestability and fair competition in several ways:

- Politically connected firms can benefit from easier access to credit, fewer competitors, larger sales, and access to sectors with barriers to entry.
- The existence of privileges can deter unconnected firms from entry, which often leads to improvements in connected firms' performance and value (Maaloul, Chakroun, and Yahyaoui 2018; World Bank 2022).
- The privileges and benefits the politically connected enjoy often come at the expense of unconnected firms—in terms of both unfair competition and contract enforcement—inhibiting them from expanding in size and creating jobs (Enterprise Survey 2019/20; World Bank 2022).

Further, recent studies show that politically connected firms in Tunisia have abused entry regulations for their own gain and are more likely to avoid import tariffs (Rijkers, Baghdadi, and Raballand 2017; Rijkers, Freund, and Nucifora 2017).

a. The 2020 round of the Tunisia Enterprise Survey included a question that asked respondents the following: "Has the owner, CEO, top manager, or any of the board members of this firm ever been elected or appointed to a political position in this country?" This is the strict definition of political connections used in the analysis.

Making matters worse on the competitive front are institutions and policies that are underdeveloped and thus unable to safeguard competitive neutrality—that is, the principle that all firms (public or private, domestic or foreign) should face the same set of rules. Instead, there is excessive regulation that often causes unfair and noncontestable market structures and high market concentration.

Restrictive entry regulations and excessive price controls. Tunisian regulations make it difficult for energy, transportation, and communications firms to enter market segments where competition is viable. Entry is hampered by excessive technical requirements, direct restrictions on investment, and noncompliance with regulations for interconnectivity and access to infrastructure. For example, maritime transportation has minimum capital and ownership requirements and foreign direct investment restrictions that undercut new private investment. For freight transportation, regulations control the minimum and maximum rates that can be offered (Pop et al. 2021).

Barriers to foreign direct investment and high import tariffs. Regulatory barriers also hamper investment and trade across borders. In several sectors—such as real estate, transportation, retail trade, and agriculture—foreign ownership is constrained by allowing only joint ventures (Pop et al. 2021). Further, entry restrictions are based on nationality, and the public procurement law requires foreign tech companies that participate in tenders to associate with specialized Tunisian companies.²³ The share of inputs not covered under the European Union Association Agreement preferential rates—and thus paying most-favored-nation tariffs—ranges from 35.5 percent (wood and paper) to 53.1 percent (agriculture). Although the average most-favored-nation tariffs on certain inputs are low, such as for electrical and transportation equipment imports (6.1 percent), they reach double digits for food (17.8 percent), agricultural products (16.8 percent), minerals (15.5 percent), and chemical imports (12.7 percent).

High nontariff barriers on certain products. Import licenses and quotas apply primarily to consumer goods that compete against locally produced equivalents manufactured by developing industries, or to goods for which domestic production is deemed sufficient (World Bank, forthcoming). Two noteworthy categories are agricultural products and passenger cars. Automotive import quotas are based to some extent on the number of Tunisian-produced automobile components used in foreign manufacturers' automobile designs. Importers must ask the government for an allotment to receive an import license—and although the quota is only for cars with small engines, local consumers cannot freely import foreign vehicles privately, due to strict foreign exchange controls.

Taken together, restrictive regulations and a heavy SOE footprint hamper competition in Tunisian product markets, often causing unfair

and noncontestable market structures and high market concentration. This acts as a disincentive to firms and dissuades them from entering certain markets as the probability of survival is low and potential profits are small. Moreover, additional fees or bribes paid to administrative agents, to ensure registration or obtain licenses, add to the time spent to comply with cumbersome administrative procedures and slow judicial processes and increase the costs of formalization.

CONCLUSION

After an in-depth review of Tunisia's informality—in particular, through an institutional lens—what are the key takeaways for the country in its pursuit of a sustainable, inclusive growth path? Here, it is useful to begin with a look at what each of the three realms has highlighted.

Realm 1: How the Social Protection Systems Affect Formality, Poverty, and Inequality

Despite virtually universal coverage, many workers do not contribute to social insurance. The legal framework—determined by the Constitution, the Labor Code, and the Social Security Code—mandates virtually every worker in Tunisia to contribute to social insurance, except for contributing family workers. Despite such a legal inclusive blanket, a share of workers who are required to contribute to social insurance do not do so, limiting the extent of risk pooling and implying suboptimal coverage among formal workers against the risk of illness, death, disability, and longevity. The institutional analysis has shown that the design and functioning of contributory and noncontributory insurance, together with the minimum wage and firing regulations as well as weak enforcement, are likely responsible for firms' and workers' behavior that delivers subpar formal employment and little coverage against risks.

The value of contributory social insurance to workers does not seem to equal its cost to firms, thus contributing to informal employment. The two most expensive risks covered by contributory social insurance are health insurance and retirement pensions. Contributory health insurance imposes significant costs in terms of long waiting lines and low-quality services when opting for public health care and in terms of low reimbursement rates when going private. The pension system presents discontinuities that make it unlikely for some informal workers to meet the eligibility criteria to access an annuity. The system is more than actuarially fair for those who reach the minimum requirements, and these are more likely to be high-wage workers in the private sector as well as public sector workers.

Social protection policies are falling short in promoting inclusive growth. To the extent that the social protection system incentivizes informal employment and informal firms, which have lower productivity and are smaller than formal ones, social protection policies hinder productivity gains and inclusive growth. Such growth requires both total factor productivity growth and well-designed social protection policies that expand insurance coverage, reduce poverty, and mitigate inequality.

In practice, there are two main ways in which contributory social insurance can deliver redistribution: from high- to low-wage workers and from firms to workers. In Tunisia, there are limitations that make redistribution likely to be small:

- Sizable copayments for ordinary health care absorb a large share of low-wage workers' income.
- Low-wage workers are more likely to have a discontinuous career and not meet the minimum contributions required.
- Firms are likely to be able to shift the cost of contributions back to workers in the form of lower wages.
- It is unlikely that entrepreneurs make significantly more money than their workers—especially in the case of micro and small firms, which represent 97 percent of Tunisian firms.

The interaction between contributory and noncontributory social insurance does not incentivize formal work and leads to erratic coverage. Some informal workers (namely, the poor and vulnerable) are entitled to noncontributory insurance, although it only covers illness. The conditionality imposed by the cash transfer program, which is associated with access to subsidized or free health care, might play a role in creating poverty traps—or at a minimum, deliver little and low-quality social protection coverage and act as an implicit subsidy to informal employment.

The minimum wage, dismissal procedures, and weak enforcement add a cost to formal employment. The minimum wage is set at a high level compared to average productivity—which generates an incentive for informally hiring workers with low or unknown productivity. Working conditions negotiated via collective agreements impose higher minimum wage levels—as well as wage increases agreed on at a national level that might not always be well suited to the economic and financial conditions of all firms operating in a given sector. Lengthy, uncertain, and complicated dismissal procedures, coupled with lax enforcement of labor regulations, contribute to incentivizing informal employment.

Realm 2: How the Tax System Impacts Formal Job Creation, Productivity, and Growth

The special regime for informal enterprises—combined with the VAT and contributory social insurance—creates opportunities for arbitrage and strategic behavior. The large difference in the tax burden between the special regime and the real regime makes the former attractive and incentivizes firms to stay small and keep their actual or declared value of sales below legislated thresholds to enjoy the benefits of the special regime. Unless firms expect to increase sales and profits significantly, staying below the sales threshold of the special regime is convenient as it allows them legally to pay lower taxes. In addition, this comes with VAT exemption and access to the RTFR regime with a low social security contribution for the business owner. Exemption from the VAT limits the network of suppliers and customers of individual enterprises to other individual enterprises under the special regime or informal firms or final consumers, thus blocking backward linkages from medium-size and large firms under the real regime or the CIT. Many firms are thus likely to implement strategic behavior to operate—legally or illegally—under the individual enterprise status and, in particular, under the special regime.

The special regime also distorts incentives for firms to grow. Special regimes are typically designed to facilitate participation of the self-employed and micro firms in contributory programs and bring them under the radar of the tax authority. Yet the special regime might also end up trapping entrepreneurs in small firms with low levels of productivity. After all, these firms can survive under the sales threshold of the special regimes, as their labor costs and tax burdens remain low. Overall, the special regime comes at a cost: it impedes diversification of stakeholders (firms must be informal enterprises), thus reducing access to credit and capital; it discourages the creation of economies of scale in production; it limits the extent of interaction across firms of different sizes, thus preventing technical and technological transfers; and it hampers productivity, growth, and formal job creation.

Weak enforcement of tax collection and social insurance contributions is another factor that keeps firms informal. A large segment of Tunisian taxpayers underreports their income or does not pay taxes at all. For example, only one-quarter of businesses declared a taxable return in 2019, leading to a loss of revenue estimated by the Tunisian government at TD 25 billion, or nearly half the state budget, because of tax evasion and fraud. Although there are several reasons for the failure of tax control, a main diagnosis suggests that Tunisian tax authorities are underfunded, resulting in a lack of human and economic resources at their disposal. Because the probability of getting caught and sanctioned is low,

it creates an incentive for firms to cheat, not pay their taxes, potentially hire some workers informally, and avoid paying social contributions and remain small.

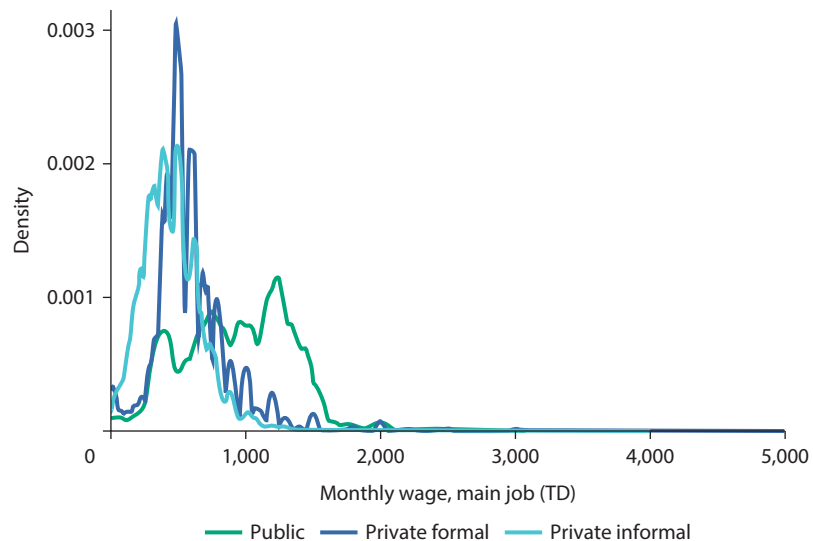
Realm 3: How Market Conditions Affect Formality, Firms' Size, Productivity, and Growth

A range of constraints prevent the private sector from creating formal jobs. While Tunisia has exhibited success in the ease of starting a business, it is difficult for enterprises to access external credit channels (such as banks), which limits their ability to expand and create formal jobs. The hardest hit are micro and small firms, which typically rely on internal sources of finance. Moreover, although resolving commercial disputes is relatively inexpensive and short in duration, the quality of judicial processes is low, which decreases the advantages of operating formally and beyond a trusted network of suppliers and clients. In addition, restrictive regulations, a heavy SOE footprint, and cronyism hamper competition in product markets, often causing unfair and noncontestable market structures and high market concentration.

ANNEX 3A: STATISTICS ON PUBLIC, PRIVATE FORMAL, AND PRIVATE INFORMAL WORKERS

FIGURE 3A.1

Distribution of Wage Workers, by Real Monthly Wages and Sector, Tunisia, 2019

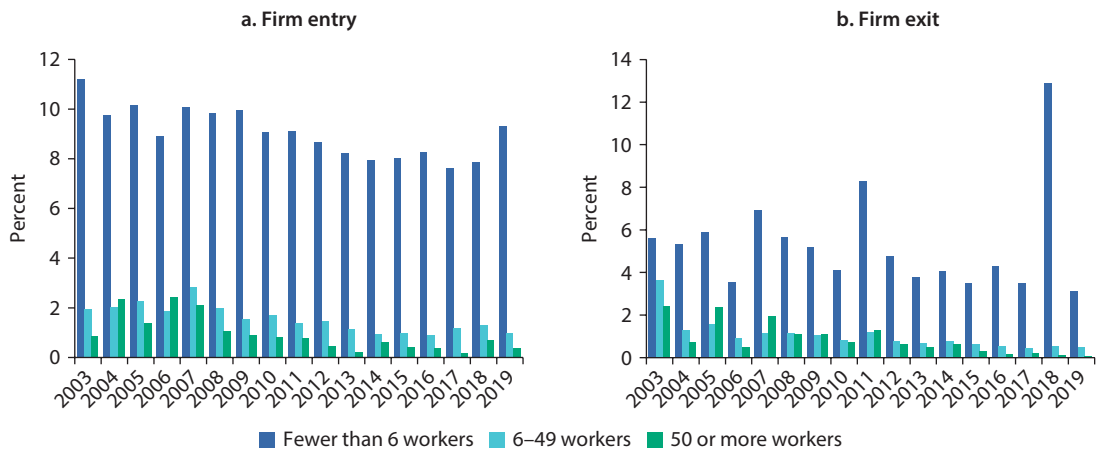


Source: Based on data from the Labor Force Survey.

ANNEX 3B: ADDITIONAL STATISTICS

FIGURE 3B.1

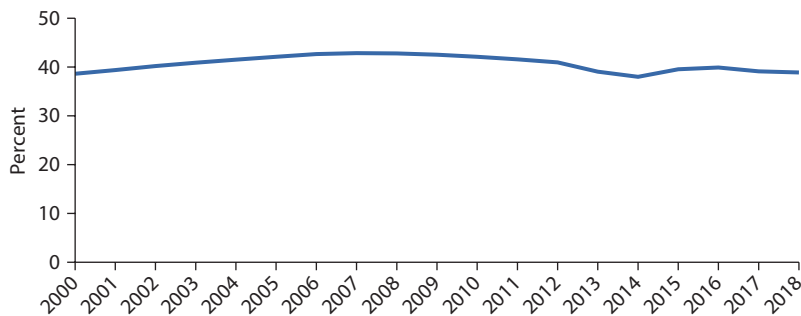
Share of Registered Firms Entering and Exiting, by Size and Year, Tunisia, 2003–19



Source: Based on data from the National Business Registry.

FIGURE 3B.2

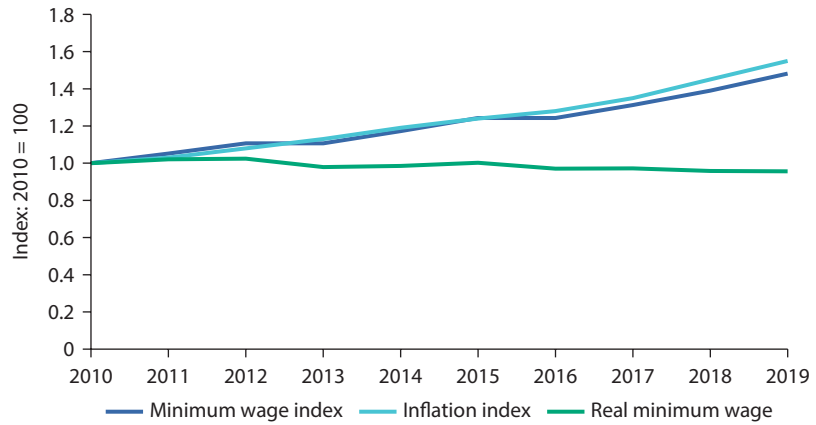
Ratio Trend in Out-of-Pocket Health Expenditure as a Share of Current Health Expenditures, Tunisia, 2000–18



Source: Based on data from World Development Indicators, World Bank.

FIGURE 3B.3

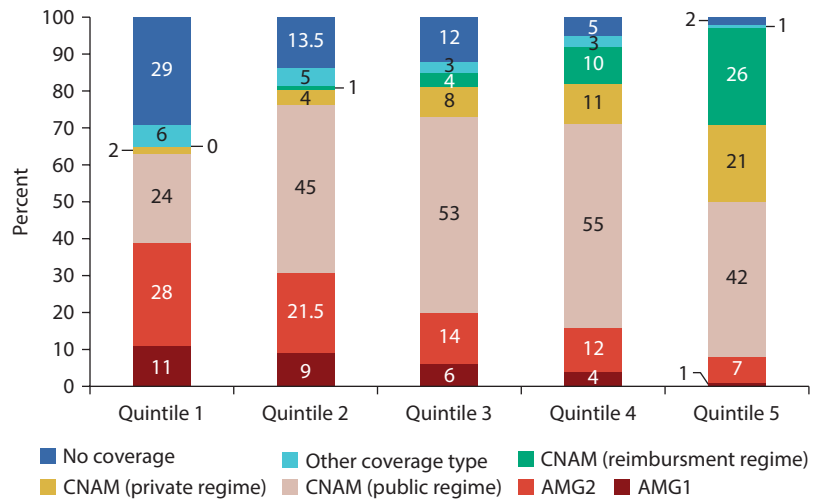
Trends in the Nominal and Real Minimum Wages for Nonagriculture Sector Workers and the Inflation Index, Tunisia, 2010–19



Source: Original figure for this publication.

FIGURE 3B.4

Distribution of Population Age 18 and Older, by Type of Health Care Access and Quintile of Household per Capita Expenditures, 2010

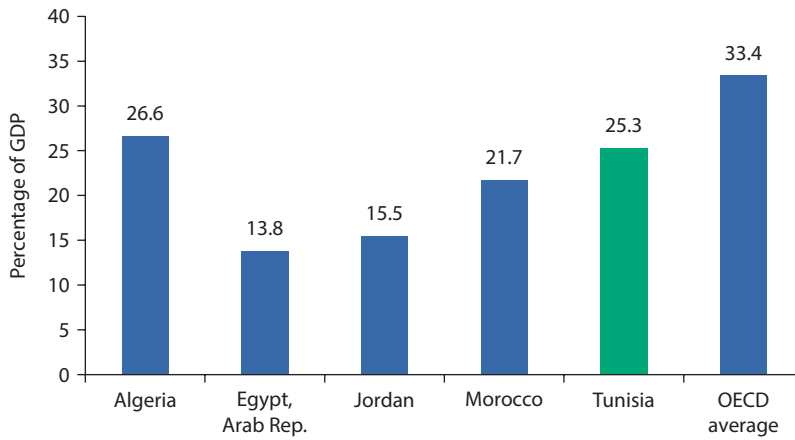


Source: World Bank 2016.

Note: AMG = free medical assistance program for the vulnerable population; CNAM = National Health Insurance Fund.

FIGURE 3B.5

Tax Revenues, as a Share of GDP, Tunisia, Regional Peers, and OECD Countries, 2019

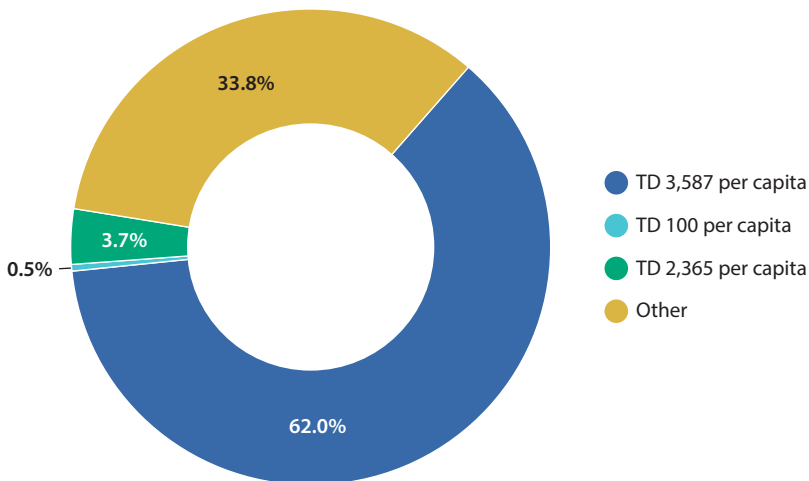


Sources: Based on data from the International Monetary Fund; OECD.

Note: GDP = gross domestic product; OECD = Organisation for Economic Co-operation and Development.

FIGURE 3B.6

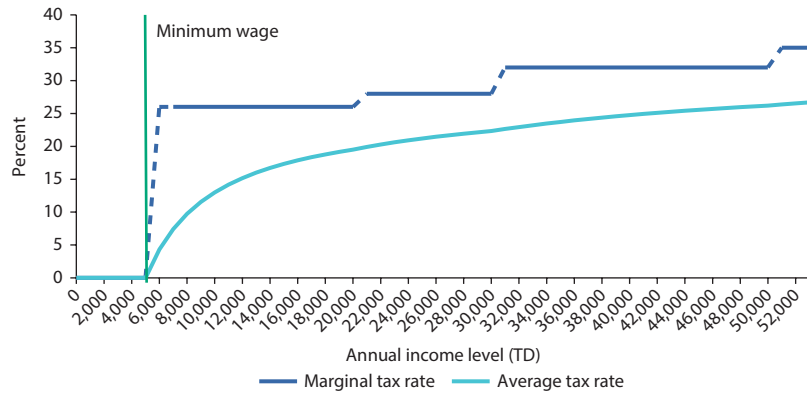
Composition of Personal Income Tax, Tunisia, 2019



Source: Based on data from the International Monetary Fund.

FIGURE 3B.7

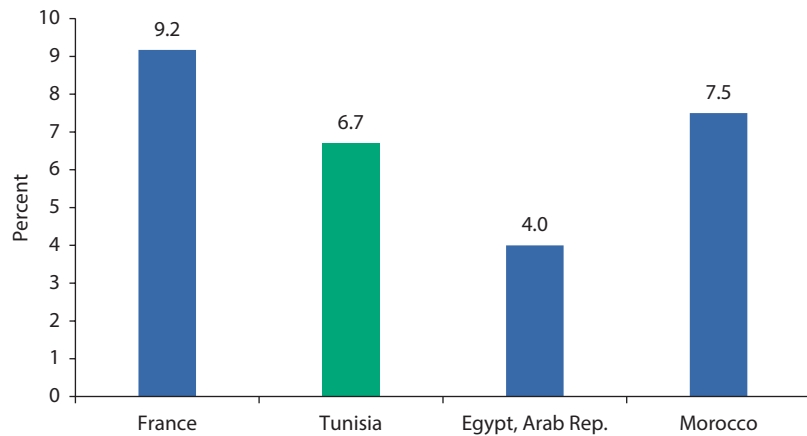
Marginal and Average Tax Rates, by Annual Income, Tunisia



Source: Based on data from the Tunisian Ministry of Finance.

FIGURE 3B.8

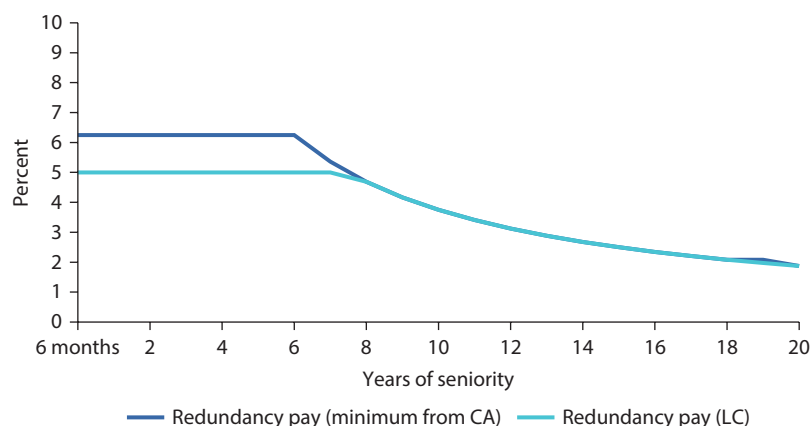
Revenues from Value Added Tax, as a Share of GDP, by Country, 2019



Source: Based on data from the International Monetary Fund.
 Note: GDP = gross domestic product.

FIGURE 3B.9

Redundancy Payment as a Percentage of the Wage, by Number of Years of Seniority, Tunisia



Source: Original figure for this publication.

Note: CA = collective agreement; LC = Labor Code.

TABLE 3B.1

Distribution of Firms and Employees, by Size and Formality Status, Tunisia, 2019

| Number of employees | Number of firms (percent) | Number of informal firms (percent) | Number of formal firms (percent) | Number of employees (percent) | Number of formal employees (percent) | Number of informal employees (percent) |
|---|---------------------------|------------------------------------|----------------------------------|-------------------------------|--------------------------------------|--|
| No employees (own-account workers) | | | | | | |
| Number | 679,770 | 441,850 | 237,920 | 0 | 0 | 0 |
| Percent | 65 | 61 | 75 | 0 | 0 | 0 |
| 1–5 employees | | | | | | |
| Number | 309,579 | 281,403 | 28,176 | 687,228 | 137,776 | 549,452 |
| Percent | 30 | 39 | 9 | 34.5 | 11 | 72 |
| 6–9 employees | | | | | | |
| Number | 25,429 | 0 | 25,429 | 124,456 | 56,549 | 67,907 |
| Percent | 2.5 | 0 | 8 | 6.2 | 4.5 | 9 |
| 10–49 employees | | | | | | |
| Number | 19,768 | 0 | 19,768 | 289,613 | 198,307 | 91,306 |
| Percent | 1.9 | 0 | 6 | 14.5 | 16 | 12 |
| 50+ employees | | | | | | |
| Number | 4,106 | 0 | 4,106 | 890,956 | 843,283 | 47,673 |
| Percent | 0.4 | 0 | 1.3 | 44.7 | 68 | 6.2 |
| Total | | | | | | |
| Number | 1,038,652 | 723,254 | 315,399 | 1,992,253 | 1,235,915 | 757,000 |
| | (100 percent) | (100 percent) | (100 percent) | (100 percent) | (100 percent) | (100 percent) |

Sources: Calculations based on data from the National Business Register; Survey of Economic Activity of Micro Enterprises; Labor Force Survey.

TABLE 3B.2

Contribution Rates, by Type of Benefit, for Employers and Employees under the RINA and RIA Regimes, Tunisia

| | Retirement | Health insurance | Sickness and maternity benefits | Lump sum death benefit | Total |
|-------------------|------------|------------------|---------------------------------|------------------------|-------|
| Contribution rate | 7 | 6.75 | 0.51 | 0.45 | 14.71 |

Source: Original table for this publication.

Note: RIA = general scheme for agricultural employees in the private sector; RINA = general scheme for nonagricultural self-employed workers in the private sector.

TABLE 3B.3

Contribution Rates, by Type of Benefit, for Employers and Employees under the RTFR Regime, Tunisia

| Contributor | Health insurance | Retirement | Total |
|-------------|------------------|------------|-------|
| Employer | 1.67 | 3.33 | 5 |
| Employee | 0.83 | 1.67 | 2.5 |
| Total | 2.5 | 5 | 7.5 |

Source: Original table for this publication.

Note: RTFR = social security insurance for low-income salaried workers in the private sector.

TABLE 3B.4

Overview of Firing Regulations, Tunisia

| Type of contract | Without compensation | With compensation | Redundancy payment |
|--|---|--|---|
| Open-ended contract | Proved reasons of serious misconduct or fault (listed in the Labor Code, article 14). | Dismissed for valid and proved economic or technical reasons (article 21 of the Labor Code). | Redundancy pay is based on seniority and the last wage. It is calculated as one day of salary per month of service with the same firm (Labor Code). It can be higher as determined by sectoral agreements: it is often 1.25 day of salary per month of service with a cap of 6 months of salary, and it can reach 2.5 days of salary per month. |
| | With notice | With Notifications (to employees and to labor inspection). Providing necessary information specifying causes of dismissals to the labor inspection one month before termination. Labor inspectors investigate the reasons for the dismissal and could accept or reject the dismissal. The process might end up in a court before a judge. | |
| Fixed-term contract (maximum duration 4 years) | Proved reasons of serious misconduct or fault (listed in the Labor Code, article 14). Without notice | In the event of termination of the contract for valid and proved economic or technical reasons before the end date of the contract. | The payment is equal to the salary corresponding to the remaining duration of the employment contract. |
| Apprenticeship contract | Dismissal without notice or compensation | | |

Source: Original table for this publication.

TABLE 3B.5

Overview of Hiring Regulations, Tunisia

| Type of contract | Trial period | Working hours | Overtime | Paid leave |
|--|--|--|---|--|
| Open-ended contract (54 percent of employees in 2019) | The duration is fixed in the collective agreements or in the contract (Article 18) Most often 3 months and up to 12 months (dismissal without notice during trial period) | 40 hours per week (in the public administration) 48 hours per week (in a majority of the private sector) with a maximum of 6 working days per week. A maximum of 2,700 hours per year for agricultural activities (article 88) | Night work (between 8 pm and 8 am): increased from 25 percent to 50 percent, depending on the branch Overtime (beyond 40/48 hours): increased at 75 percent for the 48-hour regime and 50 percent for the 40-hour regime | Annual leave: one day per month worked plus an increase of one day per year of seniority Maximum duration between 21 days and 1 month in the private sector (depending on sectoral agreements), 1 month in public administration Maternity leave: the minimum is 1 month in the private sector and 2 months in the public sector |
| Fixed-term contract (20 percent of employees in 2019) (not allowed for permanent tasks) Maximum duration 4 years | | | | |
| Apprenticeship contract | 2 months of trial | Not above 48 hours per week | | |

Source: Original table for this publication.

TABLE 3B.6

Minimum Base Salary Negotiated with Collective Agreements, Level and Percentage of Nonagricultural Minimum Wage, Tunisia, 2019

| Sector | Minimum base salary (TD) | Share earning SMIG (%) |
|---------------|--------------------------|------------------------|
| Construction | 462 | 114 |
| Textiles | 465 | 115 |
| Accommodation | 469 | 116 |
| Pastry | 527 | 130 |
| Wood | 537 | 133 |
| Trade | 552 | 136 |
| Beverages | 615 | 152 |

Source: Original table for this publication.

Note: SMIG = guaranteed minimum interprofessional wage.

TABLE 3B.7

Key Statistics of PNAFN, Tunisia

| Category | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|-------|-------|--------|---------|---------|---------|--------|-------|-------|-------|-------|
| Number of household beneficiaries (thousands) | 131.8 | 177.2 | 200.7 | 220.7 | 222.1 | 233.5 | 239.05 | 241.6 | 242.8 | 255.5 | 261.8 |
| Expenditures (TD, millions) | 94.9 | 149.4 | 23,9 | 303.4 | 341 | 444.9 | 462.8 | 473.8 | 548.6 | 583.5 | 627.3 |
| Expenditures as a share of GDP (%) | | | | | | 0.525 | 0.515 | 0.494 | 0.516 | 0.508 | 0.569 |
| Amount of monthly transfer (TD) | 56.7 | 70 | 70/100 | 100/110 | 110/120 | 120/150 | 150 | 150 | 150 | 180 | 180 |

Source: Ministry of Social Affairs 2021 data.

Note: PNAFN = National Program of Assistance to Needy Families.

TABLE 3B.8

RTFR Affiliates and Contributors, Tunisia, 2017–19

| Year | Affiliates | Contributors |
|------|------------|--------------|
| 2017 | 326,755 | 157,034 |
| 2018 | 316,621 | 156,867 |
| 2019 | 317,110 | 141,747 |

Source: Center for Research and Social Studies 2022 data.

Note: RTFR = social security insurance for low-income salaried workers in the private sector.

BOX 3B.1

Potential Arbitrage Opportunities for Firms Weighing Tax Regimes, Tunisia

A simulation was conducted to illustrate arbitrage and strategic behaviors stemming from the existence of real and special tax regimes. The objective was to assess the tax effects of the transition of an individual enterprise from one regime to the other. The simulation consisted of changing the value of sales from an amount below to one above a threshold defined under the real and special regimes, to compare the taxable income and profits. Profits were calculated as a fixed share of sales, assuming that the ratio of profit to sales is 10 percent.

There are three potential tax regimes for individual enterprises (figure 3B1.1), which carry different implications for profits and the tax burden:

- (1) If the value of sales is less than TD 10,000 (US\$3,584) per year, the first threshold, the individual enterprise is liable under the first special regime: a flat rate of TD 200 (US\$71.6) per year in communal areas and TD 100 (US\$35.8) per year in noncommunal areas.
- (2) If the value of sales is between TD 10,000 (US\$3,584) and TD 100,000

(US\$35.842) per year, the second threshold, the individual is liable under the second special regime: a flat fee of 3.0 percent of sales.

- (3) If the value of sales exceeds TD 100,000 (US\$35.842) per year, the informal enterprise is liable under the real regime: the personal income tax schedule.

Switching tax regimes may also have implications for social security schemes (figure 3B1.2), due to income differences:

- (1) An income below the minimum wage allows the contributor to **join the social security insurance for low-income salaried workers in the private sector (RTFR) scheme, which has a very low contribution rate.**
- (2) An income above the minimum wage allows the contributor to **join the general scheme for agricultural employees in the private sector if the economic activity is in agriculture, or the general scheme for non-agricultural self-employed workers in the private sector if the sector of activity is outside agriculture.**

(continued)

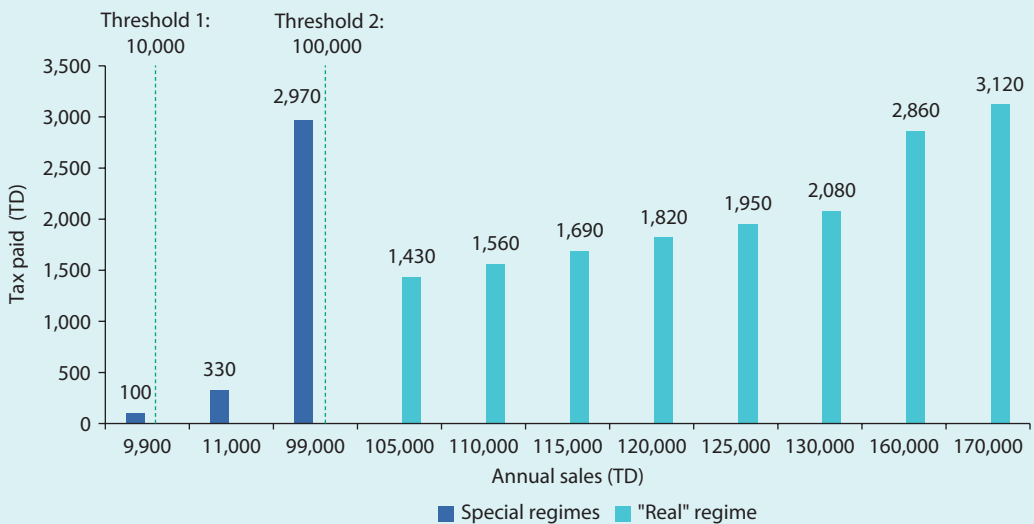
BOX 3B.1

Potential Arbitrage Opportunities for Firms Weighing Tax Regimes (continued)

- The results of the simulation show that:
- (1) It is profitable for an individual enterprise to keep sales below the first threshold: expanding the business and sales and transitioning from the first to the second special regime decreases after-tax profit from TD 890 to TD 770 (US\$276). Under the first special regime, individual enterprises can benefit from lower taxes and social security under the RTFR. The first regime incentivizes individual enterprises to remain small, at a low productivity level, and possibly hire employees informally.
 - (2) Filing taxes under the special regime requires registration with the tax authority, making the probability of being identified and incurring penalties in case of evasion high. **This provides an incentive to remain informal.**
 - (3) Transitioning from the second special regime to the real regime can be profitable: if an individual enterprise experienced an increase in sales from TD 99,000 (US\$35,484) to TD 105,000 (US\$37,634), profits would jump from TD 6,930 (US\$2,484) to TD 9,070 (US\$3,250).

FIGURE 3B1.1

Tax Paid, by Fiscal Regime and Sales, Tunisia



Source: Original figure for this publication.

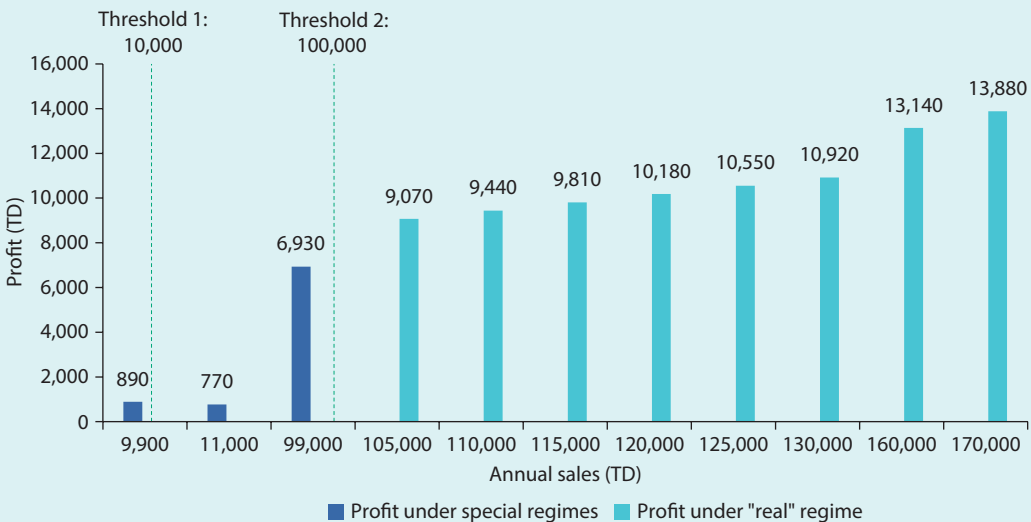
(continued)

BOX 3B.1

Potential Arbitrage Opportunities for Firms Weighing Tax Regimes (continued)

FIGURE 3B1.2

After-Tax Profit, by Fiscal Regime and Sales, Tunisia



Source: Original figure for this publication.

BOX 3B.2

Comparison of the Numbers of Tax Payers, by Income Tax Regime

In 2019, there were 692,308 taxable enterprises that fell into one of three income tax regimes (figure 3B2.1):

1. Individual enterprises under the personal income tax regime (or under the real regime), 149,277 enterprises
2. Individual enterprises under the special regime, 400,000 enterprises

3. Incorporated enterprises under the corporate income tax regime, 143,031 enterprises.

About 40 percent of all enterprises paying taxes were under the real regime, which includes personal income tax and corporate tax, while the remaining 60 percent were under one of the two special regimes. Almost 75 percent of individual enterprises

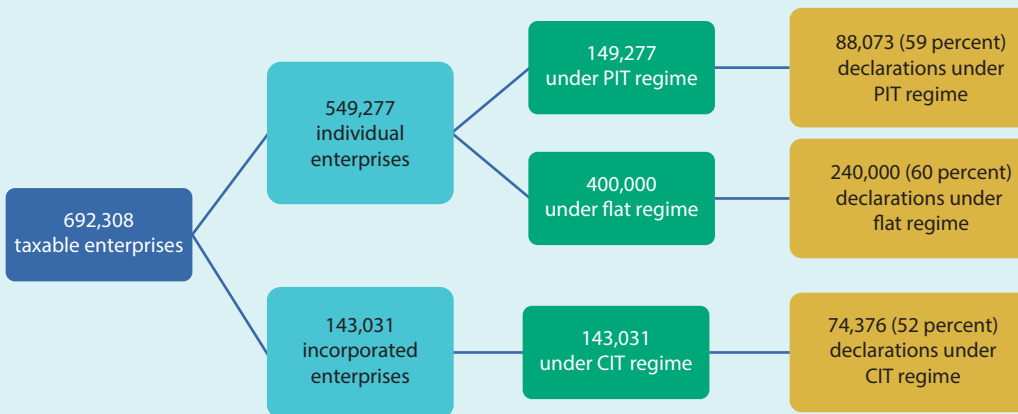
(continued)

BOX 3B.2

Comparison of the Numbers of Tax Payers, by Income Tax Regime (*continued*)

FIGURE 3B2.1

Tax Distribution of Taxable Enterprises and Payers, by Regime, Tunisia, 2019



Sources: Original figure for this publication; calculations using data from the Tax Directorate, Al Bawsala.
 Note: CIT = corporate income tax; PIT = personal income tax.

were under the special regime. Of the three regimes, the lowest contribution to overall tax revenues comes from firms in the special regime (paying 0.5 percent), followed by firms in the real regime (3.7 percent), and the CIT regime (13 percent).

Figure 3B2.2 shows the number of taxable enterprises (potential) and the number of enterprises that paid taxes (actual) by regime, thereby proxying the tax gap. It shows that

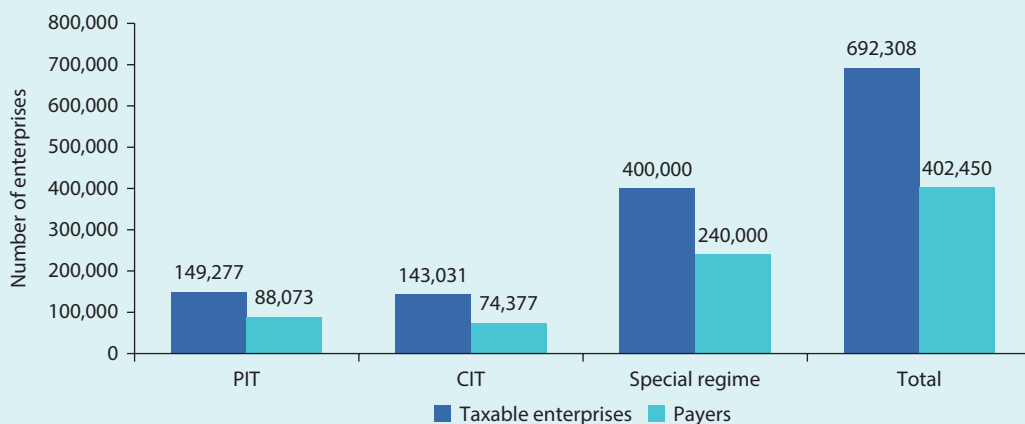
significant proportions of enterprises did not declare their profits, especially within the two special regimes. Only 88,073 (59 percent), 74,377 (60 percent), and 240,000 (52 percent) of the enterprises in the personal income regime, corporate regime, and special regime filed their tax returns, respectively, which implies a lower bound estimated rate of income tax evasion of 58 percent.

(continued)

BOX 3B.2

Comparison of the Numbers of Tax Payers, by Income Tax Regime (*continued*)

FIGURE 3B2.2

Number of Taxpayers (Declarations) among Taxable Enterprises, by Regime, Tunisia, 2019

Sources: Original figure for this publication; calculations using data from the Tax Directorate, Al Bawsala.

Note: CIT = corporate income tax; PIT = personal income tax.

BOX 3B.3

Contributory Social Insurance for Salaried Workers in Agriculture: The RSAA Regime in the Private Sector

The general scheme for agricultural employees in the private sector (RSAA) was introduced in 1989 to replace the restrictive scheme for agricultural employees. It covers employees of agricultural companies, fishers employed on vessels of less than 30 gross tonnage, self-employed fishers, and small shipowners.

In 2019, there were about 41,000 contributors (Center for Research and Social Studies 2019 data). The contribution

base is the declared wage, except in the case of self-employed fishers and small shipowners who pay contributions on the guaranteed agricultural minimum wage over a period of 75 days per quarter. The contribution rate is 12.48 percent for the employer and 6.99 percent for the employee, thus a total of 19.47 percent (table 3B3.1). In terms of retirement pensions, health insurance, and family allowances, the scheme has the same

(*continued*)

BOX 3B.3

Contributory Social Insurance for Salaried Workers in Agriculture: The RSAA Regime in the Private Sector (*continued*)

legislation as the general scheme for non-agricultural employees in the private sector. Nevertheless, given the low-wage and seasonal nature of jobs in the agriculture

sector, there is a significant gap between the number of affiliates and the number of contributors, which indicates a high level of informality in the sector (table 3B3.2).

TABLE 3B.3.1

Contribution Rates, by Type of Benefit and Separately for Employers and Employees under the General Scheme for Agricultural Employees in the Private Sector, Tunisia

| Contributor | Pensions | Health Insurance | Family allowances | Sickness and maternity benefits | Lump sum death benefit | Total |
|----------------|----------|------------------|-------------------|---------------------------------|------------------------|-------|
| <i>Percent</i> | | | | | | |
| Employer | 5 | 4 | 3 | 0.4 | 0.08 | 12.48 |
| Employee | 2.5 | 2.75 | 1.5 | 0.2 | 0.04 | 6.99 |
| Total | 7.5 | 6.75 | 4.5 | 0.6 | 0.12 | 19.47 |

Source: Original table for this publication.

TABLE 3B3.2

Number of Affiliates and Contributors in the General Scheme for Agricultural Employees in the Private Sector, Tunisia, 2017–19

| Year | Affiliates | Contributors |
|------|------------|--------------|
| 2017 | 175,078 | 41,473 |
| 2018 | 180,780 | 42,091 |
| 2019 | 187,027 | 41,077 |

Source: Based on 2022 data from the Center for Research and Social Studies.

NOTES

1. Data on firms and their characteristics are not readily available and accessible in Tunisia. The National Register of Enterprises, created and managed by the National Institute of Statistics, is an administrative database of enterprises in the nonagriculture private sector that are registered with the tax authorities. The approximation of the overall distribution of firms by size was obtained starting with the distribution of 763,000 informal employees by firm size (estimated using data from the Labor Force Survey), adding the 110 state-owned enterprises employing around 91,700 workers, and using the center of each size class to obtain the number of firms (200 for the last class). In addition, the estimated share of informal firms was taken from the micro firms survey, and the assumption is that micro and unregistered firms (estimated based on the number of informal workers) are all informal.
2. See box 3B.3, in annex 3B, for more information on contributory social insurance for salaried workers in agriculture.
3. Access to exams and competitions to enter the civil service is often conditioned by the presentation of an attestation of job seekers or unemployed.
4. SMIG stands for *salaire minimum interprofessionnel garanti*.
5. An exception is represented by workers under the RTFR regime, that is, domestic and construction workers.
6. To get access to health insurance provided under CNAM, workers need to contribute for a minimum of 50 days over the past two calendar quarters or 80 days over the past four quarters.
7. The distribution of contributors by plan is based on the Center for Research and Social Studies data for 2019.
8. The Labor Code includes provisions that apply to workers with fixed-term contracts—on wages, dismissal, and the collective agreement aspect of these provisions—without adding a lot to them. For example, article 6-4 of the Labor Code provides that workers with fixed-term contracts cannot be paid less than workers with permanent contracts and the same professional qualifications.
9. Details are illustrated in table 3B.4, in annex 3B. In the case of civil servants, dismissal is possible only for established and serious misconduct and after the consultation of a committee composed of unions and senior representatives of the administration. This may lead to a judicial process. The dismissed worker may claim pension rights or, if he/she does not meet the eligibility criteria to claim a pension, an allowance equal to one month of salary per year of service (capped at 12 months) could be negotiated.
10. Details are illustrated in figure 3B.9, in annex 3B.
11. The application file is then sent to a regional commission of the MoSA for a decision. The AMEN Social Organic Law (Law 2019-10) and Government Decree No. 2020-317 introduced new transparent, objective, and equitable criteria to assess beneficiary eligibility for the AMEN Social Services. Assessment of eligibility will be based on inclusion and exclusion filters and a score based on a proxy means testing model. The model variables come from data collected from social surveys stored in the Social Registry. The selection process will then continue to account for social workers' assessment of household eligibility and the final decision will be made by a technical regional committee. The score will allow ranking households in three groups:

- (1) the poorest 10 percent, approximately the share falling below the 2015 national poverty line, will be eligible for the Central Pharmacy of Tunisia, a free health card, back-to-school allowances, commute transportation for religious celebrations, and free transportation; (2) the next 20 percent poorest households are classified as poor and vulnerable households with low income and will be eligible for a benefit-service package that includes subsidized health cards, back-to-school allowances, and family allowances for children age 0–5 years; and (3) the remaining 70 percent are not considered poor and are not eligible for the AMEN program social benefits.
12. The tax burden under the corporate tax regime is TD 51,561 per company, as described in the corporate income tax section.
 13. This scheme was amended in 2021 and replaced with a new scheme for small businesses—along with a payment system that uses the PIT scale based on an implicit profit determined by activity and geographical area. However, even under the new scheme, it remains economically convenient for businesses to be small.
 14. See Decree No. 2014-2939 of August 1, 2014, for the full list of restricted activities: https://www.cabinetnfm.com/wp-content/uploads/2016/02/Décret2014_2939-activité-exclu-R-Forf.pdf.
 15. See box 3B.1, in annex 3B, for a comparison of tax burdens and tax evasion by regime.
 16. The report's definition of firm informality—firms that employ all their workers informally—is applied implicitly in the realm of market conditions such that (1) registered firms have a higher likelihood to hire formal workers because they exhibit higher productivity levels than unregistered firms on average and are more likely to be caught for hiring informal workers and sanctioned by authorities; (2) strong contract enforcement encourages firms to register with official authorities to benefit from the regulatory environment, including secure and low-cost transactions and credit contracts, while also allowing registered firms to grow; and (3) contestability drives the natural selection of firms and increases the integrity and benefits of the regulatory environment, encouraging firm registration and growth.
 17. Credit-constrained businesses are defined as businesses that need a loan but have their loan application rejected or are discouraged from applying in the first place.
 18. “Getting credit” covers two aspects of access to finance: the strength of credit reporting systems, and the effectiveness of collateral and bankruptcy laws in facilitating lending.
 19. The regulatory requirement for collecting collateral contributes to the higher cost of collateral.
 20. The recovery rate calculates how many cents on the dollar secured creditors recover from an insolvent firm at the end of insolvency proceedings.
 21. See the Ministry of Economics, Finance, and Investments report (in Arabic): www.mdici.gov.tn/wp-content/uploads/2021/02/BE_2021_Ar_VFinale.pdf.
 22. Commercial sectors are typically private because these sectors are contestable (there are fewer natural barriers to competition) and because in contestable markets, private firms tend to be more efficient than state-owned firms (Vining and Boardman 1992).
 23. Article 24 of decree-law n°2014-1039 dated March 13th, 2014 (as amended) related to public procurement.

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The Case of Morocco

KEY MESSAGES

- Morocco's contributory social insurance is not doing enough to encourage formal employment, due to flaws in the design of the retirement pension system and the low quality of services received with health insurance.
- The noncontributory health insurance provided via the Medical Assistance Plan to vulnerable and poor households might contribute to further diminish the quality of health insurance provided to formal workers.
- The high minimum wage and costly dismissal procedures encourage informal recruitment of workers.
- Special tax regimes and value added tax exemptions for the self-employed and corporations that operate below certain turnover thresholds—together with weak tax enforcement—discourage the growth of firms and their productivity and hinder the creation of formal jobs.
- Setting up a business is simple and inexpensive, but the laws protecting borrowers and lenders are only weakly enforced, and competition is hampered by state-owned enterprises and cronyism—severely limiting market entry and potentially formal job creation.

INTRODUCTION

Over the past 20 years, Morocco's economic progress has helped raise the living standards of its people. During 2000–19, per capita income doubled and poverty fell below 5 percent (2013–14). Health and education outcomes improved considerably, along with access to basic services (like water and electricity). However, the country's development path has not propelled Morocco into the upper-middle-income countries' club, and the average annual gross domestic product (GDP) growth rate has weakened since 2009, even before the COVID-19 (coronavirus) shock.

Moreover, economic growth has not created enough jobs for the working-age population, which grew on average by about 372,000 per year during 2001–08, while the economy only created an average of 109,000 jobs per year. This occurred against a backdrop of other labor market challenges: low labor force participation (especially among women), high youth unemployment, and a high rate of informality. Further, inadequate legal and social protections have impacted workers, as happened in Tangier on February 21, 2021, with the tragic deaths of 28 workers at an informal textile factory (Lopez-Acevedo et al. 2021).

A new, inclusive development model has been launched by King Mohammed VI to address regional development imbalances, facilitate the inclusion of youth and women, and foster better labor force skills. It seeks to provide nationwide access to education, vocational training, and social welfare programs through coordinated efforts between the public and private sectors.

An in-depth analysis of the country's high level of informality, especially through an institutional lens (see chapter 1), can shed light on how the design of the social protection system, the tax system, and market conditions—as well as their interaction—contribute to limited social insurance coverage, thus leaving workers exposed to risks typically covered by social security, subpar income and productivity growth, and ultimately slow aggregate economic growth. This chapter undertakes this analysis for Morocco. The chapter also highlights recent conversations that were held with salaried workers, employers, and own-account workers to understand not only their aspirations but also the benefits and drawbacks of formal and informal employment.

OVERVIEW OF THE MOROCCAN LABOR MARKET

Although economic growth has helped reduce the informality rate in Morocco, it has not been sufficient to make significant progress. Between 2000 and 2018, Morocco posted strong economic growth: real GDP

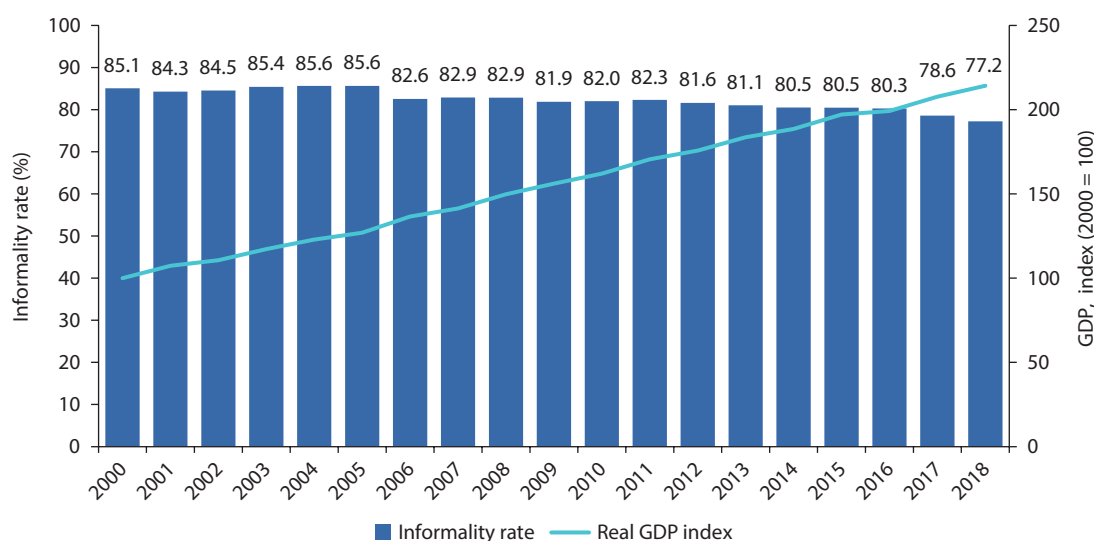
more than doubled, implying an average annualized growth rate of 4.3 percent (figure 4.1). However, in parallel, the share of informal employees in total employment decreased by only 7.8 percentage points, or 0.5 percent per year on average, from 85.1 percent in 2000 to 77.2 percent in 2018. Assuming that the relationship between growth and informal employment stays the same, a much higher rate of growth will be needed to decrease informal employment significantly, or it will take over a century to achieve a significant reduction in informality.

Given that growth alone has not led to a significant reduction in the informal employment rate, how else might policy makers further increase the rate of formal employment? This chapter applies the framework put forward by Levy and Cruces (2021), described in chapter 1, and investigates how the institutional landscape, which is composed of three broad realms—Realm 1, entrepreneur-worker relations; Realm 2, taxes and transfers; and Realm 3, market conditions—influences informality in Morocco.

Before delving into these realms, it is helpful to first take a snapshot of Morocco's labor market, as shown in figure 4.2, which (1) decomposes the working-age population (age 15 and older) into employed, unemployed, and inactive; and (2) then drills down into whether those who are employed work for wages or not,

FIGURE 4.1

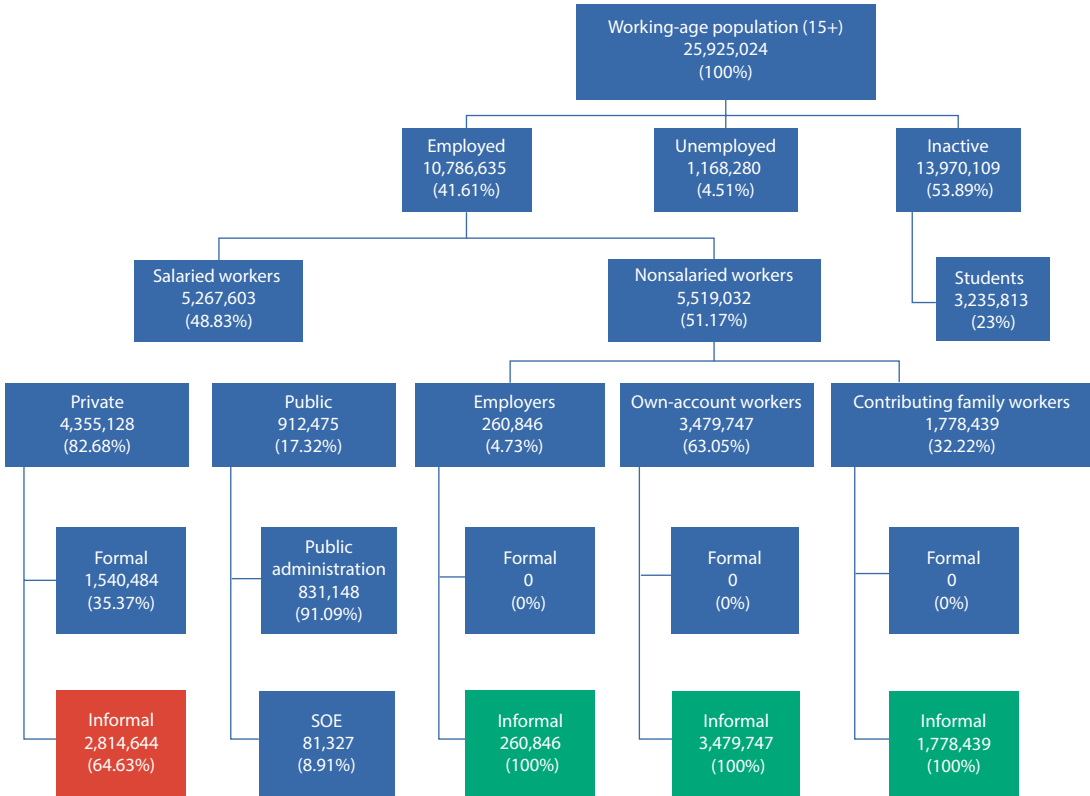
Trends in the Informal Employment Rate and GDP, Morocco, 2000–18



Sources: Based on data from the World Development Indicators, World Bank; Labor Force Survey, High Commission for Planning of Morocco.
Note: GDP = gross domestic product.

FIGURE 4.2

Overview of the Labor Market, Morocco, 2018



Source: Based on data from the Labor Force Survey, High Commission for Planning of Morocco.
 Notes: Informal employment—defined as workers not covered by contributory social insurance—is by law illegal for salaried workers, but legal for nonsalaried workers. The red box indicates illegal informal employment; green boxes indicate legal informal employment. SOE = state-owned enterprise.

the categories of nonwage workers (such as employers or own-account workers), where the public sector fits in, and the shares of informal and formal workers (see box 4.1).

A Few Key Labor Market Trends Stand Out

Labor force participation is low, especially among women. As of 2018, Morocco’s working-age population, age 15 and older, was 25.9 million, of which 10.8 million were employed and 1.2 million were unemployed. This translates into a labor force participation rate of only 47 percent (figure 4.2). Women participate in very low numbers: fewer than 3 million of 13.2 million (or 22.2 percent) are employed or looking for

BOX 4.1

Definitions

Informal employment includes workers who do not contribute to social insurance, or in the case of employees, workers whose employers do not contribute to social insurance on their behalf.

Workers are legally informal if the law does not require them to contribute to social insurance. In Morocco, only salaried workers who are not covered by contributory social insurance are illegally informal.

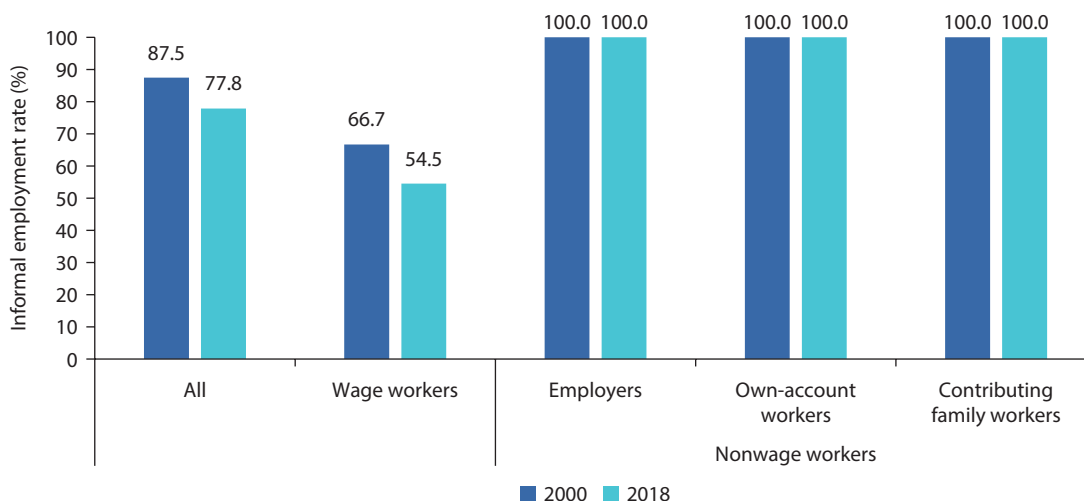
a job. This is far below the averages for the Organisation for Economic Co-operation and Development (OECD) (52.5 percent, 2018) and middle-income countries (45.3 percent, 2018), but above that for the Middle East and North Africa (MENA) (17.9 percent, excluding high-income countries, 2017).

Workers are split between self-employed and wage earners. Nonwage employment in Morocco is commonplace, representing 51.2 percent of all employment in 2018. This category covers own-account workers, employers, and contributing family workers. Wage and salaried workers represent 48.8 percent of employment, followed by own-account workers (32.2 percent), contributing family workers (16.5 percent), and employers (2.4 percent). Although the nonwage employment rate is below that for the average middle-income country (51.8 percent), it is significantly higher than the average in MENA (37.5 percent, excluding high-income countries).

Informality is very high and not limited to workers from poor households. As of 2018, the informal employment rate was estimated at about 77.8 percent, a slight improvement from 2000 (87.5 percent) (figure 4.3). Among private sector salaried workers, about 55 percent do not contribute to the social security system, although they are required to do so by law, making them illegal. While informality is most prevalent among the poorest, it remains pervasive among the middle class and affluent households. In Morocco, as of 2018, almost all workers were informal in the poorer half of the income distribution, representing 95 percent of employment (see figure 2.23, in chapter 2). However, informality rates were still high at higher deciles of income, accounting for 89 and 65 percent of employment among the middle class and workers in the top 30 percent of the income distribution, respectively—signaling that a significant proportion of informality is due to choice rather than exclusion.

FIGURE 4.3

Informal Employment Rate, by Employment Type, Morocco, 2000 and 2018



Source: Based on data from the Labor Force Survey, High Commission for Planning of Morocco.

There is greater mobility across types of employment in the private sector. The Moroccan labor market is segmented between public and private sector workers, with 8.5 percent of total employment in the public sector and 91.5 percent in the private sector and limited job mobility between the sectors. The private sector has greater mobility across types of employment. For example, in one year, about 10 percent of informal salaried workers become formal and about 9 percent of those who started formally end up working informally as salaried workers (table 4.1). In addition, informal wage jobs seem to be a good door out of unemployment. By contrast, more than 8 in 10 public sector workers remain in the same job after one year, and if they do not, they move to a formal private sector salaried job or retire (inactive). Data from the Social Security Administration shed light on the fluidity of the labor market: salaried private sector workers who registered once with the contributory social insurance scheme do not contribute continuously. For example, in 2019, only 1 in 2 registered private salaried workers paid contributions for the entire year, whereas the rest contributed for a fraction of the year, thus operating semi-informally.

Most Moroccan firms are very small or small and absorb most of the informal wage workers. In 2019, small and medium-size enterprises represented 93 percent of all companies. Among this group, 64 percent of firms were very small (fewer than 10 employees), 29 percent were

TABLE 4.1

Transition Matrix across Labor Market Statuses, Morocco, 2017–18

| 2017 | 2018 | | | | | | | |
|-------------------------------|---------------------|-----------------------------|-------------------------------|--------------------------|------------|----------|------------|-------|
| | Public wage workers | Formal private wage workers | Informal private wage workers | Private non-wage workers | Unemployed | Inactive | Not stated | Total |
| <i>Percent</i> | | | | | | | | |
| Public wage workers | 84.2 | 6.7 | 0.7 | 1.3 | 0.7 | 4.9 | 1.6 | 100.0 |
| Formal private wage workers | 2.8 | 76.8 | 8.7 | 3.5 | 2.9 | 4.7 | 0.6 | 100.0 |
| Informal private wage workers | 0.4 | 10.3 | 66.1 | 12.0 | 4.9 | 5.3 | 1.1 | 100.0 |
| Private non-wage workers | 0.2 | 0.9 | 4.7 | 84.3 | 1.2 | 8.5 | 0.2 | 100.0 |
| Unemployed | 0.6 | 4.3 | 17.2 | 9.7 | 51.5 | 15.4 | 1.4 | 100.0 |
| Inactive | 0.1 | 0.4 | 1.2 | 3.6 | 1.8 | 92.6 | 0.3 | 100.0 |
| Not stated | 10.0 | 9.5 | 14.6 | 5.0 | 3.7 | 10.8 | 46.5 | 100.0 |
| Total | 3.2 | 5.4 | 9.7 | 22.3 | 4.0 | 54.6 | 0.9 | 100.0 |

Source: Based on data from the Labor Force Survey, High Commission for Planning of Morocco.

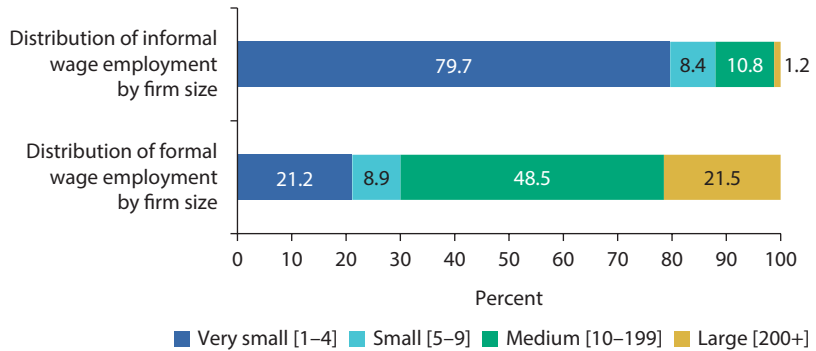
small and medium size (fewer than 200 employees), and the remaining 7 percent were large (more than 200 employees) (Higher Planning Commission 2019). Although it is not possible to investigate the distribution of firms by formality status and size, due to data limitations, informal employment can be estimated using a workers' survey (like a labor force survey), with the associated caveats.¹ As shown in figure 4.4, although very small and small firms (with fewer than 10 workers) accounted for 90 percent of all informal wage employment, they represented only 30 percent of formal wage employment. This indicates that a majority of salaried jobs, especially informal ones, are concentrated in small and micro enterprises. In contrast, large firms contributed a sizable share of formal wage employment (22 percent) but hardly any (only 1 percent) informal wage employment, making them pivotal in the creation of formal employment.

REALM 1: ENTREPRENEUR-WORKER RELATIONS

The “entrepreneur-worker relations” realm comprises a complex set of dimensions that directly affect the incentives of firms and workers to operate formally and therefore contribute to the social protection, poverty, and inequality outcomes of individuals and households. The interactions of these elements with Realms 2 and 3 affect the number, size, and inequality outcomes of individuals and households. In Morocco, the social protection system, which is complex in terms of legislation and

FIGURE 4.4

Distribution of Formal and Informal Wage Employment, by Firm Size, Morocco, 2017



Source: Based on data from the Labor Force Survey, High Commission for Planning of Morocco.

governance (box 4.2), is composed of two main pillars: the contributory component (social insurance) and the noncontributory component (social assistance to the poor and vulnerable) (figure 4.5).

Contributory Social Insurance Regimes

The contributory pillar comprises separate schemes for public and private sector wage workers. The National Social Security Fund (Caisse Nationale de Sécurité Sociale [CNSS]) delivers social insurance to employees in the private sector, whereas the National Fund of Social Welfare Organizations (Caisse Nationale des Organismes de Prevoyance Sociale [CNOPS]) and the Moroccan Pension Fund (Caisse Marocaine des Retraites [CMR]) cater to health insurance and retirement for public sector workers (figure 4.5). In addition, public sector employees can obtain complementary coverage by voluntarily contributing to the Moroccan Interprofessional Pension Fund (Caisse Inter-professionnelle Marocaine de Retraite [CIMR]).

The contributory pillar covers all social risks (as defined by International Labour Organization Convention No. 102 of 1952)—and as of 2018, only salaried workers are required to contribute to the CNSS, while nonsalaried workers must apply for private insurance for insurance against risks.²

Regimes for Salaried Workers

In the private sector, the CNSS, established in 1972, provides a comprehensive package of benefits for employees, which, as of 2018, stood at

around 3.47 million. The package includes (1) old-age, invalid, and survivors pension benefits; (2) health insurance; (3) maternity and sick leave benefits; (4) workplace accidents; and (5) family allowances. It collects social security contributions from the private sector, part of which goes to the National Health Insurance Agency (Agence National Assurance Maladie [ANAM]), which administers the health insurance scheme, Mandatory Health Insurance (Assurance Maladie Obligatoire [AMO]), to finance health insurance.

BOX 4.2

Legal Framework of Workers in Morocco

In Morocco, labor relations are governed by the Labor Code and the Social Security Code.

- The Constitution contains general provisions on the right to health and the right to work (article 31), the right to organize (article 8), and the right to strike (article 29)—without a distinction between salaried and nonsalaried workers—as well as the promotion of collective bargaining (article 8).
- The Labor Code introduces provisions that regulate employment relations for salaried workers—including remuneration, minimum wage, paid leave, promotions, trade union rights, working conditions, and hiring and dismissal rules. The Labor Code does not contain provisions for own-account workers or contributing family workers (figure B4.2.1).
- The Social Security Code provides for mandatory social security contributions of salaried workers and their employers to provide health insurance; retirement pensions; paid annual, sick, and maternity

leave; workplace accident and death insurance; and unemployment allowance. This means that informal employment—defined as employment not covered by social insurance—is illegal only for salaried workers in Morocco, whereas non-salaried workers (including employers, own-account workers, and contributing or unpaid family workers) are legally informal.

Social security contributions and benefits are separately regulated by sector. The regulation of social security is managed by the National Social Security Fund (Caisse Nationale de Sécurité Sociale) for salaried workers in the private sector and by the National Fund of Social Welfare Organizations (Caisse Nationale des Organismes de Prévoyance Sociale) for salaried workers in the public sector. The public administration and local authorities of an administrative nature are governed by the general status of the civil service (Law 1-58-008, 1958). This is a specific status that governs the working conditions, wages, and holidays for workers in public administration.

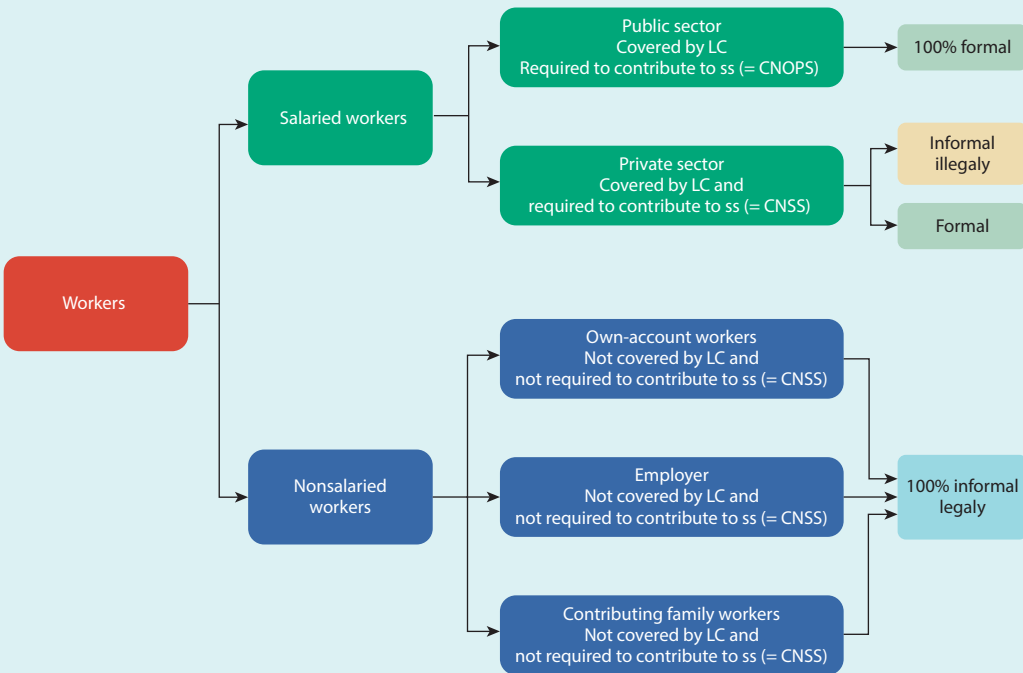
(continued)

BOX 4.2

Legal Framework of Workers in Morocco (continued)

FIGURE B4.2.1

Overview of Legislation and Regulations Covering Workers, by Type of Employment, Morocco



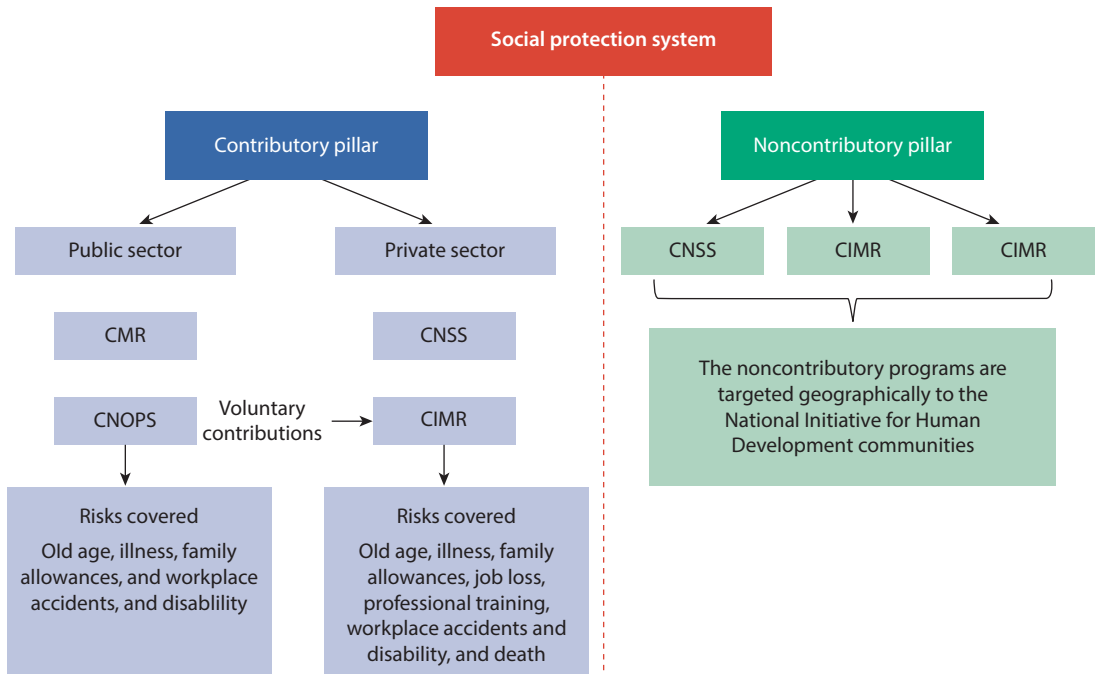
Source: Original figure for this publication.

Note: CNOPS = National Fund of Social Welfare Organizations; CNSS = National Social Security Fund; LC = Labor Code; ss = social security.

The overall contribution rate to the CNSS scheme is 26.8 percent, plus 2.74 percent that employers and workers pay to private insurance companies to cover workplace accidents and disability (table 4.2). The highest contribution rates are for longevity risk (13.46 percent), family allowances (6.40 percent), and health insurance (6.37 percent). Contributions for some components of the package—namely, retirement pensions and job loss allowances—have a cap on the amount of monthly wages on which they are calculated. In other words, workers earning more than DH 6,000 (US\$667) per month only pay contributions up to the ceiling.

FIGURE 4.5

Morocco's Social Protection System



Source: Original figure for this publication.

Note: The noncontributory pillar includes a multitude of other programs not reported here. CIMR = Moroccan Interprofessional Pension Fund; CMR = Moroccan Pension Fund; CNOPS = National Fund of Social Welfare Organizations; CNSS = National Social Security Fund.

In the public sector, civil servants receive good coverage from their two contributory social insurance schemes—the CMR and CNOPS—for the right of access to compulsory health insurance. They also benefit from great job stability and a promotion system associated with statutory salary increases.³ By law, civil servants have a right to their wage in the event of incapacity to work due to illness, workplace accidents, or maternity, as well as family allowances that are financed from the general state budget. Their contribution rates for health insurance are lower than those paid by private sector employees, and at 28 percent, contributions for pensions are equally split between the public sector and employees (table 4.3).

Retirement pension. The pension system for private sector salaried workers operates as a pay-as-you-go system with defined benefits. Workers are eligible to obtain a pension benefit at age 60, conditional on having accrued a minimum of 10.4 years of contributions (3,240 days).

TABLE 4.2

Contribution Rates for Private Sector Employees, by Type of Benefit, Morocco, 2018

| Benefit | Cap on gross monthly wage (DH) | Employer (%) | Employee (%) | Total (%) |
|---|--------------------------------|--------------|--------------|--------------|
| Retirement pension | 6,000 | 8.98 | 4.48 | 13.46 |
| Health insurance ^a | — | 4.11 | 2.26 | 6.37 |
| Family allowances | — | 6.40 | — | 6.40 |
| Job loss allowance | 6,000 | 0.38 | 0.19 | 0.57 |
| Professional training | — | 1.60 | — | 1.60 |
| Illness, maternity, and death | 6,000 | 0.67 | 0.33 | 1.00 |
| Workplace accidents and disability insurance ^b | — | 1.90 | 0.84 | 2.74 |
| Total CNSS | — | 22.14 | 7.26 | 29.40 |

Source: Original table for this publication.

Note: CNSS = National Social Security Fund.

a. Companies that provided medical insurance before the introduction of Mandatory Health Insurance are exempt from health insurance contributions and pay a solidarity rate of 1.85 percent.

b. These benefits are provided by private insurance companies and are not administered by the CNSS.

TABLE 4.3

Contribution Rates for Public Sector Employees, by Type of Benefit, Morocco, 2018

| Benefits | Taxable base | Administration (%) | Employees (%) | Total (%) |
|---|--------------|--------------------|---------------|-----------|
| Retirement pension | Gross wage | 14 | 14 | 28 |
| Health insurance | Gross wage | 2.5 | 2.5 | 5 |
| Family allowances | — | — | — | — |
| Disability / workplace accident insurance | — | — | — | — |
| Total | — | 16.5 | 16.5 | 33 |

Source: Original table for this publication.

Note: Family allowances are financed by the State Budget of the Ministry of Economy and Finance.

The reference wage is the average wage, capped at DH 6,000 (US\$667), of the last 8 years of contributions before retirement. Workers can contribute up to 24.2 years to receive the maximum pension benefit, which equals 70 percent of the reference wage. The pension benefit equals 50 percent of the reference wage for the first 10.4 years of contributions, and it is increased by 1 percent for each additional block of 215 days of contributions, to reach a maximum benefit of 70 percent of the reference wage. In addition, employees can obtain complementary coverage by voluntarily contributing to the CIMR. However, workers who

do not meet the minimum of 10.4 years—which is the case for at least 16 percent of private sector salaried workers—are incentivized to switch to informal employment (see box 4.3).

The pension system is, on average, more than actuarially fair—the discounted sum of pension benefits is greater than the discounted sum of contributions paid (the ratio benefits/contributions, denoted by G , is 1). A simulation shows that there are significant differences in the value of G depending on the salary level (figure 4.6, panel a). First, eligible workers receive a pension benefit that is higher than what they paid in contributions. The value of G is highest at 10.4 years of contributions, when workers receive up to about 2.5 times the amount paid. Second, the system does not incentivize contributing more than the minimum number of years, as the value of G declines in the number of years of contributions paid because after the first 10 years, each additional year contributes only 1 percent of the reference wage. In other words, the system is not actuarially fair at the margin. This discourages working formally beyond the

BOX 4.3

Shortfalls of the Pension Scheme for Private Sector Salaried Workers

Workers who do not meet the minimum number of years of contributions are entitled to a lump sum payment that corresponds to the contributions they paid plus interest, as decided by the National Social Security Fund (CNSS), excluding the two-thirds of contributions paid by their employer. This means that they must bear the longevity risk, as they cannot get access to an annuity. They also bear the full cost of the health risk, as they cannot join the public health insurance system during retirement. Such an arrangement, in effect, introduces a tax on private sector salaried workers with short formal careers and might play in favor of informal employment.

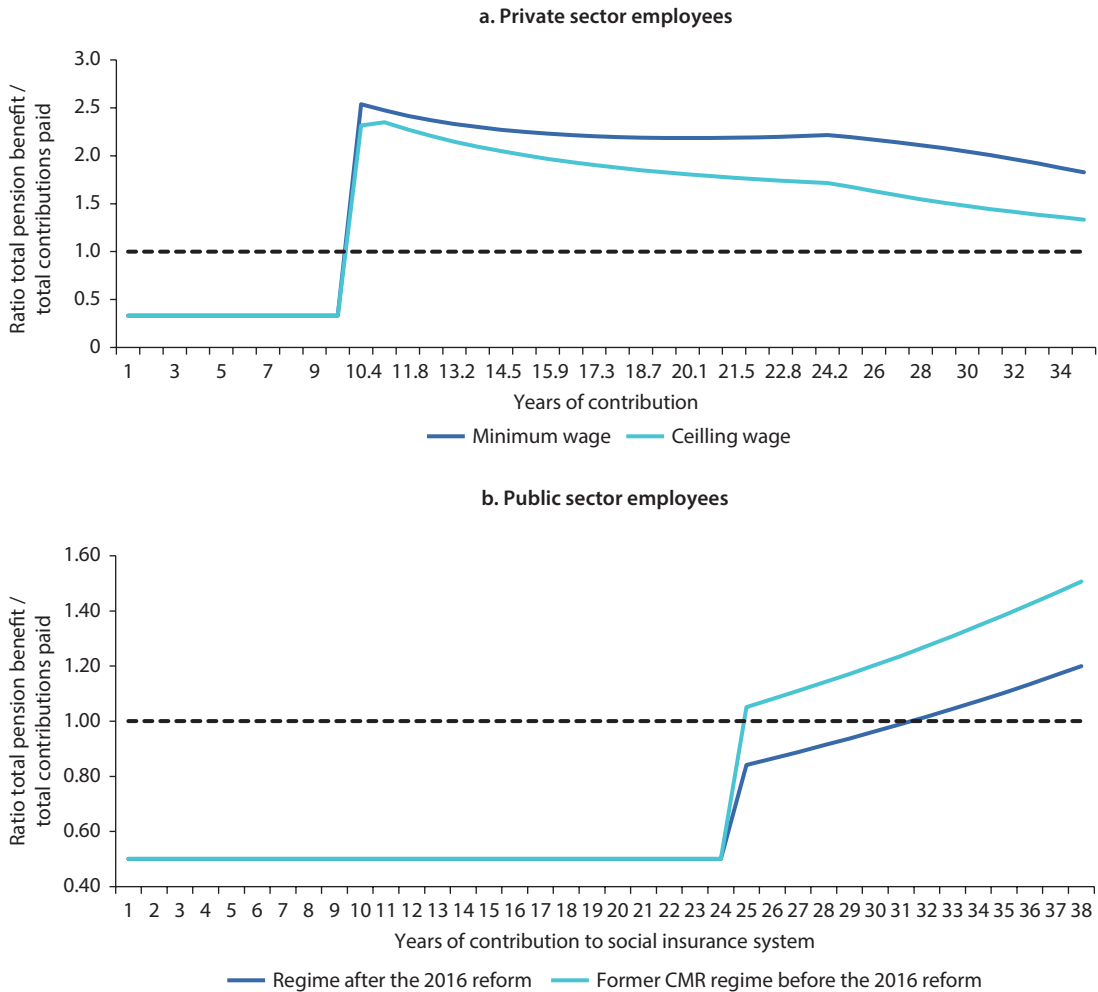
Estimates indicate that 16 percent of all private salaried workers might not meet the eligibility criteria of 10.4 years to receive

a pension. However, these numbers could be even higher. In 2019, only 50 percent of workers contributed to the CNSS throughout the year and about 23 percent contributed for less than 6 months. The assumption is that such a distribution of number of months of contributions holds in every year of a worker's career. The average age of entry in the labor market is 25 years.

In addition, the system might have a regressive component, to the extent that low-wage workers are more likely to experience discontinuous formal careers, and thus might end up not meeting the eligibility requirement for a pension benefit and subsidizing high-wage workers. If they expect to have discontinuous careers, low-wage workers might not have an incentive to contribute to the system.

FIGURE 4.6

Ratio of Total Retirement Pension Benefits to Total Contributions Paid, by Number of Years of Contributions, Morocco



Source: Original figure for this publication.

Note: Assumptions used in the simulation: salary growth rate: 3 percent; capitalization rate: 2.5 percent; discount rate: 1.5 percent; life expectancy at age 60: 14 years; age at first job: 25 years. CMR = Moroccan Pension Fund.

minimum number of years required to receive a full pension. It also hurts the financial stability of CNSS. Third, the system has a progressive component, whereby a low-wage worker (paid the minimum wage) receives for each US\$1 of contributions paid proportionally more compared with a high-wage worker (paid DH 6,000 (US\$667) per month): the value of G is always greater for low-wage workers, as their wage is below the cap.

In contrast to the private sector pension scheme, the civil service one mandates that workers must contribute for 24 years in the case of men and 18 years in the case of women—compared to 10.4 years in the private sector—although the required age to receive benefits is also 60. A simulation shows that among public workers, there are also significant differences in the value of G (figure 4.6, panel b). Particularly, eligible public sector workers receive a benefit that is higher than what they paid, which increases over time and peaks at 1.2 times the amount paid, or 1.51 under the former regime (before the 2016 reform), after 38 years, thereby incentivizing public workers to contribute for their entire careers. This discrepancy can lead to segmentation between public and private sector workers, given that there is no portability of contributions across the two schemes. Pension contributions and benefits are calculated on an uncapped salary, providing incentives to work longer for workers with high salary increases toward the end of their career. Civil servants' pensions are high and appear to be better than those in the private sector, but public sector workers must contribute over a longer period and at a higher percentage of their salary, which is not capped. Combined with job stability, higher salaries and guaranteed salary increases, and nonmonetary allowances, this generates a segmented labor market between the public and private sectors.

The public pension scheme became less generous after the 2016 CMR reform. The old scheme provided a retirement pension calculated as 2.5 percent of the last salary for each year of contributions at a contribution rate of 20 percent. Now the pension is calculated at 2 percent of the last salary for each year of contributions at a contribution rate to 28 percent, and it is likely that contribution rates will rise further in the near future (World Bank 2015).

Family allowances. These have both a progressive component and a regressive component and penalize workers with short formal job spells. Family allowances are paid in the amount of DH 300 (US\$33.3) per child for the first three children and DH 36 (US\$4) for the next three children.⁴ They are financed exclusively by employers' contributions with no wage ceiling—that is, employers pay more for high-wage workers than for low-wage workers, but all workers receive the same benefits, conditional on having the same number of children of the same age. Access to family allowances is provided only to workers with a minimum of 108 days (4.15 months) of discontinuous contributions during a period of 6 calendar months of registration and with a wage equal to at least 60 percent of the legal minimum wage.⁵ In the case of civil servants, contributions are paid by the public administration from general tax revenues.

Based on the distribution of workers by number of months of contributions to the CNSS in 2019, at least 20 percent of private formal salaried workers might not be eligible for family allowances. This group is likely to be composed of temporary workers, who are then left without access to this benefit and might be better off being informal and having at least part of the employer's saving transferred as a higher wage. In addition, high-wage workers with long stays in formality (typically employees with open-ended contracts) cross-subsidize low-wage workers who meet the eligibility requirement (4.15 of 6 months of contributions). However, high-wage workers might also have an incentive to declare a wage that is not higher than the cap for pension contributions, to minimize the amount of contributions paid while still benefiting from the system.

Unemployment insurance. The job loss allowance is very low. The CNSS provides private sector employees who involuntarily lose their jobs and who are actively seeking a new job an allowance for up to 6 months. The allowance cannot exceed 70 percent of the average salary received during the 36 months prior to the loss of employment, with a ceiling equal to the minimum wage. In addition, eligibility conditions are strict and include the following:

- Workers must have contributed to social security for at least 780 days over the 3 years preceding the date of loss of employment, of which 260 days of contributions must have been during the last 12 months.
- Workers must be registered as job seekers with the unemployment agency (National Agency for the Promotion of Employment and Competencies).
- Workers must not be entitled to a disability or retirement pension.
- Workers must be able to work.

In 2019, of 32,564 private sector employees who requested access to the compensation system for job loss (Job Loss Allowance), only 46 percent were able to benefit from it.⁶ According to the Ministry of Labor, the most common reasons for rejection are an insufficient number of insured days or lack of documentation on the number of days of contributions.

Contributory health insurance. In 2002, the government introduced AMO, a mandatory contributory basic health coverage scheme for private and public sector wage workers. It is operated by CNSS for those in the private sector and by CNOPS for those in the public sector.

In the private sector, to be eligible, workers must contribute for a minimum of 54 days over a period of 6 months. The overall contribution

rate is 6.37 percent, of which 4.11 percent is paid by employers. There is no ceiling on taxable wages, which means that high-wage workers pay much more than low-wage workers for the same service. Thus, some redistribution could occur from high-wage to low-wage workers in the private sector, although some high-wage workers might declare a lower wage if their employer agrees, the probability of getting caught is sufficiently low, and the sanction is limited. There might also be some redistribution from workers with continuous formal employment spells to those with short formal employment spells. Workers who cannot reach the minimum number of days for coverage are taxed, with their contributions subsidizing health insurance for other formal workers.

Contributory health insurance provides access to a range of services and medicines through public and private clinics. In theory, this coverage is good, but in practice, the quality is limited. According to the World Bank (2018), more than 50 percent of patients of primary health care facilities complain about the cost of prescription drugs, waiting times, and infrastructure quality. Other shortcomings include a limited supply of health care and an unequal distribution of providers and human resources between urban and rural areas and across regions (ONDH 2018).

Moreover, costs can be considerable, especially for ordinary treatments. AMO reimburses 70 percent of the legal tariff if workers and their families receive treatments through private providers. This can sharply increase out-of-pocket expenditures, given that market tariffs are typically higher than negotiated tariffs. These expenditures stood at 38 percent of total health care expenditures for private sector workers and 32 percent for public sector workers, as of 2018, compared to 13.8 percent in OECD countries. In addition, low-wage formal workers are unlikely to be able to afford private clinics and hospitals and might be limited in their choice of public health facilities, where the quality of services is low. Thus, for low-wage workers, the protection against health risks might in practice be considerably lower relative to that of high-wage workers. To the extent that income matters for workers' access to health care services, this defeats the purpose of social insurance.

Public sector workers benefit from the same health insurance at a lower contribution rate relative to private employees, but the refund rate is higher (80 percent of all treatments with a total cost up to DH 200 [US\$22.2]). Given that many public employees have higher wages than private ones, they probably can afford to use private providers. As with private employees, workers at different salary levels pay the same contribution rate, leading to a redistribution from high-wage workers to low-wage workers. However, since the

contribution is capped at DH 400 (US\$44.4), the redistribution is limited compared to the private sector.

Labor Regulations

Minimum wage. Over the past two decades, the minimum wage has increased modestly in real terms. The minimum wage is fixed by a government decree after consultation with various partners (representatives of employers and employees). Currently, three distinct minimum wage levels are in place:

- *The legal minimum wage (SMIG)*—which is the minimum wage in the industry, commerce, and service sectors—is calculated on the basis of 191 hours of work per month.
- *The guaranteed minimum agricultural wage (SMAG)*, which is the minimum wage in the agriculture sector, is calculated based on 26 working days per month.
- *The minimum wage for domestic workers*, which cannot be less than 60 percent of the SMIG.

In 2019, the SMIG was around DH 2,699 (US\$300) per month and the SMAG was around DH 1,904 (US\$211) per month. Since 2000, the SMIG minimum wage has been revised upward in nominal terms, increasing by about 11 percent (21 percent for SMAG) in real terms.

The problem is that minimum wages are high relative to the average wage. Although the ratio of the minimum to the average wage decreased by 6.2 percentage points between 1999 and 2019, going from 53.8 to 51.4 percent (for formal salaried workers registered with the CNSS), it remains at a high level by international standards—averaging 40 percent among 75 countries (Kuddo and Moosa 2019). In 2019, the distribution of wages in the private sector showed that 45 percent of all CNSS workers received a monthly wage that was on average below the SMIG minimum wage. This was mainly because these workers were on temporary contracts and did not work for a whole year—and thus their annualized monthly wages were below the legal minimum. In addition, the minimum wage was about 70 percent of the average value added per worker, a measure of labor productivity. Thus, the minimum wage potentially discourages formal recruitment of workers with unknown productivity (labor market entrants) or low productivity (Chauffour 2018).

Collective agreements. These agreements can negotiate better working conditions for employees and can take place at the company, sector, or national level.² At the national level, the bargaining process is

tripartite and takes place between government, unions, and the General Confederation Enterprises of Morocco representatives. According to the Labor Code, collective agreements are valid only if they are signed with the “most representative” trade union at the company level (the union must have at least 35 percent of the total number of elected staff representatives). However, given the multiplicity of trade unions (28 registered) in Morocco, it is difficult to reach 35 percent of elected representatives and sign a collective agreement.

The large number of small and medium-size enterprises further limits the use of collective agreements at the company level, as these firms pursue a low-cost strategy and seldom seek to provide additional or complementary benefits to employees. Thus, only a few collective agreements exist at the company level, and they are essentially restricted to large companies. According to the latest available figures from the Ministry of Employment and Professional Training (2018), only 17 collective agreements at the level of private enterprises had been ratified and 39 sectoral collective agreements had been signed. Moreover, noncompliance with the Labor Code often leads to strikes—with the strike participation rate increasing from 45.7 percent in 2017 to 66.4 percent in 2018 (Ministry of Employment and Professional Training 2018).

Hiring and firing regulations. Many workers are hired without a contract. According to the High Commission for Planning of Morocco, as of 2019, over half of salaried workers did not have a written contract (54.9 percent), whereas among those who did have a written contract, 26.5 percent had an open-ended contract, followed by 11.4 percent on fixed-term contracts (the rest only had a verbal agreement with the employer). Fixed-term contracts are allowed for nonpermanent tasks in specific cases prescribed by the Labor Code—including seasonal work, temporary replacement of a permanent worker, temporary increases in a company’s activity, opening a business, or launching a new product in an existing company. Firms can hire workers on fixed-term contracts for a period of one year, renewable once. After this period (a maximum of 2 years), the contract is converted into an open-ended one if employees hold the same position. Hiring workers on fixed-term contracts provides flexibility in managing human resources, particularly in terms of simplified and cheaper dismissal procedures.

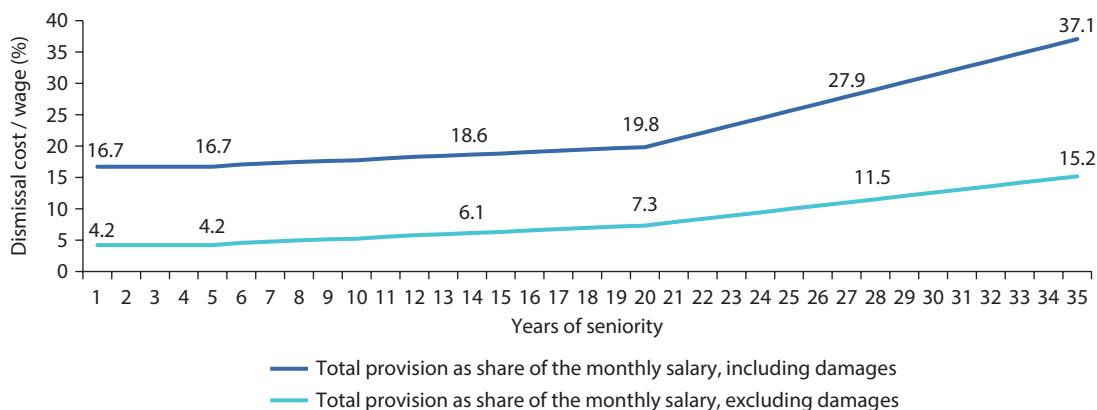
In terms of firing or dismissal of workers on contracts, employees have a probation period that allows employers to terminate without notice or compensation; after that, termination must respect specific conditions.⁸ Workers on fixed-term contracts can be dismissed ahead of the expiration of the contract. However, in the absence of misconduct or economic reasons, dismissed workers are entitled to damages

that correspond to the salary for the remaining months or days of the contract. With open-ended contracts, dismissal costs can be high and procedures complex, particularly if firms do not comply with the procedures indicated in the Labor Code (figure 4.7).² In practice, some companies try to reach an agreement with workers, sometimes paying compensation without going to court. Dismissing workers is authorized in the case of serious misconduct (article 39 of the Labor Code; for instance, theft, being in a state of drunkenness, using drugs, and others) or in the case of structural, economic, or technical reasons. In case of a dispute, the power to control the disciplinary decisions is with the courts, and if a dismissal is not considered justified by a court, the dismissed employee is entitled to indemnities and damages as prescribed by the Labor Code.

Enforcement. Although enforcement is key for ensuring compliance with labor regulations, the resources allocated to labor inspectorates are insufficient. The Employment Directorate of the Ministry of Labor is responsible for labor inspections, which include monitoring, advising, and arbitrating between employers and employees. Inspectors can visit companies, question employers and employees, and request documents that prove compliance with labor regulations. Refusal to submit to their requests is punishable by heavy penalties. However, the financial and human resources are well below what are needed to ensure adequate inspections. The International Labour Organization guidance for a lower-middle-income country is that the ratio of labor inspectors

FIGURE 4.7

Dismissal Cost as a Percentage of the Wage, by Number of Years of Seniority, Morocco



Source: Original figure for this publication.

to employees should approach 1/20,000 (Kuddo and Moosa 2019). In Morocco, with 304 inspectors, the ratio is about 1/40,000 (Gannat and Betcherman 2021). Moreover, the inspectors are responsible for supervising negotiations between employers and employees in the event of individual or collective labor disputes, a function that takes time and resources from what should be their key mission of ensuring compliance with labor regulations.

Noncontributory Regimes

The noncontributory pillar is composed of a myriad of social programs—notably, Morocco’s flagship social protection and health program—the Medical Assistance Plan (Régime d’Assistance Maladie aux Economiquement Démunis [RAMED])—which was set up in 2008 and extended nationwide in 2012.¹⁰ It is managed by the ANAM, which also regulates basic health care coverage. As of 2016, about 45 percent of the Moroccan population remained uncovered by any health scheme; almost 36 percent of the population was covered by contributory schemes; and 19 percent was covered by RAMED.

All residents of Morocco are entitled to free public primary health care services, despite geographic barriers. However, public secondary and tertiary hospitals and primary and secondary health care providers deliver health care services conditional on patients’ payments. RAMED provides access to health care to poor and vulnerable people, who are not protected by compulsory health insurance. Beneficiaries are entitled to free health care, subject to availability in public hospitals, like formal salaried private sector workers. Access to a secondary or tertiary public hospital is allowed only if a recommendation from the reference primary care center is provided. The benefits do not include health care delivered by private providers.

The program uses a mixed targeting methodology, combining proxy means testing and community targeting (World Bank 2018). Individuals must file an application with the Ministry of the Interior with information about their socioeconomic conditions. This information is used to generate weighted income and socioeconomic scores, according to a proxy means testing formula based on the 2001 Household Budget Survey.¹¹ The last decision is with interministerial local committees that decide on the eligibility of applicants, particularly those with weighted income scores above the poverty/vulnerability threshold. Eligible applicants are registered for 3 years in the case of poor families and 1 year in the case of vulnerable households. The latter must pay an annual fee of DH 120 (US\$13.3) per beneficiary, with a cap at DH 600 (US\$66.7) per household.

Social Protection, Informality, and Poverty

As of 2013–14, more than 9 million workers, or around 77 percent of Morocco’s employed population, and their families were not covered by contributory social insurance because they were employed informally as wage workers (3.6 million) or nonwage workers (5.4 million) (see box 4.4). Table 4.4 maps out workers according to formality status (and separates public sector workers from private sector ones) and household per capita expenditures. It shows that in 2013–14:

BOX 4.4

Behavioral Constraints on Formal Employment: Evidence from Interviews

For a better understanding of why some Moroccan firms or workers choose to operate formally while others do not, the World Bank conducted interviews with business owners, employees, and own-account workers. The focus was on workers and business owners who have the means but are reluctant to formalize. Their responses suggest the presence of five behavioral bottlenecks that impact an individual’s decision to operate formally (see annex 4B for more details).

Bottleneck 1: Social context and beliefs about what is considered the norm. Operating informally—that is, running an unregistered business, not paying contributions, and working without a contract—appears to be accepted as the norm. Further, there is evidence that among the target groups, it is common for people and businesses to evade taxes: “In general, it is for contractual and financial reasons that I do not declare the rest of the employees. This is common.” It is also common to accept and pursue unregistered employment: “I didn’t ask for a contract because that’s how it is in this business, there is usually no contract.”

Possible remedy: Harness the power of social norms in tax communications. A World Bank study done in collaboration with Albania’s tax authority shows that highlighting people’s civic duty by pointing out how taxes finance public goods is more effective in increasing tax compliance than letters focusing on the enforcement capacity of tax authorities (Karver, Shijaku, and Ungerer 2022). But given Morocco’s relatively high level of informal work, such messaging could backfire when the desired behavior does not reflect the perceived norm (Cialdini et al. 2006). In such cases, recent findings suggest that framing the desired behavior as an emerging trend might be more effective (Mortensen et al. 2019).

Bottleneck 2: Difficulty weighing the present and future costs and gains. This stems from “present bias”—that is, the tendency to overvalue immediate rewards at the expense of long-term intentions. If benefits are in the present and costs are in the future, people tend to ignore the costs, even if it is not in their best interest (Green, Fry, and Myerson 1994). Qualitative data suggest

(continued)

BOX 4.4

Behavioral Constraints on Formal Employment: Evidence from Interviews (continued)

that such short-sighted thinking appears to make some Moroccans favor saving on taxes today over receiving “future” benefits (such as for health-related issues or unemployment): “No, I do not have health insurance, it will cost me, and I am in good health so for the moment I do not need it. I’ll think about it when I get older.”

Possible remedy: Making the future more salient and tangible. A series of randomized controlled trials run by Hershfield et al. (2011) demonstrate that people choose to contribute more to their retirement when they are shown digitally generated images of their “future selves” (Hershfield et al. 2011). Prompting Moroccan business owners or own-account workers to envision their future selves may encourage those who are on the fence about formalizing to reevaluate their priorities for future health, pension, and tax benefits.

Bottleneck 3: Perceived lack of agency and low self-efficacy. While structural barriers certainly exist, some people believe that their life outcomes are almost exclusively contingent on events outside their control—not their own actions. This belief illustrates what psychologists call an external locus of control. People with this trait might be more likely to accept informal employment and completely forgo the opportunity to be hired formally, even if it is accessible to them. This often results in a depressed mental state. As one respondent put it: “Informal work is common in Morocco,

around me ... there is almost only that. Many of us are in need, we have no choice but to work informally. Nobody helps us, how are we supposed to do things right? ... We are condemned to live this way.” This mind-set also makes some individuals more vulnerable to being hired informally by business owners looking to lower operating costs: “There is nothing stopping me from working formally...I started this new job on the assumption that I was going to work formally, but my employer has made me wait for 5 months so I have the hope that he will.”

Possible remedy: Increase workers’ sense of agency and self-efficacy. This might boost their confidence and persistence in a difficult job market, adding pressure on exploitative employers. It could be done with positive psychological interventions, which consist of goal-setting and resource-building assignments (Ouweneel, Le Blanc, and Schaufeli 2013). Similarly, promoting formal job opportunities, especially in sectors that are perceived to operate mostly informally, might correct people’s misperceptions about what is possible.

Bottleneck 4: Loss aversion in the face of unstable influxes of income or revenue. Given that regular income or revenue streams are less likely in the informal sector, threats to liquidity—like the upfront cost of taxes and contributions—can amplify feelings of loss. Losses tend to overshadow potential gains, making the loss of capital weigh

(continued)

BOX 4.4

Behavioral Constraints on Formal Employment: Evidence from Interviews (continued)

more heavily than potential gains of the same magnitude (Kahneman and Tversky 2013). Many respondents said that they fear that they will not regularly be able to fulfill their tax or contribution commitments: “This [informal work] allows you to start, to try, to understand the system before declaring yourself and paying your taxes and contributions.” In particular, new business owners and own-account workers who are just entering the market seem to worry about their ability to comply with payment cycles: “In my opinion, entrepreneurs do not register because of the taxes to be paid. There are annual and monthly taxes; ... usually when you start you have very little funds, and you don’t necessarily want to lose them in taxes.”

Possible remedy: Greater payment flexibility and framing to accommodate fluctuations in income or revenue. Prescriptive savings programs with variable contribution schedules have shown that they can significantly increase employees’ pension contributions (Thaler and Benartzi 2004). In addition, a field experiment in Mexico has shown that voluntary retirement contributions increase significantly when simple Short Message Service reminders highlight the future financial security of the account holder’s family (Shah et al. 2019).

Bottleneck 5: Lack of knowledge and unclear information. This poses a considerable

barrier, especially for those with little education. Morocco’s informal sector varies greatly, with active participants ranging from unskilled shadow workers to highly educated freelancers and business owners who simply prefer the flexibility and added disposable income associated with operating informally. Although some respondents reported that formalization processes are clear and the steps are easy to follow, others—especially those with low educational attainment and the elderly—reported the opposite: “In my opinion, the main problem is the lack of clarity and the lack of information; ... as long as this is the case, there will always be informality.” Communications on certain benefits do not seem to penetrate all of society: “No, I didn’t even know what it [National Social Security Fund contributions] was; ... it was only recently that my daughter explained to me that it was a reimbursement system for the doctor and the medicine.”

Possible remedy: Simplify enrollment processes and fine-tune communications. This would be especially prudent given Morocco’s recent introduction of the freelance status. The problem with large amounts of information—notably, on eligibility criteria—is that it often tends to cause mental overload and lessen the likelihood of the desired behavior (Paas, Renkl, and Sweller 2004).

TABLE 4.4

Distribution of the Employed Population, by Poverty and Formality Status, Morocco, 2013–14

| Status and proportion | Public sector workers | Formal private workers | Informal private wage workers | Informal private nonwage workers | Total |
|-------------------------------|-----------------------|------------------------|-------------------------------|----------------------------------|------------|
| Nonpoor, nonvulnerable | | | | | |
| Number | 537,367 | 1,446,788 | 3,594,537 | 5,425,199 | 11,003,891 |
| Percent | 89.9 | 99.7 | 92.1 | 92.9 | 93.7 |
| Nonpoor, vulnerable | | | | | |
| Number | 3,710 | 2,837 | 85,087 | 126,158 | 217,792 |
| Percent | 0.7 | 0.2 | 2.1 | 2.2 | 1.9 |
| Poor | | | | | |
| Number | 2,181 | 2,128 | 224,740 | 287,317 | 516,366 |
| Percent | 0.4 | 0.1 | 5.8 | 4.9 | 4.4 |
| Total | | | | | |
| Number | 543,258 | 1,451,753 | 3,904,364 | 5,838,674 | 11,738,049 |
| Percent | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Based on data from the 2013/14 Household Budget Survey, High Commission for Planning of Morocco.

Note: Vulnerability is defined according to the distance of household per capita consumption from the official poverty line (≤ 10 percent). Public sector employees are identified using industrial codes (public administration, excluding workers in health and education services). All workers with missing industrial codes have been classified as private sector workers.

- Most informal workers were neither poor nor vulnerable. Between 92 and 93 percent of informal workers belonged to nonpoor and nonvulnerable households, with a similar share among salaried and nonsalaried workers.
- Noncontributory programs only cover illness, which means that informal workers are not insured against disability, workplace accidents, unemployment, and longevity and might easily fall below the poverty line in the case of a shock.
- The large number of informal workers constrains the extent of risk pooling and thus contributes to delivering suboptimal coverage even to formal workers, compared to a scenario where most workers contribute to the system.

The interactions between the contributory and noncontributory social insurance schemes do not incentivize formal work and lead to erratic coverage. The way the two schemes play out is especially clear

for informal salaried workers, who, unlike own-account workers and employers, are required to contribute to the CNSS. The following scenarios could emerge:

- *Poor workers* have several incentives to become formal and make social security contributions: they would have access to better health care from CNSS, and they would be paid at least the minimum wage. However, there are trade-offs. They would no longer receive free access to public primary health care through RAMED, along with cash transfers from Tayssir (the cash transfer program for children) if they have children, although both programs provide limited benefits. Moreover, firms might not be incentivized to hire formal workers with very low productivity—given that these workers would need to be paid at least the minimum wage, and if adjustments to the labor force are needed, employers would have to pay considerable dismissal costs to those hired with an open-ended contract.
- *Informal nonpoor, vulnerable workers* might face a similar trade-off, with the main difference being that they have access to RAMED, conditional on paying a small annual fee. Unless they attribute significant value to insurance against other risks—particularly pension benefits, as well as family allowances—they might be better off working informally.
- *Informal nonpoor, nonvulnerable workers*. A large part of the 9 million informal nonpoor, nonvulnerable workers would opt for contributing to the system if the net value of contributory social insurance were sufficiently high, but they do not. The main reason is that the value and quality of the benefits provided varies across different groups of these workers. For example, low-wage salaried workers with sufficiently long formal careers might benefit from pension benefits more than high-wage workers—but they might also be incentivized to declare a lower wage, as there is no cap on contributions paid for health insurance. High-wage salaried workers might also enjoy the benefits of a retirement pension, although they receive proportionally less compared with low-wage workers for each US\$1 of contributions, and they might have an incentive to declare a lower wage since there is no cap of contributions paid for health insurance. Thus, depending on the degree of bargaining power, some workers might be able to receive a higher wage by working informally, thanks to savings on the employer's side, which derive from not contributing to social insurance and a higher degree of flexibility in managing the workforce.

A big problem for the noncontributory pillar is the low level of government outlays on RAMED—at about 0.15 percent of GDP in

TABLE 4.5**Public Expenditures on Pensions and Health Insurance, Contributory and Subsidized, Morocco, 2019**

| Type of plan | Expenditures (DH, millions) | Share of GDP (%) |
|--------------|-----------------------------|------------------|
| Pensions | 70,109 | 6% |
| AMO | 14,294 | 1.24% |
| RAMED | 1,710 | 0.15% |

Sources: Calculations based on Budget Law 2021 (Ministry of Finance); ACAPS 2020.

Note: AMO = Mandatory Health Insurance; GDP = gross domestic product; RAMED = Medical Assistance Plan.

2019, compared to about 1.24 percent of GDP spent on contributory health insurance (table 4.5). The population covered by RAMED was estimated at 10.9 million in 2019, which means an average allocation of about DH 157 (US\$17.4) per person, according to data from the National Agency for Health Insurance. In the case of AMO, with about 13.3 million beneficiaries, the average per capita allocation is estimated at about DH 1,075 (US\$119.5) (Ministry of Economy and Finance 2019; ACAPS 2020).

Although resources allocated to the Ministry of Health have increased since the start of RAMED (by 75 percent from 2008 to 2016) (World Bank 2018), the total allocation is still well below what is needed to address the needs of the increasing number of beneficiaries without penalizing the supply of public primary health care available to formal workers. As a result, there have been significant increases in waiting times for care and a decline in the quality of health care. This is potentially a disincentive to formal employment—especially for low-wage workers who cannot afford private health care providers—as it lowers the value of contributing to health insurance under the CNSS. In addition, about 3 percent of GDP, compared to an average of 1.8 percent among other middle-income countries, finances regressive consumer subsidies for liquefied petroleum gas, sugar, and flour.

REALM 2: TAXES AND TRANSFERS

The “taxes and transfers” realm is composed of various dimensions that directly influence whether economic agents adhere to their tax obligations or hide under the radar; whether they opt for real or special tax regimes; and, often as a by-product, whether they operate informally or formally. In particular, the design of tax schedules, strength of tax enforcement, and existence of preferential tax regimes for firms are all

important determinants of actual tax revenues and the overall tax burden, and they affect the productivity of firms, number of workers covered by contributory social insurance, and redistributive power of social protection systems, thereby also affecting other social and economic outcomes, such as poverty and inequality. This section focuses on three core elements of overall tax revenue: (1) the personal income tax (PIT), (2) corporate income tax (CIT), and (3) value added tax (VAT).

OVERVIEW OF THE TAX SYSTEM

Direct taxes include the PIT and CIT, whereas indirect taxes include the VAT, consumption tax (such as excise tax), customs tax, and others (such as stamp duties and local taxes). In 2018, about 57 percent of tax revenue was attributable to indirect taxation—the VAT (38.8 percent), consumption tax (12.9 percent), customs tax (4.4 percent), and others (0.5 percent)—while direct taxation accounted for around 43 percent of tax revenue, of which the CIT and PIT represented 23.5 and 19.8 percent, respectively (figure 4.8, panel a).

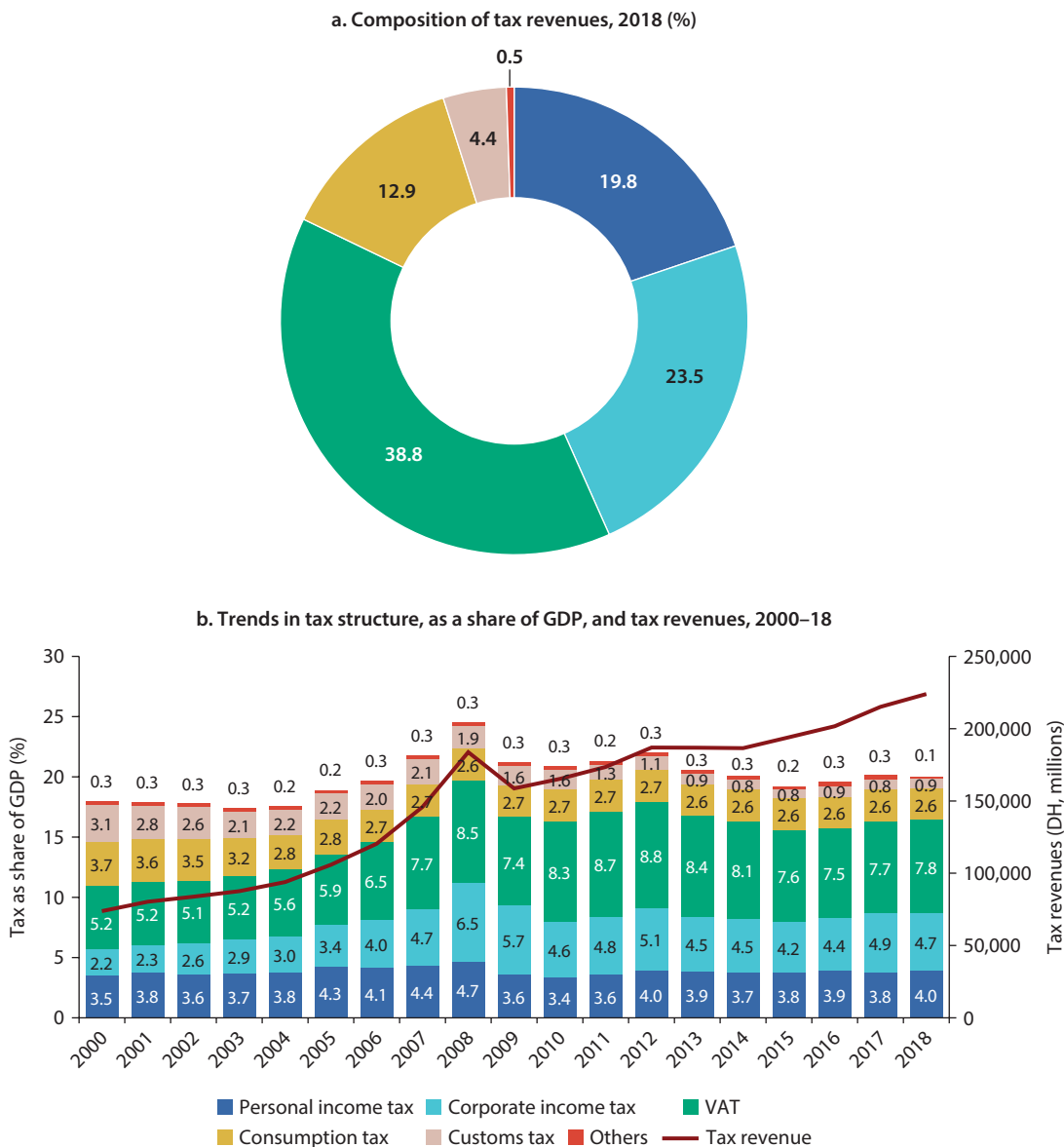
Since 2000, the dirham value of Moroccan tax revenues has increased considerably, from DH 74 billion (US\$8.2 billion) in 2000 to DH 224 billion (US\$24.9 billion) in 2018 (up 203 percent), but tax revenues as a share of GDP have followed a different path (figure 4.8, panel b). Although they initially expanded more rapidly than GDP—from 18.0 percent in 2000 to 24.5 percent in 2008, thanks to increases in VAT, CIT, and, to a lesser extent, PIT receipts—they mostly declined thereafter. Indeed, relative tax revenues dropped to 20 percent of GDP in 2018. The reasons for the decline are threefold:

- The 2008 financial crisis and ensuing economic fallout slowed down economic activity, which reduced individual incomes and business revenues and, in turn, direct tax revenues.
- CIT rates were lowered to attract domestic and foreign investment—in 2008, for financial institutions, from 39.6 to 37.0 percent, and for other sectors, from 35.0 to 30.0 percent.
- The contribution of indirect taxes to GDP, notably the VAT, also decreased, reaching 7.8 percent in 2018.

In 2018, Morocco's total tax revenue represented 21.9 percent of GDP, and although it was greater than that in the Arab Republic of Egypt (14.2 percent) and Jordan (15.8 percent), it was below Tunisia (23.3 percent), Algeria (27.1 percent), and the OECD average (24.6 percent) (figure 4A.7, in annex 4A). Moreover, almost 8 in 10 workers

FIGURE 4.8

Share of Structure of Taxes and Tax Revenue, Morocco



Source: Based on data from OECD statistics database.
 Note: GDP = gross domestic product; VAT = value added tax.

and most enterprises are informal and, thus, do not pay taxes. As a result, the tax burden is unusually high, falling on a small number of contributors, mainly taxable formal private and public salaried workers and large firms. This makes the informal-to-formal transition costly, possibly discouraging formalization among workers and enterprises.

Moreover, the Ministry of Economy and Finance and the CNSS are responsible for collecting taxes and social security contributions, respectively, which often leads to subpar enforcement. This is because communication and information exchange between the two authorities is weak, increasing the likelihood of arbitrage, fraud, and evasion. In 2019, the ministry noted that while only 33 percent of companies reported profits, as much as 73 percent of them paid the minimum tax bill (Ministry of Economy and Finance 2019).

PERSONAL INCOME TAX

The PIT is levied on individuals' income (if their earnings are above the minimum wage) and profits of companies (that have not opted for the CIT). It is levied on income from wages, salaries, pensions, annuities, other sources of personal income derived from individual assets (such as real estate), returns on investment, agricultural revenues, and the income of businesses that are outside the CIT regime (mostly professionals who are self-employed) (figure 4.9, panel a).

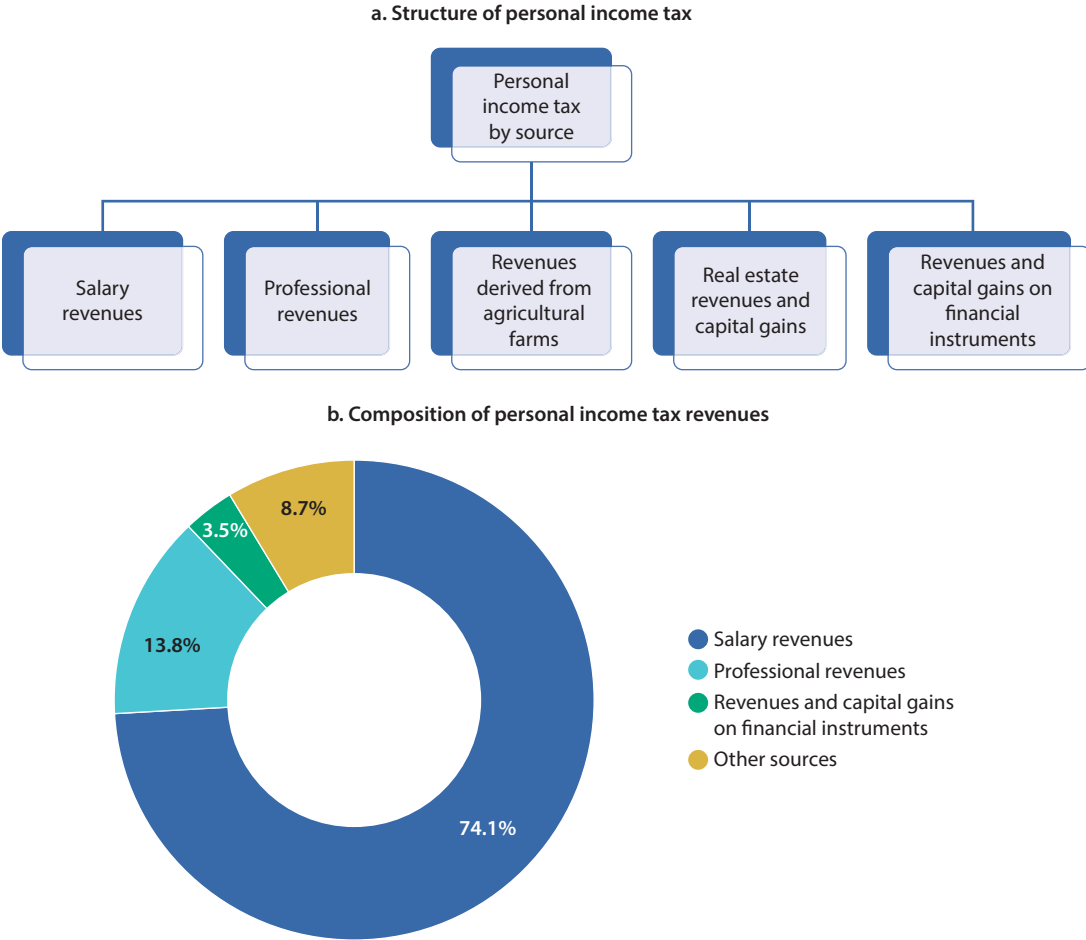
In 2018, formal employees contributed the most. Taxes levied on salaries and wages represented 74.1 percent of PIT revenues, 13.6 percent of total tax revenues, and 3.9 percent of GDP, which is high compared to the average developing country (2.5 percent of GDP) (IMF 2022). Moreover, professional revenues and capital gains derived from financial instruments represented 13.8 and 3.5 percent of total PIT revenues, respectively, while the remaining 8.7 percent was ascribable to both real estate and agricultural revenues (aggregated as "other sources") (figure 4.9, panel b).

The marginal PIT rate jumps significantly around the minimum wage, which may disincentivize formal employment among low-wage workers. As shown in figure 4.10, workers with an annual salary below or at the minimum wage (DH 2,500, or US\$278) are not subject to PIT obligations. Thereafter, the marginal tax rate jumps to 10 percent, with a progressive increase reaching 38 percent for monthly incomes above DH 15,000 (US\$1,668.5) (DH 180,000, or US\$20,022, per year). The increase at the bottom of the PIT schedule might generate an incentive to be informal among low-wage workers or to declare a monthly wage below or equal to the minimum wage.

Although it is not possible to estimate the share of formal workers earning the minimum wage or less (due to limited access to data on wages), as of 2018, informal employment accounted for as much as 65 percent of wage employment in the private sector. This means that at least 2.8 million informal workers did not pay social security

FIGURE 4.9

Share and Composition of Personal Income Tax, Morocco, 2018



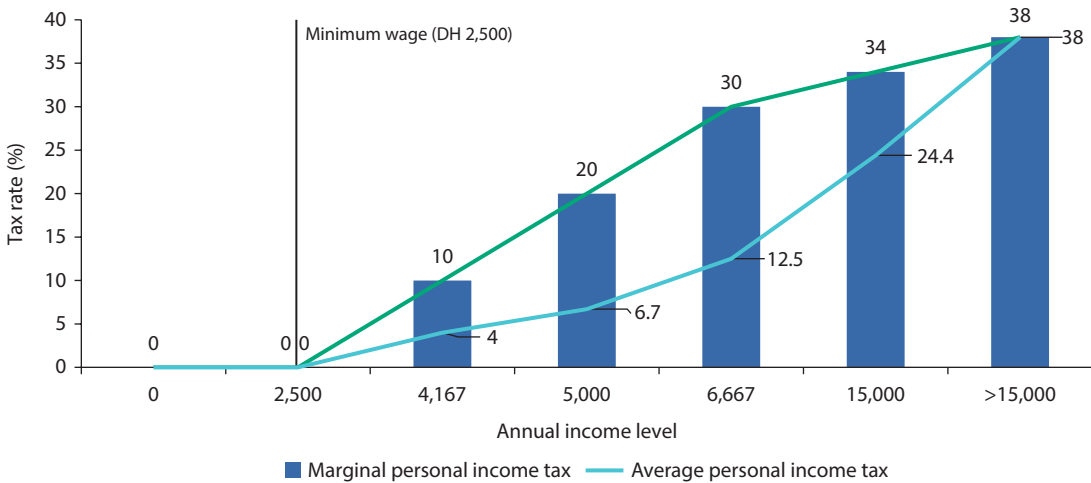
Sources: Panel a, based on data from PricewaterhouseCoopers; panel b, based on data from the Organisation for Economic Co-operation and Development.

contributions or the PIT. As a result, the PIT burden among salaried workers falls on just a few formal employees who earn above the minimum wage, while the rest are exempt or evade. In 2017, 95 percent of tax revenue coming from wages was paid by formal employees operating in 11.5 percent of companies registered with the tax authorities (Economic, Social, and Environmental Council 2019).

Widespread exemption from and evasion of taxes influence the informal/formal divide in several ways. First, wage workers earning the minimum wage or less may decide to be informal due to the functioning of the social insurance system (as discussed in the section

FIGURE 4.10

Marginal and Average Tax Rates by Monthly Income, Morocco, 2018



Source: Based on data from Ministry of Economy and Finance.

on Realm 1). Second, workers earning above the minimum wage are liable to pay the PIT, while their employers are liable to pay social insurance contributions. These costs may further encourage evasion and informal employment for workers and employers trying to reduce individual and firm costs, which, in such cases, represent the nonpoor proportion of informal wage earners in Morocco. The inefficient and inequitable market outcome leads to a sizable proportion of high-wage workers opting for informality, thus not contributing to social security and evading taxes, while potentially benefiting from inexpensive social protection under noncontributory regimes or purchasing private health insurance.

The revenues from self-employed professionals fall under a more favorable tax regime compared to salaried workers. These individuals operate within three groups: (1) commercial, industrial, and craft professions; (2) real estate professions (such as real estate developers, land developers, and property traders); and (3) liberal professions, including doctors, lawyers, and architects. Unlike salaried workers, where taxes are deducted at the source by employers, those falling under the professional revenues PIT regime must declare their revenues—and they will be subject to one of three professional PIT regimes, which offer preferential tax rates according to the type of business and amount of turnover (table 4.6).¹²

TABLE 4.6

Professional Income Tax Regimes, Morocco, 2018

| Professional activity | Real net income regime (DH) | Simplified net income regime (DH) | Fixed-benefit regime (DH) |
|---|-----------------------------------|--------------------------------------|-------------------------------|
| (1) Commercial professions, industrial or craft activities, owner of a fishing boat | Turnover less than 2 million | Between 1 million and 2 million | Turnover 1 million or less |
| (2) Real estate professions | Turnover greater than 0.5 million | Between 0.25 million and 0.5 million | Turnover 0.25 million or less |
| (3) Liberal professions | | | |

Source: General Tax Code, 2022.

Morocco has introduced special regimes to promote entrepreneurship in specific sectors, by providing large tax incentives to individuals who start a business.¹³ The following are examples:

- *Auto-entrepreneur status* came into effect in 2015, with the objective of reducing informal activities and encouraging access to the labor market through self-employment. This status potentially covers self-employed people and those who want to start a new self-employed activity—but not regulated professions (like lawyers, health care practitioners, or notaries).¹⁴ The ceilings for eligibility are (1) DH 500,000 (US\$55,617) for commercial, industrial, and artisanal activities; and (2) DH 200,000 (US\$22,847) for services.¹⁵ The former pay 1 percent on revenues, and the latter, 2 percent. They are exempt for 5 years from the start date, and they do not pay the VAT.¹⁶
- *Full tax exemption for small farmers* is available to those whose turnover is less than DH 5 million (no PIT or CIT obligations). If annual turnover exceeds the threshold, they must pay the PIT and CIT for that year and the following three years, albeit at a preferential rate.¹⁷
- *Large farms* can benefit from lower tax rates if turnover exceeds a certain threshold.¹⁸

These special regimes further incentivize legal informality. They entice salaried workers into self-employment to benefit from the lower tax rates offered under the special regimes, while sacrificing their access to social insurance, as CNSS laws have so far excluded the self-employed. The special regimes also do not encourage the self-employed to grow, given that once revenues exceed a certain threshold, they are liable to a less favorable tax regime and might end up with lower post-tax profits. Taken together, although such schemes can increase the number of workers registered with the tax authorities, they do little to

insure workers against risks and do not promote the affiliation of workers to CNSS—or encourage the self-employed to grow, structure their company, hire formal workers, and pay the CIT.

CORPORATE INCOME TAX

The CIT is levied on the turnover of corporations, private limited liability companies, public institutions, and other legal entities that carry out profit-making operations. The marginal tax rates, based on companies' net profits, range from 10 percent for firms with annual net profits of less than or equal to DH 300,000, to 31 percent for firms with net profits equal to or more than DH 1,000,000 (equivalent to about US\$111,235) (table 4.7). In addition, expenses incurred in the operation of the business are deductible unless specifically excluded. The CIT cannot be lower than a minimum contribution of 0.5 percent (or 0.25 percent for specific products) levied on the turnover and other specific revenues. The minimum contribution is not due during the first 36 months once activities have begun—but it rises to 0.6 percent when, beyond the 36-month exemption period, the current result, excluding amortization, is declared negative for two consecutive fiscal years.

There are multiple special CIT regimes for specific types of companies to attract industrial investors, both domestic and foreign:

- *Export sector.* Exporting companies receive a full exemption from the CIT for 5 consecutive years and a reduced tax rate of 17.5 percent applied to the part of net profit that exceeds DH 1,000,000 (equivalent to about US\$111,235) for the subsequent years (this rate was raised to 20 percent under the 2020 Budget Law).
- *Free trade zones.* These pertain to companies that operate in industrial export acceleration zones. The main tax advantage for companies in this group is total exemption from the CIT during the first 5 financial years from the date of the start of operation—and a tax rate of 8.75 percent for the next 20 consecutive years.

TABLE 4.7

Marginal Income Tax Rate and Net Profit of Companies, Morocco, 2018

| Marginal income tax rate (%) | Net profit of companies (DH) |
|------------------------------|------------------------------|
| 10 | 0 to 300,000 |
| 20 | 300,001 to 1,000,000 |
| 31 | 1,000,001 and above |

Source: Based on data from PricewaterhouseCoopers.

- *Hotel companies.* These are exempt from the CIT on foreign currency turnover for the first 5 years—and they have a preferential CIT rate of 17.5 percent on the part of their taxable base corresponding to foreign currency turnover.

The problem for Morocco is that CIT special regimes divert the tax burden onto a small share of large formal enterprises under the general regime. Multiple corporate tax regimes that offer companies different CIT schedules based on turnover encourage fraud among those that want to stay or appear small and not declare their true turnover, so that they can pay lower taxes. If the tax authorities were to increase enforcement and monitor firms more stringently, firms could split into several separate legal entities and report lower turnover to pay less taxes. Such fraudulent behavior is already apparent, exemplified by the fact that a very small share of companies pay the CIT. In 2017, 95 percent of corporate tax revenue was covered by only 6.1 percent of firms registered with the tax authorities.¹⁹ Overall, the current CIT system taxes large, productive firms that are most likely to create formal jobs, while subsidizing firms that are motivated to stay small and at a lower productivity level with little scope for creating formal jobs, thereby encouraging informality.

VALUE ADDED TAX

The VAT is due on all industrial, commercial, and handicraft transactions taking place in Morocco, as well as on importation operations. It is the main indirect tax and largest contributor to tax revenues in Morocco (38.8 percent in 2018). It follows the so-called credit-invoice method and is a noncumulative tax levied at each stage of the production and distribution cycle. Thus, suppliers of goods and services must add the VAT to their net prices. Where the purchaser is also liable for the VAT, the input VAT may be offset against the output VAT. Although the VAT is ultimately borne by the consumer by being included in the price paid, the responsibility for charging, collecting, and paying it to the tax authority at each stage of the process rests with the business making the supply. As of 2018, five VAT rates were applied in Morocco (one standard and four reduced rates):

- The standard VAT rate is 20 percent, applicable to most goods and services.
- The first reduced VAT rate, which has the right of deduction, applies 7 percent to certain daily use goods, such as powdered milk, pharmaceutical products, and water supplied to various public utility networks.

- The second reduced VAT rate, which has the right of deduction, applies 10 percent to certain food products, beverages, tourism sectors and hotels, tourist establishments, and financial operations.
- The third reduced VAT rate, which has the right of deduction, applies 14 percent to nonartisanal butters, passenger and freight transportation, and electric power.
- The fourth reduced VAT rate, which does not have the right of deduction, applies 14 percent to all services of insurance agents.

The main downside of the VAT system is related to exemptions offered to those falling under the special regimes (like auto-entrepreneurs). It creates an incentive for them to remain small and pay lower taxes, and it discourages firms in the real regime from exchanging with them. This is because goods and services purchased from the self-employed under a special regime cannot be included in the calculation of the deductible VAT. As a result, those under the special regime trade mostly with other informal firms or sell to final consumers. The lack of exchange and competition between individual enterprises in the real and special regimes hinders connections between micro or small and medium or large enterprises—thus preventing technical and technological knowledge transfer, and inhibiting economies of scale, growth, and the creation of formal jobs.

REALM 3: MARKET CONDITIONS

The “market conditions” realm comprises a complex set of dimensions that directly affect the number, size, and productivity of firms, and their interactions with Realms 1 and 2 contribute to determine the social protection, poverty, and inequality outcomes of individuals and their households.²⁰ This section focuses on three areas that affect the entry, exit, and growth of private sector firms: (1) registration procedures and costs, (2) enforcement of credit and commercial contracts, and (3) competition in the product market. These areas primarily draw on the World Bank’s Doing Business report, which covers 12 areas (“dimensions”) of business regulation (World Bank 2021), and on findings from the Enterprise Survey (2019/2020).

Registration Procedures and Costs

Morocco achieved a high score on the “starting a business” dimension of doing business, scoring 93.0 out of 100 and ranking 43rd in the

world, higher than MENA (84.0) and even the OECD average (91.3). The exceptional performance reflects two policy interventions: (1) creation of a one-stop center called the Regional Investment Center (Centre Régional d'Investissement), which pools together procedures related to social security (2002), taxes, and business registration; and (2) abolishment of the minimum capital requirement for a minimum liability cost (2013). Overall, starting a business is an efficient process that has fewer steps, takes less time, and is inexpensive compared to regional peers. It consists of 4.0 procedures, compared to 6.5 in MENA; takes an average of 9.0 days, compared to 20.3 days in MENA; costs around 3.6 percent of income per capita, compared to 16.7 in MENA; and has no minimum capital requirement, compared to almost 9.0 percent of income per capita in MENA.

On the “registering a property” dimension, Morocco scored 65.8 out of 100, outperforming MENA (63.4) but notably less than the average for OECD countries (77.0). This process takes an average of 20 days, has 6 procedures, and costs 6.4 percent of the property value, while in MENA, there are slightly fewer procedures (5.4) and it is cheaper (5.6 percent of property value), but the process takes significantly more time (26.6 days). Moreover, buying and registering land remains a severe constraint on doing business for all types of firms in Morocco—domestic or foreign, and small or large (World Bank 2021). This is driven by a multitude of regulatory inefficiencies caused by a complex land tenure system, diverse land management regulations, and inadequate land administration.

Enforcement of Credit and Commercial Contracts

Despite some improvement in the financial system—notably, the introduction of credit scores in 2017—accessing finance remains one of the biggest challenges for firms. Indeed, Morocco achieved its lowest score in the “getting credit” dimension of doing business, scoring 45.0 out of 100 and ranking 119th in the world, slightly better than the MENA average (41.8) but far worse than the OECD (64.3). The two metrics of this dimension on which Morocco performed particularly poorly were “strength of legal rights index” and “credit registry coverage.” For the former, which measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders, Morocco scored 2.0 (out of 12.0), while MENA scored 3.1, and the OECD scored 6.1. For the latter—which reports the number of individuals and firms listed in the credit registry as a percentage of the adult population, and thus acts as a measure of the strength of credit-reporting systems—Morocco scored 0 (percent of adult population), significantly less than MENA’s

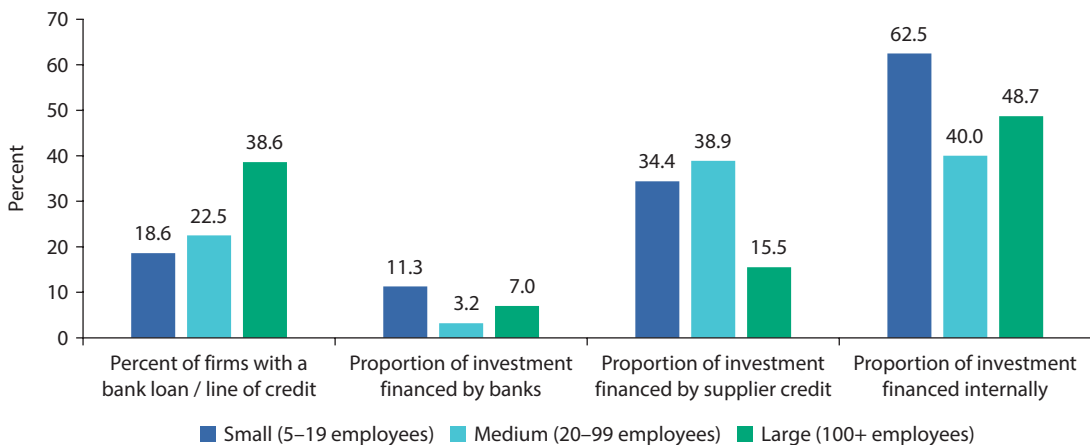
15.8 and the OECD’s 24.4. While getting credit is difficult for all firms in Morocco, it is particularly challenging for the smallest ones, which mostly rely on internal sources of finance (figure 4.11).²¹

What happens when there are commercial disputes? With an overall score of 63.7 (out of 100.0), Morocco performs well, exceeding MENA (56.0) but still lagging aspirational leaders, such as the OECD (67.8), on the “enforcing contracts” dimension. However, the overall score masks significant differences in quality within this element. Although settling commercial disputes is fast in Morocco—taking 510.0 days, compared to 622.0 days in MENA and 589.6 days in the OECD—it is a relatively expensive process, costing 25.6 percent of the claim value, compared to 24.7 percent in MENA and 21.5 percent in the OECD.

The most prominent shortcoming is related to the “quality of judicial process index,” which measures the efficiency of the court structure and proceedings, case management, court automation, and alternative dispute resolution. Morocco scored 9.5 out of 18 (compared to the OECD’s 11.7). One problem is that the congestion of the courts slows down the settlement of disputes. Another is that issues related to the commercial court system are overburdened by the volume of cases, and court sessions often require judges to render decisions and rulings on multiple cases in a single hearing. The simultaneous resolution of cases that are relatively small in terms of financial interest (like default cases) and those that are economically more important are also problematic.

FIGURE 4.11

Use of Credit, by Firm Size, Morocco, 2019–20



Source: Based on data from the Enterprise Survey, World Bank.

On the “resolving insolvency” dimension, Morocco scored 52.9 (out of 100)—which is significantly higher than MENA’s weak performance (34.5) but far less than the OECD (70.2). It takes 3.5 years and costs 18 percent of the estate to resolve an insolvency in Morocco, compared to 1.7 years and 9.3 percent of the estate in the OECD. Recovery rates in Morocco remain comparable to the regional average but significantly lower than the OECD (70.2 cents per US\$1). Although Morocco has taken steps to make resolving insolvency easier (like encouraging the continuation of the debtor’s business during insolvency proceedings), such changes are barely reflected in its score.

Competition in the Product Market

State-owned enterprises (SOEs) monopolize most sectors in Morocco and benefit from privileges that are unavailable to competitors, thereby limiting private sector contestability. There are approximately 725 SOEs—including 210 statutory public establishments and 515 limited liability companies of which the state is the ultimate owner and over which it exercises partial or total control (World Bank 2019). A World Bank survey shows that nearly 23 of 29 surveyed sectors in Morocco had at least one SOE. Examples include the following:

- The National Office of Electricity and Drinking Water, which is an SOE, dominates the electricity sector in generation, distribution, and transmission of electricity—distributing electricity to nearly 55 percent of the population.
- In the banking sector, the top three banks hold two-thirds of the banking system’s assets.
- In telecommunications, competition in fixed broadband is weak, with Maroc Telecom (which is 22 percent state-owned) holding a market share of 89 percent of fixed lines, as of September 2018.

Importantly, Moroccan SOEs deliver commercial goods and services, often in direct competition with private sector firms. In the absence of structural or accounting separation between commercial and noncommercial activities, SOEs can use the revenues from noncommercial activities to cross-subsidize commercial activities where they face private competition (World Bank 2019). Although SOEs are subject to the VAT, some are exempt from corporate taxes and may enjoy parafiscal tax revenues instituted for their benefit. Such privileges discourage firms from entering some markets, as the probability of survival is low and the potential profits are small.

Domestic market contestability is further stifled by cronyism and the privileges enjoyed by some operators, making it hard for young firms to enter markets. Many of Morocco's lucrative industries remain in the hands of a few families, competing on an uneven playing field with smaller businesses that face high barriers to entry (Saadi 2016). About 7 percent of Moroccan firms are politically connected and have access to privileges that deter new firms and inhibit unconnected firms from growing (Islam, Moosa, and Saliola 2022). Economic activity is driven mostly by established firms rather than new ones—with total revenues from large, listed companies representing 31 percent of GDP—and mostly in a limited number of nontradable sectors (like construction, real estate, and commerce) with low potential for quality job creation and value addition (IFC 2019).

However, Morocco has made some progress on two fronts:

- *Promoting private sector participation.* It has opened several traditional government activities (like water and electricity distribution and management of nonhazardous waste) to private domestic or foreign operators via delegated management or concession arrangements. These activities generally have tendering procedures.
- *Regulating SOE activities.* It has established a Code of Good Corporate Governance Practices. This requires greater use of standardized public procurement and accounting rules, outside audits, inclusion of independent directors, board evaluations, more transparency, and better disclosure. Various governance-related initiatives—like multiyear contracts with major SOEs—also aim to enhance performance and transparency.

Price controls, which span markets where competition is typically viable, may further distort the incentives of private firms to participate in such markets and provide quality goods and services. In Morocco, the law allows businesses ample freedom to apply price controls; this undermines the general principle of freedom of prices. Price controls include not only those established by decree—which can cover virtually any product or service—but also those requested by business or professional associations.

As of 2019, for example, price control regulation in retail remained in place for 12 products/services, including (1) the energy sector (electricity and butane gas), (2) transportation (urban/interurban), (3) staples (drinking water, sugar, flour, pharmaceutical products, detergent, and tobacco), and (4) regulated professional services (notaries, medical, and judicial services) (World Bank 2019). Moreover, some of these price-controlled products (like transportation, sugar, and flour) remain

heavily subsidized, causing further distortions of consumption patterns and a bigger burden on public expenditures. Thus, to encourage competition, growth, and formal job creation, it is important that the government limit exemptions from the application of the Competition Law, especially for potential abuses of dominance and nontransitory price controls.

CONCLUSION

After an in-depth review of informality in Morocco—through an institutional lens—what are the key takeaways for the country in its pursuit of a sustainable, inclusive growth path? Here, it is useful to look at what each of the three realms has highlighted.

Realm 1: How the Social Protection Institutions Affect Informality, Poverty, and Inequality

The system of contributory social insurance has design features that can incentivize informal employment. The legal framework mandates salaried workers to contribute to social insurance, whereas own-account workers and employers were not required to do so before the recent, and still ongoing, reform aimed at extending health insurance to all citizens. This means that about 1 in 2 workers are legally informal. More specifically:

- *Contributory health* insurance provides access to a range of services and medicines through public and private clinics, with a refund rate capped at 70 percent of the legal tariff when opting for ordinary treatments through private providers. Yet the public health system is characterized by several shortcomings, including a limited supply of health care and an unequal distribution of providers and human resources between urban and rural areas and across regions. Consequently, physical access to hospitals remains problematic for the population, and workers are usually confronted with long waiting lines and low-quality treatments.
- *Retirement pensions* are more than actuarially fair. However, the discontinuity introduced at 10 years of contributions imposes a de facto tax on workers with short formal careers.

The minimum wage and potentially lengthy dismissal procedures increase the cost of hiring formal private sector workers. A big part of the problem is that the minimum wage is set at a high level relative to the average, which does not help the formal recruitment of workers whose productivity

level is very low or unknown (such as in the case of first-time job seekers). Further, firing costs are a sizable share of an employee's wage, which rise the longer the employee stays with the firm—and dismissal procedures can be complex and lead to uncertainty if the employer and worker fail to reach an agreement and appeal to the courts. These factors might favor the informal hiring of workers if employers want to have more leeway in adjusting the size of the workforce in case of shocks—especially given that some workers might assign a low value to contributory social insurance.

Contributory social insurance has mixed effects on inequality. There are two channels by which social insurance can deliver redistribution: high- to low-wage workers and firms to workers. In Morocco, there are limitations that make any redistribution likely to be small:

- There is a wage ceiling above which salaried workers do not pay contributions for retirement pensions.
- Low-wage workers are more likely to have a discontinuous career and not meet the minimum contributions required to be eligible for a pension benefit, thus redistributing resources from low- to high-wage workers.
- Health insurance does not cover all the costs of services (except for chronic diseases), and sizable copayments penalize low-wage workers relatively more than high-wage ones.
- Depending on the functioning of the labor market, firms might be able to shift the cost of contributions to workers in the form of a lower wage, thus reducing the extent of redistribution in the right direction.
- Firms' owners are likely to have higher incomes than workers in medium-size and large firms, which are few in Morocco, thus limiting the extent of income redistribution from low- to high-income individuals.

The interaction between contributory and noncontributory social insurance contributes to lower the value of formality. Although resources allocated to the Ministry of Health have increased since the introduction of RAMED, the total allocation is still well below what is needed to address the needs of a rising number of beneficiaries without deteriorating the supply of public primary health care. Waiting times for care have risen, along with a decline in the quality of health care provided. This is potentially an important disincentive to formal employment, particularly among low-wage workers who cannot afford to use private health care providers, thus decreasing the value of contributing to health insurance under the CNSS.

Realm 2: How the Tax System Impacts Formal Job Creation, Productivity, and Growth

Because of the limited tax base, the tax burden is relatively high and does not incentivize formality. The share of tax revenue in GDP is slightly less than the share of OECD countries. But due to the limited number of taxpayers—largely formal salaried workers with a salary higher than the minimum wage and enterprises under the CIT real regime—the average tax burden is high. This is especially so given that the formal sector must also pay social security contributions. Thus, the expectation of a relatively high tax burden (under the income tax or in the form of social security contributions) encourages tax evasion and makes transitions from the informal to the formal sector costly and unappealing. This is coupled with inefficiencies and a lack of tax administration resources that reduce the probability of being caught and sanctioned.

The complexity of Morocco's tax system undermines formalization, particularly among the self-employed. A significant proportion of the overall tax system is based on self-declaration of income or revenues, which applies to the self-employed and those under corporate tax regimes. This design encourages fraud by means of tax evasion and arbitrage, as workers under professional regimes or corporate tax regimes have an incentive to under-report revenues to pay less tax while also benefiting from fewer social contributions. For instance, the contribution of professional workers to tax revenue was very low (13.8 percent of PIT revenue), compared to that of formal salaried employees (74.1 percent), in 2019. Taken together, the incentive structure created by the current design of the tax system encourages the self-employed to keep revenues below a particular threshold, stay small and unproductive, and create few formal jobs.

The tax system offers VAT exemptions to own-account workers under a special regime, hurting firm growth and formalization. The VAT is applied under the credit-invoice method: firms selling intermediate inputs issue invoices including the VAT, and buying firms deduct the VAT paid on intermediate inputs so that consumers of final goods only pay tax on value added. However, most informal firms are not registered with the tax authorities, and when they are, they usually pay taxes under special regimes, which may impede them from selling to formal firms because they cannot issue invoices. The interface between these regimes and the VAT implies that informal firms (including “auto-entrepreneurs”) can sell only to other informal firms or to final consumers, reducing the VAT revenues while increasing the appeal of informality and remaining small to firms (particularly for self-employed workers who benefit from preferential tax rates). Moreover, the lack of exchange and competition with formal firms hinders connections between micro or small and

medium-size or large enterprises, thus preventing technical and technological transfer and inhibiting economies of scale.

Realm 3: How Market Conditions Impact Formality, Firm Size, Productivity, and Growth

Registering a business is straightforward and unlikely to hurt firms' formalization decisions. The more complex, lengthy, and costly the procedures necessary to register and comply with the law are, the less attractive and likely it is that micro and small firms will comply with the law and operate formally. In Morocco, starting a business is an efficient process with just a few steps, low costs, and no minimum capital requirement.

Difficulty accessing credit is a major constraint for all Moroccan firms, especially small ones. When it is cumbersome and expensive to access finance, firms may prefer to keep control of their assets and remain unincorporated and avoid the risk being impounded if they have a credit contract. In such instances, it may be preferable for the business to hide under the radar of the law, use internal sources of finance, and transact only with trusted partners, incentivizing firms to stay small, at low productivity levels, and informal. In Morocco, accessing finance is a primary constraint for private sector firms, and the rights of borrowers and lenders are poorly enforced, thereby hindering the ability of firms to grow and create formal jobs.

There is significant room for improvement in resolving commercial disputes. Well-functioning judicial systems and strong commercial contract enforcement directly affect the level of security and integrity of the economic transactions of formal firms. Better enforcement corresponds to lower transaction costs and more incentives to operate formally. Although resolving commercial disputes is typically a quick process in Morocco, it is expensive compared to regional peers, and the quality of the judicial process is very low, thereby decreasing the advantages of operating formally and beyond a trusted network of suppliers and clients.

Coupled with cronyism, SOEs and price controls stifle competition in Morocco's product markets. Product market competition is related to firms competing on an even field and speaks to the cost that firms face when starting operations in a market for specific goods or services and when they interact with existing firms. In Morocco, the presence of SOEs and monopolies, often in sectors where there is no rationale for their presence, combined with price controls, dissuades firms from entering markets or pushing inefficient production units out of markets. The result is fewer firms, lower productivity, and less formal job creation. In addition, Moroccan cronyism in the form of politically connected firms further undermines market contestability and fair competition through preferential access to credit, unfair competition and contract enforcement, and access to sectors with barriers to entry.

ANNEX 4A: ADDITIONAL STATISTICS

TABLE 4A.1

Distribution of Private Sector Employees Declared to the CNSS, by Sex and Number of Months of Contributions, Morocco, 2019

| Number of months | Men | Share of men (%) | Women | Share of women (%) | Total | Share of total (%) |
|------------------|-----------|------------------|-----------|--------------------|-----------|--------------------|
| 1 | 115,404 | 66 | 60,328 | 34 | 175,732 | 5 |
| 2 | 97,358 | 66 | 49,831 | 34 | 147,189 | 4 |
| 3 | 87,528 | 64 | 48,646 | 36 | 136,174 | 4 |
| 4 | 76,691 | 65 | 41,230 | 35 | 117,921 | 4 |
| 5 | 76,398 | 67 | 37,664 | 33 | 114,062 | 3 |
| 6 | 107,051 | 68 | 50,864 | 32 | 157,915 | 5 |
| 7 | 78,767 | 65 | 42,062 | 35 | 120,829 | 4 |
| 8 | 66,943 | 66 | 35,085 | 34 | 102,028 | 3 |
| 9 | 78,843 | 66 | 40,987 | 34 | 119,830 | 4 |
| 10 | 101,118 | 63 | 59,536 | 37 | 160,654 | 5 |
| 11 | 155,882 | 64 | 87,198 | 36 | 243,080 | 7 |
| 12 | 1,185,245 | 69 | 527,661 | 31 | 1,712,906 | 52 |
| Total | 2,227,228 | 67 | 1,081,092 | 33 | 3,308,320 | 100 |

Source: Based on data from CNSS 2020.

Note: CNSS = National Social Security Fund.

TABLE 4A.2

Distribution of Private Sector Employees Declared to the CNSS, by Sex and Salary Bracket, Morocco, 2019

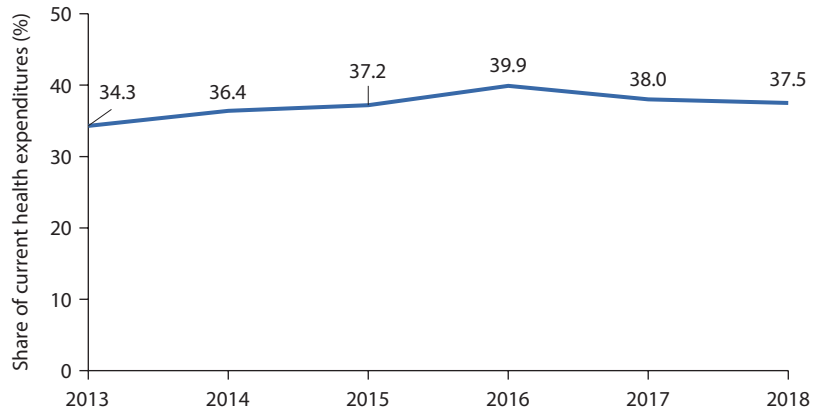
| Wage bracket | Men | % | Women | % | Total | % |
|--------------|-----------|------|-----------|------|-----------|------|
| 1–SMIG | 1,041,120 | 43.2 | 573,815 | 50.6 | 1,614,935 | 45.6 |
| SMIG–6,000 | 1,008,767 | 41.9 | 406,391 | 35.8 | 1,415,158 | 39.9 |
| 6,000–10,000 | 188,863 | 7.8 | 78,113 | 6.9 | 266,976 | 7.5 |
| > 10,000 | 171,485 | 7.1 | 75,909 | 6.7 | 247,394 | 7.0 |
| Total | 2,410,235 | 100 | 1,134,228 | 100 | 3,544,463 | 100 |

Source: Based on data from CNSS 2020.

Note: CNSS = National Social Security Fund; SMIG = legal minimum wage.

FIGURE 4A.1

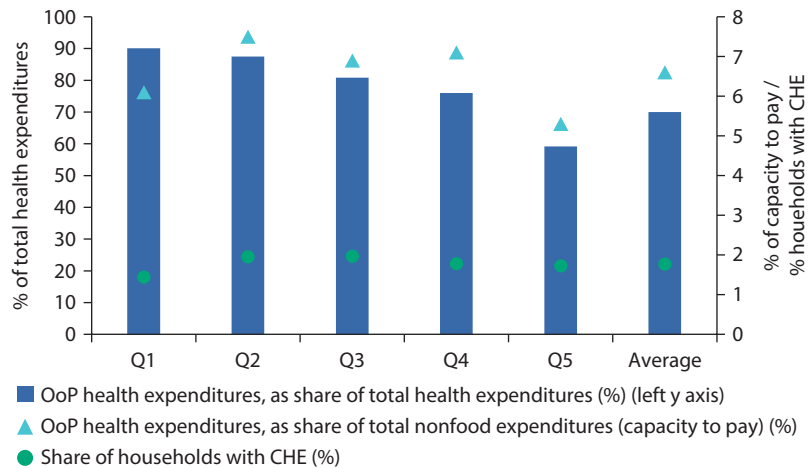
Trend in Out-of-Pocket Health Expenditures Paid by Private Formal Employees, Morocco, 2013–18



Source: Based on data from the National Health Insurance Agency.

FIGURE 4A.2

Incidence of Out-of-Pocket and Catastrophic Health Expenditures, by Quintile of per Capita Household Expenditures, Morocco, 2013–14

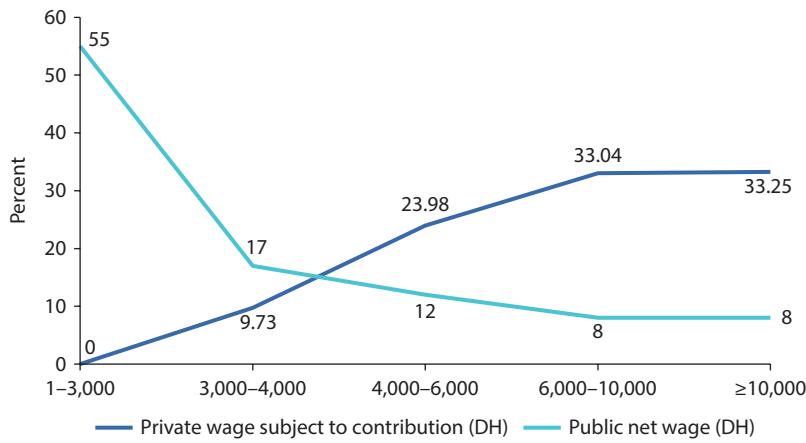


Sources: Based on data from the Household Consumption and Expenditures Survey 2013, High Commission for Planning of Morocco; Oudmane, Mourji, and Ezzrari 2019.

Note: CHE = catastrophic health expenditures; OoP = out of pocket.

FIGURE 4A.3

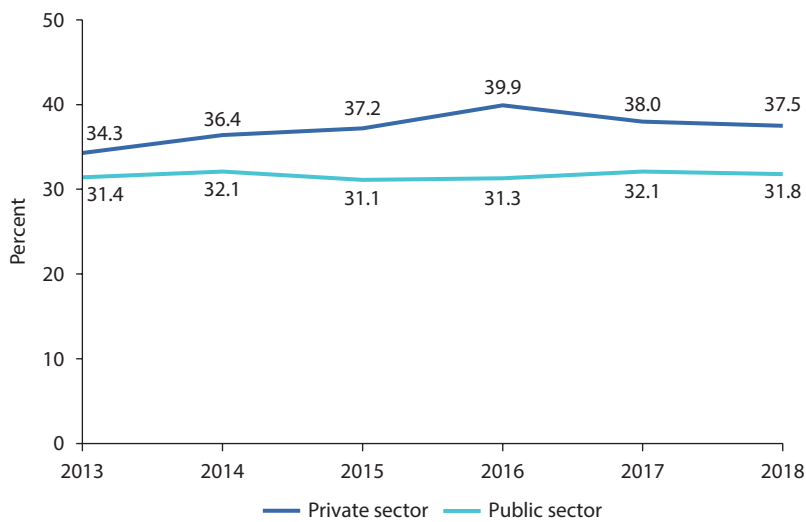
Distribution of Monthly Wages, by Sector, Morocco, 2019



Sources: Based on Budget Law 2020, Ministry of Finance; CNSS 2019.

FIGURE 4A.4

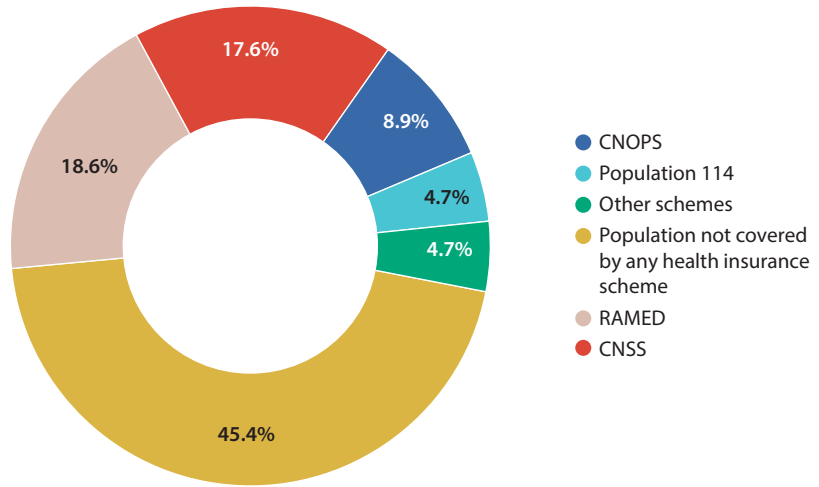
Trends in the Share of Medical Expenses Sustained by Individuals with Public and Private Health Insurance, Morocco, 2013-18



Source: Based on data from ANAM 2018.

FIGURE 4A.5

Distribution of the Moroccan Population, by Type of Coverage against Health Risk, Morocco 2016



Source: Based on 2019 data from the Ministry of Health.
 Note: CNOPS = National Fund of Social Welfare Organizations; CNSS = National Social Security Fund; RAMED = Medical Assistance Plan.

FIGURE 4A.6

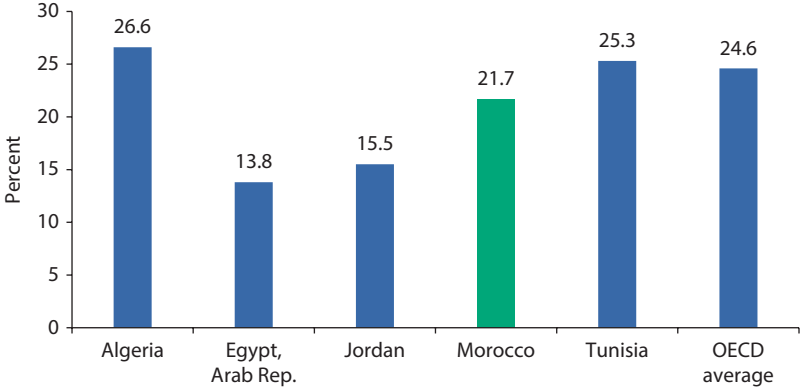
Distribution of Monthly Wages among Private Sector Formal Employees, Morocco, 2019



Source: Based on data from the Labor Force Survey, National Statistics Institute.

FIGURE 4A.7

Tax Revenues as a Share of GDP, Morocco, Regional Peers, and OECD Countries, 2018



Sources: Based on data from the International Monetary Fund; OECD.
Note: GDP = gross domestic product; OECD = Organisation for Economic Co-operation and Development.

TABLE 4A.3

Overview of Hiring Regulations, by Type of Contract, Morocco

| Sector | Type of contract | Trial period | Working hours | Overtime | Annual leave | |
|-------------------------|--|--|--|---|--|---|
| | Fixed-term contract (27% of salaried workers) | The company's internal rules and regulations | Agricultural activities 2,496 hours per year distributed by period according to the crops' schedules and activities | Between 6 am and 9 pm | Normal working day : 25% increase | 1.5 days after six months of work (applies for both contract) + 1.5 days for every 5 years of service (applies only to permanent contracts) The total duration of leave is 30 days |
| | | < 6 months: 1 day/week but not more than 2 weeks | Nonagricultural activities | | | |
| | | > 6 months: 1 month | 2,288 hours per year or 44 hours/week with a maximum of 10 hours per day | | | |
| | Permanent contract (59% of salaried workers) | Executives/professionals | 3 months | | Day of rest worked : 50% increase | |
| | | Employee | 1 month and a half | Between 9 pm and 6 am | Normal day: 50% increase | |
| | | Worker | 15 days | | Day of rest worked : 100% increase | |
| 14% of salaried workers | Temporary employment contract | 2 days if the contract is concluded for a period of less than one month 3 days if the contract is concluded for a period of between one and two months 5 days if the duration of the contract exceeds two months | 3 months, extendable once in case of expansion of the company's activity 6 months, nonrenewable, for the performance of seasonal work and work for which a permanent employment contract is not usually concluded due to the nature of the work | The same legal provisions applies as for the permanent and fixed-term contracts | 2.5 days for one month of actual work 2 days if the employee is a minor | |
| | ANAPEC contract or professional integration contract | The candidate is considered a trainee and not an employee The trainee may leave the company at any time without notice | Labor Code applies (as for fixed-term and open-ended contracts) The maximum duration of the contract must not exceed 24 months | | | |

Source: Original table for this publication.

Note: ANAPEC = National Agency for the Promotion of Employment and Competencies.

TABLE 4A.4

Overview of Firing Regulations, by Type of Contract, Morocco

| Type of contract | With damages | Without damages | Redundancy payments |
|---|---|--|---|
| Fixed-term contract | Premature breach of contract: Payment of damages equivalent to the amount of the wages for the period from the date of the breach of contract until the end of the contract. If any of the two parties proceeds to an abusive breach of contract, the injured party has the right to claim for damages. | The employee may be dismissed without notice or compensation for several reasons: - Dismissal for cause (serious misconduct) - Disciplinary dismissal - Economic dismissal Technological or economic reasons (procedure extremely regulated by article 66 to 71 of the Labor Code) | Premature breach of a fixed-term contract by one of the contracting parties, which is not due to serious misconduct of the other party or force majeure, shall result in payment of compensation in the amount of wages corresponding to the period from the date of termination of the contract to the term specified in the contract. |
| Permanent contract | Unilateral termination of an open-ended contract subject to a notice period. Applicable in case of failure to comply with the notice period, which obliges the party responsible for the failure to comply to compensate the other party. | | In case of dismissal after six months of work in the same company, regardless of the type of remuneration and frequency of payment of wages. The amount of dismissal compensation for each year or fraction of a year of actual work shall be: — 96 hours salary for the first five years of seniority — 144 hours pay for the period of seniority from the 6th to the 10th year — 192 hours pay for the period from the 11th to the 15th year — 240 hours for the period after the 15th year (Article 53 of the Labor Code) Compensation for damages (1.5 months salary per year worked up to a maximum of 36 months (24 years of service). |
| Temporary employment contract | The employer may breach the employment contract without notice or compensation. | | No compensation |
| ANAPPEC contract or professional integration contract | The employer may dismiss the intern without notice or compensation. | | No compensation |

Source: Original table for this publication.

Note: ANAPPEC = National Agency for the Promotion of Employment and Competencies.

TABLE 4A.5

Special CIT Regimes and Their Advantages, Morocco

| Tax regime | Advantages |
|---|--|
| Free trade zones | Exemption from CIT for the first five years and taxation at a reduced rate of 8.75% for the following 20 years. |
| Casablanca Finance City | Exemption from corporation tax for the first five years and taxation at a reduced rate of 8.75% after the expiration of the exemption period. |
| Exploitation of hydrocarbons | Full exemption from corporation tax for a period of 10 consecutive years from the date on which any exploitation concession is duly put into production. |
| Newly created industrial activities | Industrial companies that carry out activities specified by regulation benefit from a full exemption from corporation tax for the first five years of exploitation. |
| Exports | Companies that export products or services, excluding recovered metals, and generate export turnover benefit from a full exemption from CIT on that turnover for a period of five years, and from taxation at a reduced rate of 17.5% upon expiration of this exemption. |
| Hotel companies | Exemption from CIT for five years and taxation at a reduced rate of 17.5% after the expiration of this exemption, for that part of their taxable base corresponding to their turnover in foreign currencies. |
| <ul style="list-style-type: none"> • Craft enterprises whose production is the result of essentially manual work • Private educational and vocational training establishments • Sports companies | Taxation at a reduced rate of 17.5% for the first five years following the start of operations. |
| Farms with a turnover of DH 5 million | Exemption from CIT for their agricultural income. |
| Agricultural operations | Reduced CIT for the first five years (17.5%). |
| Exporting mining companies | Reduced CIT of 17.5%. |

Source: Mondaq 2019.

Note: CIT = corporate income tax.

TABLE 4A.6

National, Regional, or Provincial Government Control across Sectors, Morocco

| Government control in sector | Yes | No | Organization |
|--|-----------|----------|---|
| Electricity generation, importing, transmission, distribution, and supply | X | | National Board of Electricity and Drinking Water (ONEE) |
| Production, importing, transporting, distribution, and supply of gas | X | | ONEE, National Petroleum Resources and Mines Board (ONHYM) |
| Fixed, mobile, and internet telecommunications services | | X | |
| Basic postal and courier services | X | | Barid Al-Maghrib |
| Rail transportation | X | | Office National des Chemins de Fer Marocains (ONCF) |
| Air transportation | X | | Royal Air Maroc |
| Road transportation, goods transported by road | X | | Société Nationale des Transports et de la Logistique (SNTL) |
| Maritime, freight, and passenger transportation | | X | |
| Operation of air transportation infrastructure | X | | National Airports Agency (ONDA) |
| Operation of water transportation infrastructure | X | | Société d'Exploitation des Ports (Marsa Maroc), Tanger Med Port Authority |
| Operation of road infrastructure | X | | National Highway Company of Morocco (ADM) |
| Operation of railway infrastructure | X | | Office National des Chemins de Fer Marocains (ONCF) |
| Water collection, treatment, and distribution | X | | Office National de l'Eau Potable, autonomous water distribution authority (RADEEMA) |
| Manufacture of tobacco products | | X | |
| Manufacture of refined petroleum products | X | | Société Nationale des Produits Pétroliers (SNPP) |
| Basic metallurgy | X | | AOULI mines |
| Manufacture of metal products, machinery, and equipment | | X | |
| Construction and repair of ships and boats | X | | National Agency of Ports (ANP) |
| Manufacture of railway and tramway locomotives and rolling stock | | X | |
| Manufacture of aircraft and spacecraft | X | | SMES: JV between RAM & Safran |
| Construction | X | | IDMAJ SAKAN, Al Omrane (HAO), Cements of Morocco |
| Wholesale trade, including of motor vehicles | X | | National Seed Marketing Company in Morocco (SONACOS) |
| Retail trade, including motor vehicles | X | | Maghreb Arab Trading Company (MARTCO), Beni Snassen Wine Cooperative (Vinicoop) |
| Accommodation and food and beverages | X | | Minimum wage |
| Other urban, suburban, and intercity passenger transportation | X | | CASA TRANSPORTS, RATS, RATAG, RATC, RATF, RATM, RATMA, RATR, RATT |
| Financial services activities, excluding central banking, insurance, and pension fund activities | X | | Crédit Agricole du Maroc Deposit and Management Fund (CDG) |
| Insurance, reinsurance, and pension financing | X | | Central Reinsurance Company (SCR) |
| Other business activities | | X | |
| Activities related to human health | X | | CH5 |
| Distribution and projection of cinematographic films | | X | |
| TOTAL | 23 | 7 | |

Source: Original table for this publication.

ANNEX 4B: KEY FINDINGS FROM CONVERSATIONS WITH MOROCCAN EMPLOYEES, OWN-ACCOUNT WORKERS, AND EMPLOYERS

Informal Employees

None of the respondents in this target group has a written contract with their employer. Agreements were purely verbal if details and conditions had been discussed at all. The respondents were willing to accept this because they had no knowledge about contractual processes, implicitly expected to be declared eventually, were promised a contract in the future, or they believed they had no other choice but to accept informal work to make a living. At the same time, most said that they would prefer formal employment and would be willing to pay into the system to receive benefits such as medical insurance, workers' protection, and pension if they had the economic means to do so.

Advantages of working informally. Only a few advantages of informal work were mentioned in the interviews, including more personal freedom and less commitment to employers, avoidance of the income tax, and the possibility of generating income—especially when access to formal jobs is limited. Some believe that they can earn more competitive rates or keep more of the money they earn.

Precarious working conditions and general disadvantages of informality. The vast majority of the respondents did not see any advantages to informal work due to its precarious nature. Examples of this are the inaccessibility of social security and health care services, usually low pay, inability to provide proof of employment to financial or other relevant institutions, inability to prove years of (informal) work experience, and unhealthy power dynamics between employers and employees.

Reasons to work informally. Despite the precarious nature of informal employment, many report finding themselves forced into it due to a lack of formal job opportunities (exacerbated by high competition and high turnovers in some sectors), low educational attainment or illiteracy, lack of formal work experience (potentially an informality trap), and unwillingness of employers to declare. Some have never worked formally, do not know how to find formal employment, or have simply accepted that this is the only mode of work accessible to them (it is considered the norm).

Own-Account Workers

The interviewees were from a variety of different freelance professions and sectors and demographic backgrounds and ranged in work experience between 1.5 and 50 years of practice.

Reasons for working informally as an own-account worker. Most of the interviewees perceived informality to be very common in their respective fields. While many cited a lack of access to formal salaried jobs (for example, due to high competition and/or low educational attainment), which impacted their decision to go freelance, others chose this mode of operation more deliberately. Those that did so mentioned the possibility of gaining valuable work experience, especially when first starting out in their careers.

Benefits of working formally. There seems to be a knowledge gap about the benefits that are available and accessible for registered self-employed workers. It was repeatedly mentioned that the process of formalization seemed overwhelming and unclear, and some had only recently found out about new regulatory changes that improve access to certain benefits, such as the National Social Security Fund (CNSS). Those who were not accessing benefits mentioned unstable and unpredictable income streams and a general lack of information on the relevant processes as the main reasons for failing to register.

Formalization. There seemed to be a general awareness of the negative impact of widespread informality on the Moroccan economy as well as a general interest in formalization—under the right circumstances. The respondents recognized the potential to grow their business through formalization, as many (registered) companies refuse to contract with informal entrepreneurs. What prevented some from taking the necessary steps were a lack of information, the added “financial risk,” and a lack of perceived institutional support for own-account workers. The associated bureaucratic process appeared lengthy, difficult, and inaccessible to some, while others perceived it as easy to follow based on the information provided by the government. Those who were interested in but lacking access to the correct information typically consulted their peers. It was also mentioned that “auto-employed” was a newly introduced status, which was not yet recognized everywhere and by everyone.

Business Owners

The business owners who were interviewed operate registered businesses and hire few employees; some had formal contracts and others did not. More specifically:

Reasons to hire informally. Financial and contractual reasons were the most widely mentioned motivations for not declaring employees. Some business owners also mentioned not having access to skilled workers and their own reluctance to cover the (financial) risk of hiring staff while not knowing whether they would be temporary or permanent. Some of the businesses operated on a seasonal basis, and

the owners complained about laws not being adept at their unique situation. The majority believed that the costs associated with hiring staff formally (for example, CNSS contributions) were too high. Some offered to pay for job-related medical expenses out of pocket. The business owners believed that the regulatory framework was too rigid and the processes were cost- and time-inefficient. There seemed to be little faith in government institutions, and some pointed to a preference for not attracting their attention.

Willingness to hire formally. The financial risk associated with hiring new staff seemed to be a significant barrier for the business owners. Some stated that they preferred testing employees first and were willing to declare them once they were sure that the employees were qualified to stay. Nonetheless, the interviewees spoke of the benefits of running legitimate businesses with appropriate declarations and protections.

TABLE 4A.7

Thematic Analysis: Codebook

| Global theme (answer): Enabling factors of informality in Morocco | | | |
|---|---------------------------|--|--|
| Theme | Basic theme / code | Description | Extracts from transcripts (translated from French to English) |
| Behavioral barriers/ beliefs | Present bias | Shortsighted thinking: favoring smaller, immediate rewards over larger ones in the future. | <p>"People working in the dark, prefer to continue without formalities, they say it's easier; ... and of course all the money comes back to them. They live day to day; ... they don't think about the future."</p> <p>"We live day to day, we save very little and we can't make plans. It just allows you not to starve."</p> <p>"No I do not have health insurance, it will cost me and I am in good health so for the moment I do not need it. I'll think about it when I get older."</p> <p>"I don't know, never thought of that [pension]. I'm still young and not yet married, so I don't necessarily think about it at the moment."</p> |
| | Status quo/ default bias | Subconscious preference for "business as usual," acceptance of informality as the norm. | <p>"It is very common, when you are offered a job, you are hardly ever told about a contract in general. It's not the first thing you ask for as an employee too. There are a lot of turnovers in the restaurant industry. You always have a trial period, after that we make you a transfer and then we check if you are sure to stay. The restaurant only works with cash."</p> <p>"No reason I just didn't have an opportunity, in my job it's common to work informally, ... so I just accepted the first opportunity I was offered. I don't know exactly how it [formalizing] happens, but it shouldn't be very complicated; ... I could find out on the internet I think, ... if not from my friends who have already done this. I just haven't tried to find out yet."</p> <p>"I didn't ask for a contract because that's how it is in this business, there is usually no contract. Besides, I know it's a temporary job since the little one will grow up and start going to school, so they probably won't need me in a few years."</p> |
| | External locus of control | Belief that own actions do not significantly impact one's life outcomes. | <p>"Informal work is common in Morocco, around me, in the medina for example, there is almost only that. Many of us are in need, we have no choice but to work informally. Nobody helps us, how are we supposed to do things right? It's impossible. I did everything to get my daughter to school, but despite that, she too has no formal job. We are condemned to live this way."</p> <p>"I missed opportunities because I was not lucky enough to be born into a wealthy family; ... it's hard to get out of this vicious circle. I have an informal status quite simply because the jobs offered to me are automatically without a contract."</p> <p>"There is nothing stopping me from working formally; ... when I started this new job on the assumption that I was going to work formally, but my employer has made me wait for 5 months so I have the hope that he will. Otherwise, I never had the idea of working informally. There is nothing better than things that are done in a legal way."</p> <p>"It depends, in this new government we see more active people, some things are changing for the better; ... Otherwise I do not feel that I have an influence on what happens in parliament, for example. I have no idea about these questions. There is a political illiteracy in Morocco which makes it normal for you not to have confidence. Nobody understands how it happens and politicians take advantage of it and complicate things. I don't trust them. For me everyone works for his own interest; ... they work for themselves and their children. They do nothing for people, like me, in difficulty. Nothing is done. I don't trust anyone; ... I don't even vote in elections. ... I don't trust anyone anymore; ... there is no change. I haven't believed in that for 33 years. I think even if people vote, they end up putting what they want. For me, whatever the result, there will be no change."</p> |

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TABLE 4A.7

Thematic Analysis: Codebook (continued)

| Global theme (answer): Enabling factors of informality in Morocco | | | |
|---|------------------------------|--|--|
| Theme | Basic theme / code | Description | Extracts from transcripts (translated from French to English) |
| | Desire to remain uncommitted | Preference for the autonomous use of one's time. | <p>"The advantages are that I keep a certain freedom, I have no obligations or fixed schedules, I can leave whenever I want if I don't like the job anymore. My hands are not tied."</p> <p>"It also suits me to work without a contract, because those who have a contract work from 8 a.m. to 6 p.m., it's difficult. Me, on the other hand, I don't work all day, it's more pleasant, I come when I want. Unless there is a very important event or client."</p> <p>"The first advantage is that I do not pay income tax. Nothing is taken away from your income. The second is that there is a certain flexibility in terms of working hours. What is also good about my work, in this center, is that the more the classroom is full, the more money I earn. I am paid according to the number of students. There is also the fact of remaining free, in a certain way you are not "committed" to your employer."</p> |
| Financial incentives | Tax (avoidance) | Inability or unwillingness to cover tax, health care or pension-related costs. | <p>"Just the tax system. ... I guess in most cases companies don't register so they don't pay taxes. Otherwise, there are no other apparent reasons in my opinion, I live in Rabat, it is a developed city where there are several registered companies."</p> <p>"In general, it is for contractual and financial reasons that I do not declare the rest of the employees."</p> <p>"But it also includes taxes, which makes it much less interesting."</p> <p>"I think not everyone can pay taxes, it depends of the case. Some can't afford it. I think we have to check the situation, some people are fighting just to eat."</p> <p>"None, because if he does not declare or does not declare the totality, it is that there is a reason; ... it is surely because he cannot afford to pay them. Between supporting oneself and paying taxes, the choice is quickly made."</p> <p>"In my opinion, entrepreneurs do not register because of the taxes to be paid. There are annual and monthly taxes; ... usually when you start you have very little funds, and you don't necessarily want to lose them in taxes; ... Especially since the first six months, in general, you don't earn almost nothing. It's true that the taxes are not excessive for the first 5 years, but it's still restrictive; ... it's still very difficult to create a project in Morocco in the sense that there is very little information around it. For support programs, for example, you really have to look for information. It's often word of mouth, or someone who knows someone. Even on the internet, when you type 'help startup Morocco,' for example, you will be offered huge investment programs that are not accessible. ... Access is often impossible, restricted and very competitive."</p> <p>"But to come back to the subject of invoices, sometimes I have problems with companies that do not accept invoices from auto-entrepreneurs... sometimes because of the VAT, which is only 1% for auto-entrepreneurs. I work with my clients with tax free, I do not have the right to add tax. As a result, it happens that the company's accountant does not accept my invoice. In this case, I go to other companies who sell me their invoices so that I can give them to my customers. I pay for them myself."</p> |

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TABLE 4A.7

Thematic Analysis: Codebook (continued)

| Global theme (answer): Enabling factors of informality in Morocco | | | |
|---|--------------------------------------|--|---|
| Theme | Basic theme / code | Description | Extracts from transcripts (translated from French to English) |
| | Competitive salaries | Some stay in informality because they believe their payouts to be larger than within formal employment (especially own-account workers). | <p>"Probably better paid; ... Informal work makes it easy to work and have a salary to survive."</p> <p>"I don't see any advantages, apart from my salary..."</p> <p>"For my part, I earn a salary that I would never have had if I stayed with my parents. ... I'm happy to earn money so that my parents can live well. I have no complaints either, I eat my fill and I feel good within this family."</p> |
| | Scarcity/ unstable income or revenue | Informality as a necessity due to economic constraints. | <p>"I'm the only one in this neighborhood, but usually there are a lot of women who work the same way as me, informally. There are pastry shops and bakeries that sell the same thing as me, but the prices are much higher, ... so people prefer to buy from us because they know that we don't have the means; ... they help us."</p> <p>"Yes, it is common, there are many street vendors like me. Especially in popular neighborhoods. Some have pick-ups and go to the small alleys of wealthy neighborhoods. It's normal, everyone buys juice or oranges from sellers like us."</p> <p>"In my street, I'm the only one, but next to the market there are quite a few. In general, people who do this already have another job on the side, they sell oranges to supplement their salary."</p> <p>"Yes, I would like, ... in the next few years, or even in the year, ... I don't know yet. ... What scares me is all that is financial. I'm afraid to start with 2 big projects that will take me 2 years of work and put people to work, and then of not being able to pay them after these two projects... the fear of not having the same luck over the years that follow. It's the fear of being responsible for the lives of other people..."</p> <p>"I do not contribute [CNSS], and it is an idea that I do not even have in mind. I have an unstable income, so one month I may be able to pay and the next month I may not. This morning, for example, I only had 30 dirhams left, I gave part of it to my wife and the other part was used to put some gasoline in my motorbike."</p> <p>"Do businesses stay small and informal to avoid detection by the authorities? Surely yes, but I don't think it's by choice. These are people who have very little means and who have no choice but to work this way. They prefer to stay small to keep their stability and not lose everything."</p> <p>"It's pretty common in this industry. There are often phases where there is no work, so I pay them by the day. It costs me less, knowing that the sector is very competitive, I can barely make ends meet."</p> <p>"No unfortunately I can't afford it, I already have to pay the rent, the food, the transportation costs. ... It's difficult for me to pay extra things."</p> <p>"It's probably for financial reasons, I don't have access to this information but I imagine that's why. In general, they are afraid to declare people and then after having to pay more in case of departure, the balance of all accounts, etc., they are afraid of finding themselves in a bad situation. They prefer to make the person work informally while waiting to be sure that they will stay, rather than declaring them from the start."</p> |

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TABLE 4A.7

Thematic Analysis: Codebook (continued)

| Global theme (answer): Enabling factors of informality in Morocco | | | |
|---|----------------------------------|---|--|
| Theme | Basic theme / code | Description | Extracts from transcripts (translated from French to English) |
| Market conditions | Entry into job market | Some respondents enter informality temporarily with the intention of gaining work experience. | <p>"In my field, it is very common. ... Most of the time it is informal. There are very few registered Graphic Designers; ... beginners always start informally. You begin to work at first with your family, your relatives informally. It is only when you gain experience and customers increasingly demand your services that you are obliged to register as a self-employed entrepreneur; ... but during the first two years, you are generally not declared; ... you manage to collect invoices from friends who are declared, and you pay them their taxes."</p> <p>"This is just the case for beginners, who do not necessarily declare everything at the beginning, the time to grow a little. It's normal... at the beginning there is not a lot of money coming in; ... we prefer to test the waters before doing things in a completely formal way."</p> <p>"It is very common to work informally, especially for young people who do not want to waste their time and their future doing nothing. Because it is the most accessible area for them and it also depends on the environment. It's relatively simple and doesn't take much time."</p> <p>"It's common yes, in general, we do this job just to make ends meet, it's not often a stable job. In my old job I also worked without a contract. In general, when we are new, we work without a contract; ... then when we have seniority, the employer offers us a contract."</p> <p>"The majority work without a contract, ... and those who have a contract are generally those who have worked for a long time... who have experience."</p> |
| | Lack of formal job opportunities | Many would want to work formally but find themselves in precarious employment instead, partially due to high competition in the job market. This also increases the chance of exploitation. | <p>"Yes, it is common. In my office, apart from me, there are 3 other people who work without a contract. Many firms do it, they recruit interns by promising them a contract at the end of the internship and exploit you as a real employee. For in the end never to declare you."</p> <p>"It's easier to find work and I don't have to declare and therefore pay taxes. I haven't studied either and in general informal work opens more doors for people like me."</p> <p>"Informal work is common in Morocco, around me, in the medina for example, there is almost only that. Many of us are in need, we have no choice but to work informally. Nobody helps us, how are we supposed to do things right? It's impossible. I did everything to get my daughter to school, but despite that, she too has no formal job. We are condemned to live this way."</p> <p>"The working environment is catastrophic for the workers whose rights are violated and who pay the highest price; ... them and the State."</p> <p>"No, I don't have a contract. It's in the interest of my employers not to give me a contract, they pay less for me, and they don't prefer to take risks by giving a contract."</p> |

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TABLE 4A.7

Thematic Analysis: Codebook (continued)

| Global theme (answer): Enabling factors of informality in Morocco | | | |
|---|-------------------------------------|---|--|
| Theme | Basic theme / code | Description | Extracts from transcripts (translated from French to English) |
| Institutional/regulatory factors | Lack of trust/ corruption | Those negatively affected by precarious employment and informality have little faith that they will receive support and/or protection from state authorities. | <p>"The informal sector is one of the vital sectors of the Moroccan economy but unfortunately it is generally neglected by the government in a crisis situation. I feel it even more in my sector which is completely sidelined and to which no importance is given. In Morocco, they are part of our daily life. So I would say that the problem is important but we have no choice. Most people who work informally have had no other choice. They have no education, they were born into a poor family, so they follow the family pattern."</p> <p>"I don't think I'm wrong in answering you that the majority of Moroccans do not trust government institutions."</p> <p>"I cannot be the only one to think so. This is the image that Moroccans have of government institutions: ... incompetence and corruption. I don't think my complaint will be taken seriously since I have an undeclared job and I'm a woman. I have never been harassed by one of these institutions and I have never been in this situation, so I do not have an objective opinion. But bribes are common in Morocco, so I wouldn't be surprised if it happened to other people..."</p> <p>"Honestly, I think that if something happens in my work as a freelancer, no one will protect me..."</p> <p>"The procedures are cumbersome and complicated; ... suddenly, I cannot trust these structures. ... Maybe they will take my complaint seriously... honestly, I have never faced this situation, ... but the accounting sector is known so I think that my request will be taken into account. I've never been harassed, but I know it's a possibility..."</p> <p>"Regarding bribes, it is very common; ... you always have to give something to succeed in a procedure..."</p> <p>"Yes, I have already been harassed and mistreated just because I am different and I do not accept the lack of professionalism; ... moreover with a long difficult past with the public administration, I do not trust them at all. For me they are all on the same level; ... none stands out. I just don't trust them. Between the bribes and the lack of seriousness, there is nothing to trust them. Everyone knows it."</p> |
| | Small perceived risk of enforcement | Respondents believe that there is little to no perceived risk of persecution from state authorities as a consequence of informality. | <p>"Regarding labor inspections, they are mainly done when there are late payments or after a dismissal."</p> <p>"Regarding labor inspections, they are infrequent, even rare."</p> <p>"I think the tax system is behind in Morocco, there is still a lot of work to do. I'll give you a simple example, if a self-employed person doesn't declare for 1 year, no one will sue him. But this is surely explained by the fact that the majority of taxes are paid by large companies, holding companies, and the like; ... so we do not pay much attention to small businesses or small entrepreneurs."</p> <p>"I know a lot of people who work informally. Even when there are controls, it is not taken seriously. The labor inspector comes and sees that we are not declared, then they disappear."</p> |

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TABLE 4A.7

Thematic Analysis: Codebook (continued)

| Global theme (answer): Enabling factors of informality in Morocco | | | |
|---|--|---|--|
| Theme | Basic theme / code | Description | Extracts from transcripts (translated from French to English) |
| | Lack of information about benefits and processes | Information on how to formalize or how people may benefit is not readily available. | <p>"I think that informality has a negative impact on Morocco's economy. In my opinion, the main problem is the lack of clarity and the lack of information; ... as long as this is the case, there will always be informality. If people don't see the benefit of it, why would they? It's like the anti-COVID vaccine, if you don't know what it is, you're not going to do it..."</p> <p>"No, I didn't even know what it [CNSS contributions] was; ... it was only recently that my daughter explained to me that it was a reimbursement system for the doctor and the drugs."</p> <p>"I contribute to the CNSS. But it's recent because I didn't know before that it was possible for self-employed status. Since the arrival of Aziz Akhannouch in the government, it has become automatic. ... Own-account workers did not know that they could benefit from the CNSS before... They paid their taxes but did not pay the CNSS and therefore did not benefit from it."</p> <p>"I don't know, I think I'll tell people around me or people who do the work that I would like to do in private and I will see afterwards. I never really thought about it, it's just guesses. No, I never tried to apply, I wouldn't even know how."</p> <p>"I know only that I would be legal and that I would benefit from the CNSS. On the other hand, I don't know where to get information on this subject..."</p> <p>"I don't even know the procedure and I don't know how to do it. No, I don't have access to information, the people around me also work without papers."</p> |
| | Rigid regulatory framework | Complaints that the law does not reflect the economic reality (for example, seasonal/temporary employment). | <p>"Declaring employees should be automatic but the law is not adapted, they do not do it on a case-by-case basis. In my situation, I don't need to hire the person all year and I don't even know if they will last the season."</p> <p>"If the need is temporary, I hire informally, especially when these are trades where it is common to work informally. The additional costs are obviously the payment of taxes for each employee in addition to the salary."</p> <p>"In my opinion the critics of labor regulations are clearly dismissal restrictions and compensation costs. This is why I prefer to hire an employee formally when I am sure of his profile and his seriousness."</p> <p>"What is binding in my status is that I am obliged to specialize in a field. You don't really have the possibility of expanding your field of services... For example, if I want to do production, I have to add it to my basic status...and therefore pay new taxes. Whereas if I register as a communication SARL company, I can offer all the services that a self-employed person can do alone. The law concerning the status of auto-entrepreneur specifies all the professions that are eligible for the status; ... these are very specific professions because this status was created as a basis for people who cannot easily enter the labor market or who do not have the funds to set up a company. In my case, I bring together a lot of these professions, but I declare only one speciality."</p> |

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TABLE 4A.7

Thematic Analysis: Codebook (continued)

| Global theme (answer): Enabling factors of informality in Morocco | | | |
|---|--|--|--|
| Theme | Basic theme / code | Description | Extracts from transcripts (translated from French to English) |
| | Noninclusivity of administrative processes | High-level complexity of administrative processes associated with formalization. | <p>"But you have to be careful not to get the information wrong. ... It may be that after two months of waiting, your file will be refused because of a small error; ... in this case, you have to redo everything from the beginning, ... which is discouraging."</p> <p>"I find that the procedure is far too complex for people who do not have a good level of education."</p> <p>"I don't know if it is complicated but from an outside point of view, all the procedures seem complicated in Morocco."</p> |

NOTES

1. Because “worker” is the level of analysis in such surveys, the estimates are not statistically representative of the distribution of firms, but rather the distribution of employment across firms.
2. As of 2020, however, five categories of nonsalaried workers are required to contribute to social insurance: physiotherapists, midwives, adouls (public notaries), tour guides, and bailiffs.
3. This is the Collective Retirement Benefit Scheme (Régime Collectif d’Allocation de Retraite) for employees of state-owned companies.
4. The age of children is limited to 12 years for dependent children residing in Morocco, 18 years for a child who is placed in an apprenticeship, and 21 years for a child who has passed the baccalaureate and is pursuing studies in Morocco or abroad. There is no age limit for a disabled child who does not have a regular source of income.
5. The 60 percent threshold is intended to account for temporary workers registered with the CNSS working for less than a full month.
6. See <https://www.cese.ma/media/2021/11/Indemnite-pour-perde-demploi.pdf>.
7. “Agreements are eligible for extension throughout the sector if they cover a minimum of 50 percent of employees working in the sector. If a collective agreement covers two-thirds of employees in the sector, extension throughout the sector is mandatory. Extensions are set by decree of the Ministry of Labor for a specific area or at the national level” (Gannat and Betcherman 2021).
8. Civil servants can be fired in the case of a reduction in the number of permanent jobs in the public sector or because of professional incompetence. In the first case, the dismissal takes place with the application of special Dahir (decrees) that provide the conditions of notice and compensation. In the second case, the civil servant who cannot be assigned to another administration or position is entitled to retire or, if not entitled to a pension, is dismissed. The decision is made by the minister in charge of the administration or the service to which the public worker is affiliated.
9. Severance pay is based on seniority and calculated based on the average salary received over the 52 weeks preceding the termination date as follows: (1) 96 hours of pay for each of the first 5 years of work; (2) 144 hours of pay for each of the 6th to 10th years; (3) 192 hours of pay for each of the 11th to 15th years; and (4) 240 hours of pay for each year over 15 years. In the case of damages, the allowance is equal to 1.5 months of salary per year of seniority, capped at 36 months.
10. The two other flagship social programs targeted to the poorest segments of the population are the cash transfer program for children (Tayssir) and the cash transfer program for widows with children (DAAM). In 2008, Morocco launched Tayssir, a conditional cash transfer program focused on enhancing school enrollment among children in all municipalities with a poverty rate above 30 percent (and all households with children age 6–15). During 2010–18, up to 800,000 children in 434 municipalities received regular cash transfers that were conditional on school enrollment and attendance (Gazeaud and Ricard 2021). Enrollment rose, but larger class sizes suggest that the

program constrained learning by putting more pressure on existing resources in beneficiary areas (Gazeaud and Ricard 2021). In 2014, Morocco established DAAM, which in 2018 benefited at least 87,984 households (ESCWA 2019). Because cash transfers are not conditional on formality status or the household's income level, Tayssir and DAAM do not directly influence decisions to operate informally. However, they may improve educational outcomes for beneficiaries and increase formal employment for the next generation.

11. Based on information available at <https://www.ramed.ma/fr/SInformer/ConditionsAdhesion.aspx>, the following eligibility criteria apply: Urban areas: Household annual per capita income of less than DH 5,650 after weighting declared income (including transfers) by socioeconomic variables; socioeconomic conditions score, calculated based on variables related to household living conditions, less than or equal to 11. Rural areas: Asset score less than or equal to 70 per person in the household; socioeconomic conditions score, calculated based on variables related to household living conditions, less than or equal to 6.
12. See annex 4A for a detailed description of the computation method and tax schedule for each professional income regime.
13. See table 4A.5, in annex 4A, for list of special regimes in Morocco.
14. The detailed list is in Decree n°2-15-263 04/10/2015 (<https://www.svp.com/article/adoption-du-statut-dauto-entrepreneur-au-maroc-100007515>).
15. When the business activity exceeds this ceiling, the status is a single-member limited liability company or *entreprise unipersonnelle à responsabilité limitée*.
16. Registration with the Moroccan Postal Service (Barid Al Maghrib) is required to qualify for these benefits. In 2017, Law n°98-15, 2017, was passed, extending the benefits provided by the health insurance (*assurance maladie obligatoire*) to auto-entrepreneurs. However, the implementing decrees are still being prepared.
17. Farmers benefit from a reduced rate of 17.5 percent for the first five tax years following the first year in which they become subject to CIT.
18. More concretely, temporary taxation of large agricultural holdings (whose turnover exceeded DH 35 million [US\$3.89 million], DH 20 million [US\$2.22 million], or DH 10 million [US\$1.11 million], respectively, in 2014, 2018, and 2020) at the reduced rate of 17.5 percent in terms of the CIT during the first five consecutive fiscal years, starting from the first fiscal year of taxation.
19. See <https://www.cese.ma/media/2020/10/Rapport-Un-syst%C3%A8me-fiscal.pdf>.
20. The report's definition of firm informality—firms that employ all their workers informally—is applied implicitly in the realm of market conditions such that (1) registered firms have a higher likelihood to hire formal workers because registered firms exhibit higher productivity levels than unregistered firms on average and are more likely to be caught and sanctioned for hiring informal workers; (2) strong contract enforcement encourages firms to register with official authorities to benefit from the regulatory environment, including secure and low-cost transactions and credit contracts, while also allowing registered firms to grow; and (3) contestability drives the natural

selection of firms and increases the integrity and benefits of the regulatory environment, encouraging firm registration and growth.

21. Unfortunately, the Enterprise Survey does not record whether firms without credit sought such credit; nor does it record the terms and conditions for the subset of firms that obtained credit. However, Morocco's high share of "credit constrained" firms (75 percent), as defined in the Enterprise Survey (2020), may suggest that it reflects a lack of availability rather than tepid demand.

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The Case of the Arab Republic of Egypt

KEY MESSAGES

- The Arab Republic of Egypt's social insurance regulations (prior to 2019) created disincentives for formality, particularly for low-wage workers, and favored higher earning and public sector workers.
- Segmentation of social insurance regulations and provisions by worker type makes it difficult to pool risk for a functional insurance scheme.
- Noncontributory social insurance programs mainly target the poor and have limited coverage. Overall, the coverage of social protection programs is limited—at least 40 percent of workers have neither contributory nor noncontributory social protection.
- The tax system (prior to 2020) did not have a special regime for micro or small firms; however, there were provisions in place that could act as a disincentive for firms to grow. The tax system could also discourage business incorporation, which, in turn, could dampen firm expansion and productivity.
- Starting a business in Egypt is expensive relative to its regional peers, and commercial justice bottlenecks have led to extreme delays in contract enforcement—making it hard for small firms to operate and grow.

INTRODUCTION

In 2016, the Government of the Arab Republic of Egypt introduced an Economic Reform Program to address macroeconomic imbalances, improve social inclusion, and achieve sustainable growth. Key pillars of the program included fiscal consolidation, restoring confidence in the economy, and enhancing socioeconomic conditions. To achieve these objectives, universal energy subsidies were gradually phased out, new adjustments were introduced to the food subsidy system, and the value-added tax (VAT) was introduced to replace general sales taxes. In addition, the currency was devalued, and new laws were adopted to address long-standing structural challenges in the business environment. Substantial public investment was undertaken to develop or modernize infrastructure for better connectivity and to boost supplies of electricity and natural gas. The economic reforms were complemented with programs to support the poor and vulnerable via social protection and human development programs. Poverty-targeted conditional and unconditional cash transfer programs (“Takaful” and “Karama”) were introduced in 2014.

As a result of these reforms, Egypt’s economy has been relatively resilient in recent years, including through the COVID-19 pandemic. Yet several studies have pointed to the continued deterioration in labor market indicators, such as the fall in the labor force participation rate—already among the lowest in the world—the growing shares of precarious and informal employment, limited dynamism in the labor market, and the decline in real wages (Deng et al. 2022; Krafft, Rahman, and Selwaness 2019; Said, Galal, and Sami 2019; World Bank 2021a).

Moreover, the share of Egypt’s workers employed informally—that is, working without social insurance—increased steadily, from 55 percent in 2007 to 64 percent in 2019. This trend is a cause of concern, for several reasons:

- There will be a growing share of workers who lack access to publicly managed means of insuring against the risk of income loss due to unemployment, illness, disability, maternity, or old age.
- This heightened vulnerability could mean that an economywide shock, such as the one induced by the COVID-19 pandemic, could have a large negative impact on the economy.
- With informal workers unlikely to be registered with public agencies, the government’s ability to offer tailored mitigation measures in the event of shocks would also be severely constrained.

- Although poverty-targeted cash transfer programs can provide crucial support to informal workers who are poor, the programs are not designed to provide insurance or pool risks.
- As Egypt's large youth population reaches retirement age, the country is likely to face the serious problem of a large cohort of the older population not having social insurance and facing longevity without income—necessitating a considerable expansion of social assistance programs.
- The public sector route to formal salaried work is less likely to be available to new entrants to the labor force, as the sector has seen only limited hiring in the recent years. The public sector is the preferred sector of employment for most workers (Barsoum and Abdalla 2020).

The trend of rising informal employment has occurred in the context of weak growth of both household incomes and firm productivity. Households' welfare (measured by growth in real per capita consumption expenditure) did not improve during the 2010s despite gross domestic product (GDP) growth, and poverty and inequality increased (World Bank 2021a). Egyptian firms' growth (both in terms of employees and sales) was below that of firms in comparable economies, and firm-level productivity growth was stagnant or even declined (World Bank 2021a).

What has prior research on informality in Egypt found? The rise in informality—accompanied public sector retrenchment and a hiring freeze in the 1990s, and weak job creation by the private sector—could not make up for this loss in employment opportunities (El-Haddad and Gadallah 2020; Wahba and Assaad 2017). The weak job creation by the private sector could be attributed to unfair application of rules and the political connections of some firms (Diwan, Keefer, and Schiffbauer 2016; World Bank 2014). Registered firms (that is, formal firms) as well as unregistered firms, hire workers informally (World Bank 2014). A 2003 reform of the Labor Code that increased flexibility in hiring and firing regulations led to an increase in formal hiring within formal firms (Wahba and Assaad 2017).

Against this backdrop, as Egypt searches for a pathway to sustainable, inclusive growth, an in-depth analysis of the country's high and increasing level of informality—especially through an institutional lens (chapter 1)—can shed light on how the design of social protection, the tax system, and market conditions—as well as their interactions—might contribute to limited social insurance coverage, thereby dampening productivity growth and, ultimately, overall economic growth.

This chapter undertakes the analysis for Egypt, with a focus on 2010–19, as these are the years for which detailed and comparable Labor Force Survey data are publicly available. The analysis of labor market outcomes relies on survey data from the annualized Labor Force Surveys; Egypt Labor Market Panel Surveys; and the Household Income, Expenditure, and Consumption Survey. Information on institutions was obtained from published laws (in English), reports, and research papers. This period leaves out pertinent reforms that were introduced after 2019—including the reforms to social insurance laws; the gradual rollout of universal health insurance; the introduction of the special tax regime for micro, small, and medium-size enterprises (MSMEs) to promote formalization; and the expanded coverage of the Takaful and Karama programs. It is still too early in the rollout of these reforms to assess whether they will have an effect on informality. (Barsoum and Selwaness [2022] and World Bank [2022a, 2022b] discuss the most recent reforms in pensions and social assistance.)

OVERVIEW OF THE EGYPTIAN LABOR MARKET

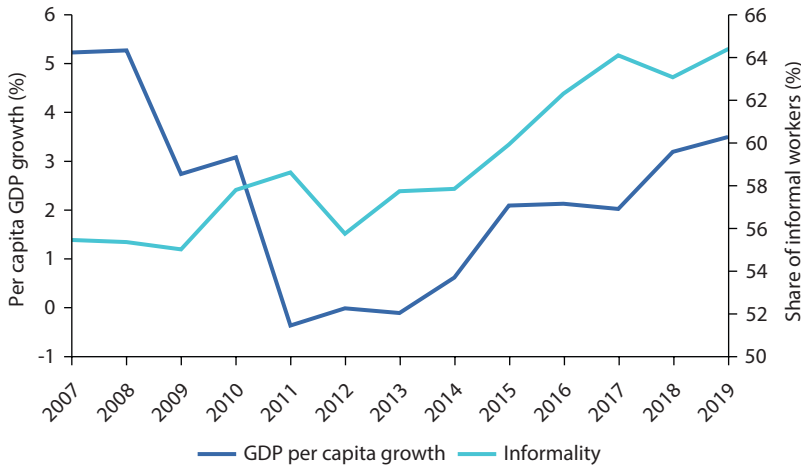
Economic growth has not led to lower levels of informality.¹ Rather, the booms and busts in GDP per capita over the past 15 years have been associated with an increasing share of informal employment. As figure 5.1 illustrates, 2012 was a peculiar point in this pattern, when contracting per capita GDP growth was accompanied by a decline in the share of informal employment (falling from 59 to 56 percent). This drop can be explained by higher unemployment and lower labor force participation rates—in other words, some informal workers may have been pushed out of the labor market or into unemployment.

Since 2012, the share of informal employment has been on a steady rise. In 2019, 64 percent of workers were employed without social insurance. As the share of agriculture in employment has fallen, this signifies that the rising informality has been mainly a feature of nonagricultural activities that are subject to labor laws and social security regulations. Greater investment in construction and real estate, a sector that experienced a higher share in private sector output between 2010 and 2019, further contributed to increased informality.

Given that growth alone has not led to a significant reduction in the informal employment rate, how else might policy makers further increase formal employment? This chapter applies the framework put forward by Levy and Cruces (2021), which is described in chapter 1. This chapter investigates how the institutional landscape—which is composed of three broad realms: Realm 1, entrepreneur-worker relations; Realm 2,

FIGURE 5.1

Share of Informal Workers and Real per Capita GDP Growth, Arab Republic of Egypt, 2007–19



Sources: For GDP per capita growth, World Development Indicators, World Bank; for the informal employment rate, Annual Labor Force Surveys.

Note: The share of informal workers is among the population age 15 and older. Data from the Annual Labor Force Surveys were harmonized by the Economic Research Forum.

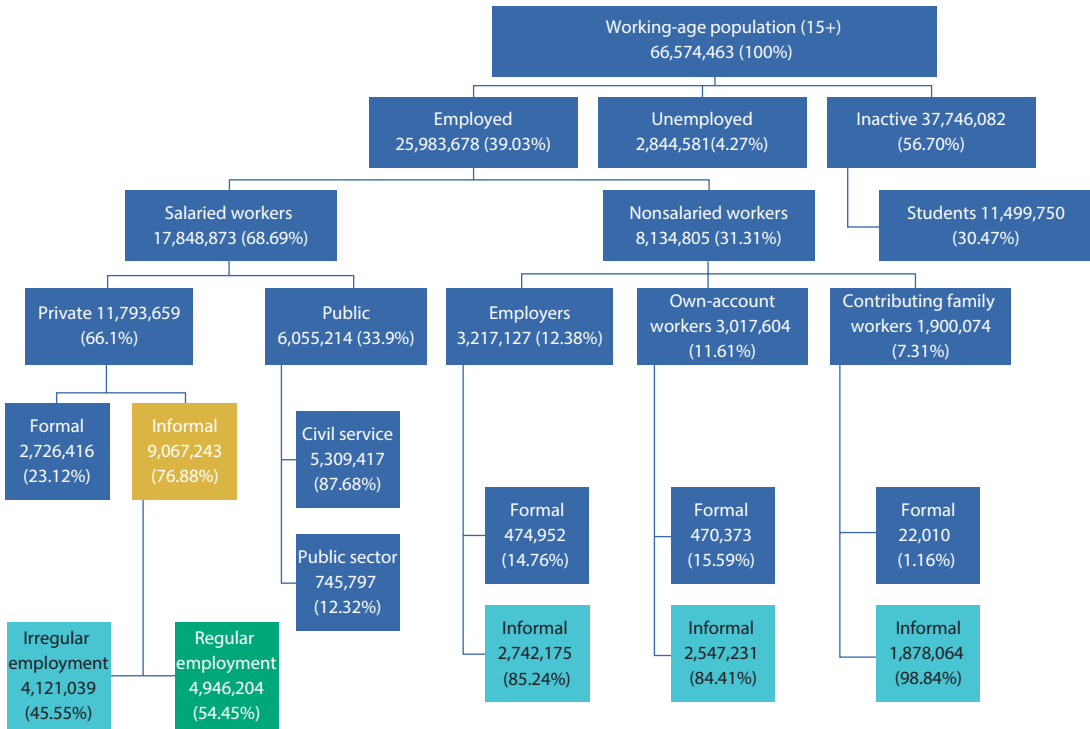
taxes and transfers; and Realm 3, market conditions—influences informality in Egypt.

Before investigating these realms, the chapter paints a picture of Egypt's labor market, as shown in figure 5.2, which decomposes the working-age population (age 15 and older) into employed, unemployed, and inactive; and then drills down into whether those who are employed work for wages or not, the categories of nonwage workers (such as employers or own-account workers), where the public sector fits in, and the shares of informal and formal workers. A few trends stand out:

- *Labor force participation is low.* The working-age population comprises 66.6 million people who can contribute productively to the economy. About 39 percent (about 26 million) of this group is active in the labor market, and about 61 percent (about 41 million) is neither employed nor looking for work. Moreover, this situation has worsened among both men and women since 2010, with the unemployment rate rising from 8.7 percent in 2010 to 13 percent in 2013, before a decline to 7.9 percent in 2019. Female labor force participation rates are low and have dropped over the past few years, from 23.9 percent in 2016 to 15.6 percent in 2019, with a further decline during the COVID-19 pandemic.²

FIGURE 5.2

Labor Market, Arab Republic of Egypt, 2018



Source: 2018 Annual Labor Force Surveys.

Note: Values are for the population age 15 and older. Data from the Annual Labor Force Surveys were harmonized by the Economic Research Forum.

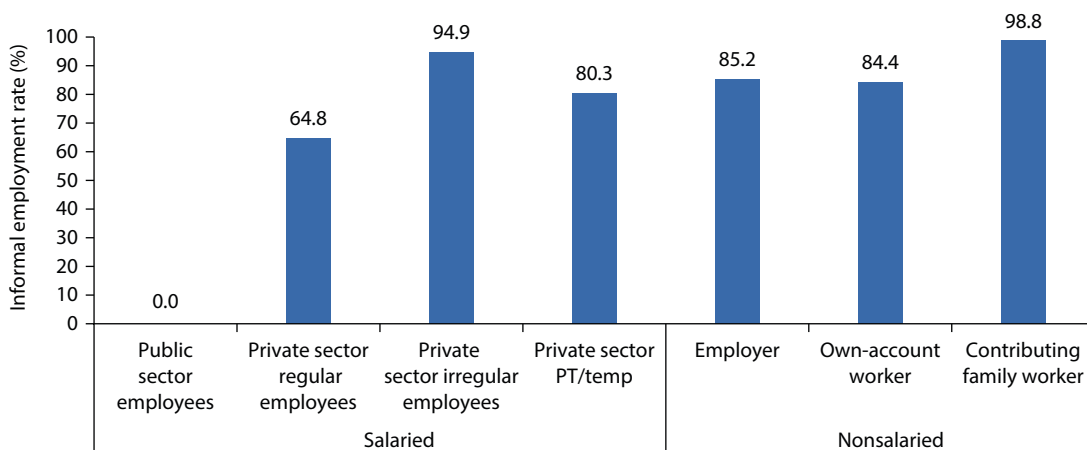
- *The labor market is dominated by irregular wage work or self-employment/ own-account work.* Salaried work accounted for 43 percent of all employment. The remaining 56 percent of workers were irregular wage workers or were engaged in nonwage work (self-employed, employers, or unpaid family workers).³ Between 2007 and 2017, the category with the largest increase in employment share was irregular wage work, which increased from 18 percent of all male employment to 26 percent. Among women, the sharp rise in the share of irregular wage workers was even more pronounced. There was also a notable reduction in unpaid family work among women over 2007–17. This composition of employment—dominated by work outside regular employment—encapsulates the challenges of reaching these groups with social protection.
- *The private sector is the largest employer, and most salaried jobs are informal.* About two-thirds of salaried workers are in the private sector and

one-third are in the public sector, representing a segmented labor market that is characteristic of many countries in the Middle East and North Africa (MENA) (figure 5.2). With almost universal access to social insurance within the public sector, the approximately 6 million workers constitute about 68 percent of formal salaried workers in Egypt. The legal framework for social insurance creates scope for legal informal employment, as certain types of workers (irregular workers and self-employed) are not required to contribute to social insurance. Only in the case of regular salaried workers is participation in social insurance mandatory, making informality for this group illegal. In the private sector, more than 60 percent of regular salaried workers are informally employed and therefore experience illegal informality (figure 5.3). The share of informal employment is close to 80 percent or higher for other work categories, but this informality does not violate the law.

- Informal employees earn less than formal workers.* The average monthly earnings for informal wage workers is LE 2,146 (US\$137), which is less than the earnings of formal private sector employees (LE 3,096, or US\$198.4) and public sector employees (LE 3,188, or US\$204.3).⁴ Egypt does not enforce a minimum wage for the private sector, and 30 percent of informal wage workers and 11 percent of formal wage workers earned less than LE 1,200 (US\$77), the minimum wage for public sector workers in 2018.⁵ Interestingly, similar shares of public

FIGURE 5.3

Informal Employment Rate, by Type of Employment, Arab Republic of Egypt, 2017



Source: Based on data from the Labor Force Survey.

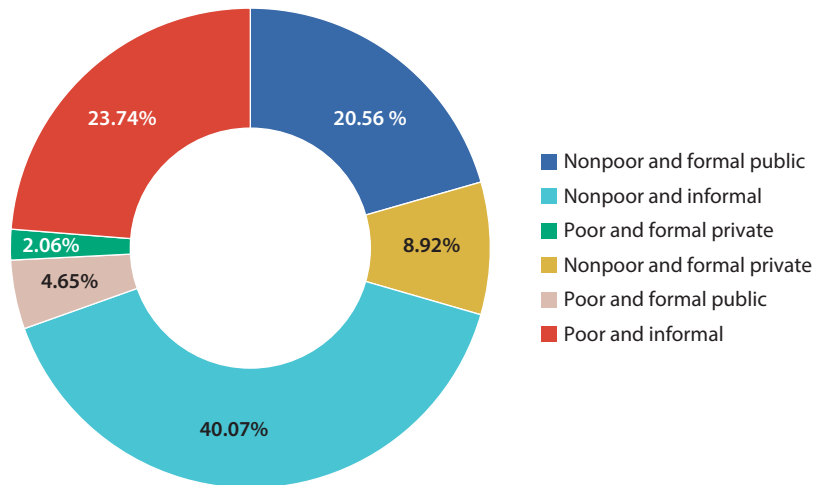
Note: PT = part time; temp = temporary.

and formal private sector wage workers earned less than LE 1,200 (US\$77). The private sector hourly wage gap between formal and informal employees is estimated at 23 percent, with just over 60 percent of the gap due to observable characteristics of workers. More specifically:

- *Informality does not mean poverty, but the poor are overwhelmingly informally employed.* Workers who are not poor but are informally employed constitute the largest share (40 percent) of workers in Egypt (figure 5.4). The second-largest group is those who are poor and informal (23.7 percent), followed by the formal nonpoor (20.5 percent). A large share of the working poor (78 percent) are informally employed, but only 57.6 percent of nonpoor workers are informal. Among informal workers, 63 percent are nonpoor, while 37 percent are poor (table 5.1). However, formality does not guarantee prosperity—about 18 percent of public sector and formal private sector workers are poor.
- *Mobility across formality-informality in the private sector means that some informal workers have made contributions to social insurance.* Just over 40 percent of formal private sector workers transitioned into informality between 2012 and 2018 (table 5.2). Workers in the private sector were more likely to transition from formal to informal

FIGURE 5.4

Shares of Poor and Nonpoor Informal and Formal Workers, Arab Republic of Egypt, 2017



Source: Household Income, Expenditure, and Consumption Survey, 2017–18.

Note: Values are for all workers age 15 and older. Poverty status is based on the national poverty line.

TABLE 5.1

Poverty and Informality, Arab Republic of Egypt, 2017–18

| Category | Formal public | Formal private | Informal | Total |
|----------------|---------------|----------------|----------|-------|
| <i>Percent</i> | | | | |
| Not poor | 29.56 | 12.83 | 57.62 | 100 |
| | 81.56 | 81.24 | 62.8 | 69.55 |
| Poor | 15.26 | 6.77 | 77.97 | 100 |
| | 18.44 | 18.76 | 37.2 | 30.45 |
| Total | 25.2 | 10.98 | 63.81 | 100 |
| | 100 | 100 | 100 | 100 |

Source: Based on data from the Household Income, Expenditure, and Consumption Survey, 2017–18.

Note: Values are for all workers age 15 and older.

TABLE 5.2

Employment Status in 2018 Compared to 2012 among Private and Public Sector Workers, Arab Republic of Egypt

| Status in 2012 | Status in 2018 | | | | | |
|---------------------------------|-------------------------------|-----------------------------|---------------------------------|--------------------------|------------|------------------------|
| | Informal employment (illegal) | Informal employment (legal) | Private sector formal employees | Public sector employment | Unemployed | Out of the labor force |
| <i>Percent</i> | | | | | | |
| Informal employment (illegal) | 37 | 24 | 16 | 6 | 4 | 13 |
| Informal employment (legal) | 21 | 49 | 5 | 3 | 4 | 18 |
| Private sector formal employees | 24 | 18 | 32 | 12 | 3 | 11 |
| Public sector employment | 4 | 3 | 4 | 73 | 1 | 15 |
| Unemployed | 12 | 12 | 5 | 8 | 13 | 50 |
| Out of the labor force | 7 | 8 | 2 | 2 | 5 | 75 |

Source: Based on data from the 2012 and 2018 Egypt Labor Market Panel Surveys.

Note: Values are for workers age 15–59 years.

employment than the reverse. Between 2012 and 2018, while 18 percent of formal private sector workers transitioned to informal private sector employment, only 5 percent of informal private sector workers transitioned to formal private sector employment. At the same time, only 32 percent of private sector formal employees remained in the same employment status. In the public sector, employment was more stable, with 73 percent of workers keeping the same status. A recent study of Egypt shows that the first job matters, especially for those starting employment outside fixed establishments (Selwaness and Ehab 2019). It finds that after 10 years of employment, only 16 percent of male informal workers inside establishments were formal, and only 8 percent of those outside establishments contributed to social insurance. Comparing across countries, Deng et al. (2022) show that labor movements into and out of formality are far lower in Egypt than in Mexico. More specifically:

- *Small firms account for most job creation, and most informal employment is in micro firms.* Firms or fixed establishments account for only about 30 percent of all employment (World Bank 2021b), and among these firms, most jobs are concentrated in small and micro enterprises. Small- and micro-scale establishments (with fewer than 20 employees) employed 73 percent of workers in 2017 (52 and 21 percent, respectively).⁶ Informal workers are predominantly in small-scale firms. The share of large-scale firms in hiring dropped from 24 percent in 1996 to 11 percent in 2017. This can be explained by the contraction of hiring in the public sector, which is dominated by large firms. The share of medium-size enterprises (20 to 99 workers) was only 10 percent in 1996, constituting the lowest share among the firm size categories. This share increased to 15 percent in 2017, exceeding the share of large firms. In firms with 100 or more employees, 75 percent of the employees are formally hired, while in smaller firms, only 30 percent are.

REALM 1: ENTREPRENEUR-WORKER RELATIONS

Social protection and jobs programs in Egypt consist of institutions that cover “entrepreneur-worker relations” (Realm 1), along with food subsidies and a range of noncontributory social assistance programs (World Bank 2022a). Realm 1 comprises a complex set of dimensions that directly affect the incentives of firms and workers to operate formally; therefore, these dimensions contribute to the social protection, poverty, and inequality outcomes of individuals and households. The interactions of these elements with Realms 2 and 3 affect firms’ hiring and productivity. This section discusses contributory social insurance, minimum wage regulations and collective agreements, hiring and firing regulations, and enforcement of labor regulations. The analysis focuses on the period prior to 2019:

- In the period studied in this report, Egypt had four social security regulations, by worker category. These included Law 79/1975 for salaried workers, which established social insurance for regular workers only (to be enrolled by employers). Irregular workers were not mandated to be enrolled. Law 108/1976 was passed for own-account workers and offered voluntary enrollment as well as only obliging self-employed workers in 15 occupations to enroll, along with employers of registered businesses. Law 50/1978 was passed for voluntary enrollment of Egyptians working abroad. Law 112/1980 included workers not covered by other schemes, such as contributing

family workers, construction workers, farmers, and others under voluntary enrollment. The new law of 2019 (Law 149 of 2019), which is beyond the scope of this report, provided a unified social insurance law for all workers and extended the same stipulations for voluntary and obligatory enrollment in the unified social insurance system for each group of workers.

- The legal framework for social insurance allows certain types of workers to opt out of participating in the social insurance system, thus creating “legal informal employment.” As table 5.3 shows, the law does not obligate many groups of workers to contribute to social insurance. These include irregular salaried workers, contributing family workers, the self-employed outside the 15 occupations stated in the law, and all those who were covered under Law 112/1980.²
- The social insurance funds are managed by the National Organization for Social Insurance (NOSI). Until 2019, NOSI was responsible for managing the Government Social Fund, covering civil servants, and the Public and Private Business Sector Fund, which covered private and public sector employees, employers, and the self-employed (Sieverding and Selwaness 2012). NOSI is managed by the Ministry of Social Solidarity. The National Health Insurance Organization (NHIO) works with NOSI to administer the contributions for health insurance.

TABLE 5.3

Legal Framework for Social Insurance, Arab Republic of Egypt, until 2019

| Worker category | Legal framework | Obligatory/voluntary | Legal / illegal informality |
|---------------------|---|---|--|
| Salaried workers | • Law 79/1975 for salaried workers | • Obligatory for regular workers • Voluntary for irregular workers | • Illegal informality • Legal informality |
| Nonsalaried workers | • Registered own-account workers (Law 108/1976) | • Voluntary • Obligatory for 15 occupations, including syndicated professionals and employers of registered business | • Legal informality |
| | • Egyptians working abroad (Law 50/1978) | • Voluntary | • Legal informality |
| | • Workers not included in all the other schemes (Law 112/ 1980), including contributing family workers and all unregistered workers | • Voluntary | • Legal informality |

Sources: Based on Law 79/1975; Law 108/1976; Law 50/1978; Law 112/1980.

- The labor laws govern employment in the private and public sectors. Egypt’s Labor Code (Law 12 of 2003) is complemented by two distinct provisions for workers in the civil service (by Law 81 of 2016, which replaced Law 47 of 1978) and for workers in state-owned enterprises (SOEs) (Law 203 of 1991, which replaced Law 159 of 1981). This segmentation sets the tone for more protective measures for workers in these sectors and more favorable working conditions that are not guaranteed to workers in the private sector.

Contributory Social Protection Programs

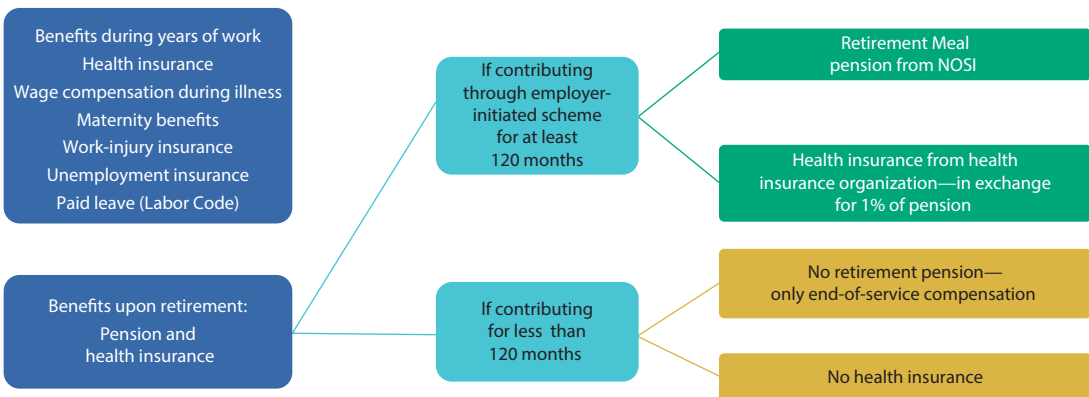
Salaried Workers in the Private Sector

Egypt’s social insurance system insures workers against various risks (figure 5.5). Law 79 of 1975 specifies the benefits for formally employed private sector salaried workers as well as public sector workers. It provides insurance coverage for old age, disability, survivorship, sickness, maternity, injury, and unemployment, but there are no family allowances. At retirement, beneficiaries receive a pension and health insurance.

Contributions for protection against each covered risk are described in table 5.4. Workers in the private sector contribute 14 percent of their “base fixed” salary, and employers contribute 26 percent. Additional payment can be added based on “variable” income (such as bonuses), which is not obligatory.⁸ Total contributions as a share of wages stand at

FIGURE 5.5

Overview of Benefits for Formal Salaried Workers in the Private Sector, Arab Republic of Egypt (Law 79 of 1975)



Source: Based on Law 79/1975.

Note: NOSI = National Organization for Social Insurance.

TABLE 5.4

Share of Private Sector Contributions to the Social Insurance Scheme, by Benefit under Law 79/1975, Arab Republic of Egypt

| Benefit | Private sector workers | | |
|-----------------------------------|---|------------------|-------|
| | Cost for firms | Cost for workers | Total |
| <i>Percent</i> | | | |
| Old age, disability, and survival | 15 | 10 | 25 |
| End-of-service bonus | 2 | 3 | 5 |
| Injury | 3 | 0 | 3 |
| Illness | 4 | 1 | 5 |
| Unemployment | 2 | 0 | 2 |
| Total cost | 26 | 14 | 40 |
| Paid leave (Labor Code) | 21 days in the first year and 30 days after 10 years of service, not including paid holidays (article 47 of the Labor Code) | | |

Source: Based on Arab Republic of Egypt Law 79/1975.

Note: Minimum and maximum bounds are set for all contributions. Illness covers sickness and medical benefits.

40 percent—which is one of the highest shares in MENA. For example, in Tunisia, contributions are at 28.75 percent for the general scheme for nonagricultural employees in the private sector.

Retirement Pension Benefit

The pension system is designed as a defined benefit scheme financed on a pay-as-you-go, partially funded basis. Benefits are determined through quasi-actuarial calculations based on lifetime contributions (Barr and Diamond 2009). The contributory pension system was initially built on a fully funded basis, but it was de facto a partially funded system (Maait and Demarco 2012). Pension benefits are payable to workers who have contributed for at least 120 months. There is no pension for those who reach retirement age without contributing for this duration. Instead, they receive a lump sum payment calculated as 15 percent of their annual pay for each year of contributions. Those who contributed for fewer than 120 months can buy years of service at an identified rate. This provision thus bifurcates social insurance benefits.

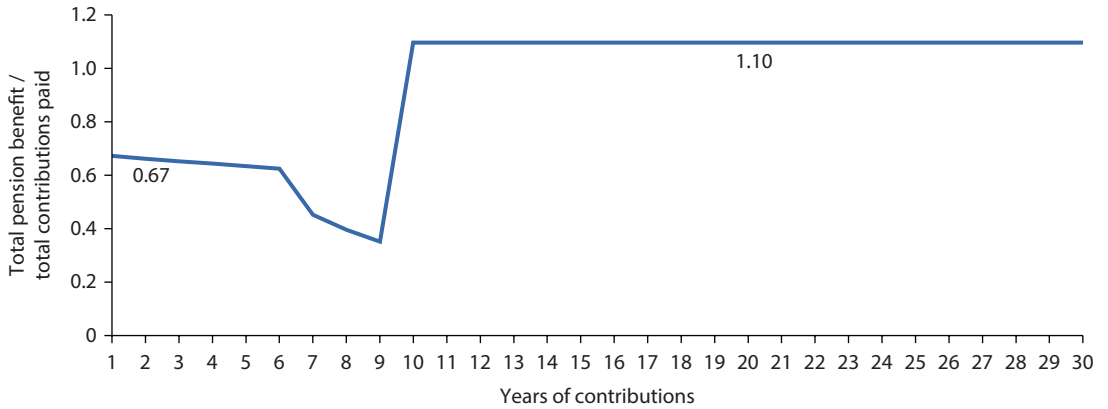
The system incentivized employees and employers to underreport wages because the calculation of the pension on the “base” salary was based on the average reported income for the last two years before retirement.² This average was not supposed to be more than 150 percent of the average for the last five years before retiring. This regulation sought to discourage underreporting earnings. The pension is calculated at a rate of 1/45 for each year of service for both the base salary and variable salary. If the pension amount is less than 50 percent of the total average monthly wage in the last two years, hypothetical

years are added to reach the minimum. The law stipulates that the total payable pension (on both basic and variable earnings) should not exceed 80 percent of the reference total monthly earnings (Social Security Administration and International Social Security Association 2011). Pension eligibility for contributions on the “variable” portion of earnings has no minimum set on the duration of contributions. However, it is only payable when retiring at age 50 or above and is calculated based on average income during full service. Contributors can further receive a lump sum compensation if the duration of contributions exceeds 36 years. Other key points here:

- Erosion of the real value of pension benefits was a concern. The government adjusted pension benefits annually, to address the risk that they may not be reflective of the cost of living. With the double-digit inflation rate the country has experienced, such adjustments became important. However, in the past, the adjustments have fallen short and eroded the purchasing power of pension benefits (see Sieverding and Selwaness 2012). The 2019 reform introduced mandatory adjustments for inflation (World Bank 2022a).
- The social insurance system provides a limited return on investment.¹⁰ The return is particularly low for those who contribute for fewer than 120 months. For this group of workers, the more years they contributed (fewer than 10 years), the more they would lose. If these workers contributed for one year, they would only receive 67 percent of the contributions of both the employer and employee. If they contributed for nine years, they would receive less than 40 percent of what was contributed. Figure 5.6 shows that those who contributed for the required duration (120 months) would receive 109 percent of their contributions, or a return on investment of about 10 percent.
- Workers who contribute for fewer than 120 months, who are likely a high share of private sector workers in Egypt, are disadvantaged at retirement, as per the design of the system. Workers who contribute for fewer than 120 months lose the share of the employee contributions when they receive the lump sum payment at retirement, effectively subsidizing the social insurance system. This is a regressive feature of the social insurance design because it is plausible that these workers (who contribute for fewer than 120 months) are at the lowest segments of income within the formal private sector. Unfortunately, there are no accessible administrative data on those who have contributed for 120 months prior to retirement and those who have not. The data on employment transitions (table 5.2) show that between 2012 and 2018,

FIGURE 5.6

Ratio of Pension Benefits to Contributions, by Number of Workers' Contributions, Arab Republic of Egypt



Source: Original figure for this publication.

Note: The figure is based on simulation of the social insurance system parameters (prior to the 2019 reform).

almost 42 percent of workers transitioned from formal private sector work to informal private sector work. An additional challenge with this system (which is addressed in the reforms after 2019) was that for workers who moved across sectors (public to private or vice versa), there was limited portability of benefits.

- Another source of regressivity arises from the minimum and maximum bounds set for total pension contributions. In 2018, the maximum for insurable earnings was set at LE 3,448 (US\$4,220) and the minimum was set at LE 750 (US\$48). As a result, low-wage salaried workers paid contributions on their full earnings, while high-wage workers whose earnings exceeded the maximum pensionable wage paid contributions on only a part of their wage. This incentivized low-wage workers to underreport their wages and evade the relatively high contribution levels (Barsoum and Selwaness 2022).¹¹ The design of contributions to the system thus had the unintended effect of raising the cost of contributions for low-wage workers relative to high-wage earners.

Unemployment Benefit

Unemployment insurance is set at 60 percent of the last insured wage. The eligibility criteria include that the worker (1) did not resign, (2) was not in conflict with the law, (3) had paid contributions for at least six

months, (4) was ready and willing to work, (5) was registered with the Ministry of Manpower and Migration (MoMM), and (6) made regular visits to the the MoMM. The compensation is lowered to 30 percent of the last salary in the case of negligence, absenteeism, alcohol consumption, or assault at work. The compensation discontinues if the unemployed worker rejects an offer by the MoMM or stops visiting the office. Access to unemployment insurance is contingent on the employer confirming that the worker did not resign but was forced to leave. In practice, and because of the high cost of firing, this is rarely the case.

Salaried Workers in the Public Sector

Public sector workers have guaranteed access to social insurance, full-time contracts, minimum wage, paid leave, and the right to promotion. Although public sector workers are governed by the same Labor Code as private sector workers (Law 12 of 2003), public sector workers are privileged by the distinct provisions of security of tenure and the enforcement of formality.

Public sector workers pay a little less than private sector workers in contributions to the social insurance system. The key difference is in the reduced contributions for workplace injuries, which vary by sector but are generally lower than those in the private sector because of the perceived limited risk of injury, due to the administrative nature of most jobs. As for private sector workers, additional contributions based on “variable” income are set by the employer. Table 5.5 shows the breakdown of contributions for public sector workers. The total contribution level varies from 35 to 36 percent, compared to a total contribution of 40 percent of the base salary paid by formal private sector workers.

TABLE 5.5

Share of Public Sector Contributions to the Social Insurance Scheme, by Benefit under Law 79/1975, Arab Republic of Egypt

| Benefit | Civil servants and workers in state-owned enterprises | | |
|-----------------------------------|---|------------------|-------|
| | Cost for employers | Cost for workers | Total |
| Old age, disability, and survival | 15 | 10 | 25 |
| End-of-service bonus | 2 | 3 | 5 |
| Injury | 1–2 | 0 | 1–2 |
| Illness | 4 | 1 | 5 |
| Unemployment | 0 | 0 | 0 |
| Total cost | 21–22 | 14 | 35–36 |
| Paid leave (Labor Code) | 21 days in the first year and 30 days after 10 years of service, not including paid holidays (article 47 of the Labor Code) | | |

Source: Based on Law 79/1975.

Note: Minimum and maximum bounds are set for all contributions.

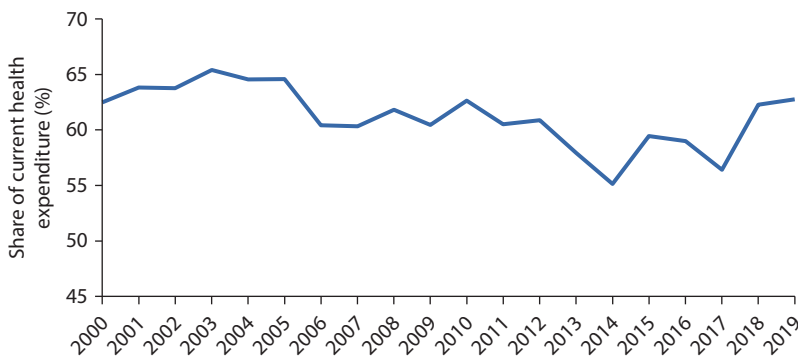
Pension benefits are the costliest element of the package. All the parameters of the social security code for the formal private sector are applicable to public sector workers. The returns to contributions are similar to those depicted in figure 5.6. In practice, however, a difference can be expected between public and private sector retirees. Public sector workers are more likely than private sector ones to accumulate the needed 120 months of contributions to receive pensions because of security of tenure in the public sector. As table 5.2 shows, public sector workers are the least likely of all to change their sector of employment—75 percent of public sector workers remained in that sector over a six-year period.

Contributory Health Insurance

For both private and public sector workers, a small share of the social insurance system contributions goes to health coverage—only 5 percent of the fixed salary is paid by both employers and employees. This explains the low quality of service and the limitations of the social insurance scheme financing, which Gericke (2005) calculates covers 50 percent of its cost. Hence, it operates more like a subsidized public finance scheme than insurance. Budget limitations can lead to long waits for procedures. Cost ceilings set for certain procedures also render such procedures impossible under the NHIO, pushing service seekers to go elsewhere and rely on out-of-pocket spending. Out-of-pocket spending has remained high (63 percent of total health expenditures) since 2000, despite fluctuations over the 20-year period (figure 5.7).

FIGURE 5.7

Share of Out-of-Pocket Outlays in Total Health Expenditure, Arab Republic of Egypt, 2000–19



Source: Based on World Bank data.

Employees in certain segments of the public sector have additional health care services that are syndicate/employer provided, with access to special hospitals and additional, better-quality health care options. These workers pay a premium for the additional service, but this further limits the redistributive power of the health insurance system and risk aggregation. However, the fact that public sector workers have access to the NHIO services does not protect public sector workers from out-of-pocket spending. NHIO service is bounded by a cost ceiling and focuses on curative care, which pushes beneficiaries to complement the service with out-of-pocket spending (Shawky 2010).

Access to health insurance is a complicated process for formal private sector workers, requiring a designated human resources operation, which is not tenable in most small and micro enterprises.¹² There is no liability for employers who do not offer support to their staff to receive the service. The complexity of the system may explain why the Labor Force Survey data show that the percentage of workers with access to health insurance is less than those with social insurance, although the two benefits are guaranteed by the same legal framework.

The design of the system allows for a highly segmented health insurance benefit structure and diminishes its redistributive power. Employers can opt out of the system if they provide alternative health insurance to their workers, which reduces their contribution share from 4 to 1 percent. It has become a common practice of employers in the upper segment of the labor market to opt out of the system to provide their workers better service quality, although this defeats the purpose of insurance risk aggregation across the private sector. This helps to explain the large (and growing) share of out-of-pocket health expenditure in Egypt.

Hiring and Firing Regulations for Private Salaried Workers

The Labor Code of 2003 increased labor flexibility and made formal hiring and firing easier for private sector firms and SOEs. It allowed definite duration (or fixed-term) contracts and stipulated that they can be terminated at the end of a contract at no cost. If a fixed-term contract ends and no new contract is signed, the agreement is turned into an indefinite contract—which can be terminated in situations of grave negligence, drunkenness, intoxication, or unexcused absenteeism for more than 10 days. A two-month notice is required. The employee's record should show notices documenting communication about negligence to justify dismissal.

The cost of firing those on open-ended contracts is high. The minimum payment for arbitrary dismissal is two months' pay for each year served. The firing cost also increases by years of service, reaching 50 percent for those serving 35 years. Collective agreements allow for dismissal if the employer makes the case that the firm is incurring "economic loss." The employer pays a month of pay for every year for the first five years of tenure and a month and half for every year after that. Dismissal of individual workers is easier to implement in practice, compared to collective dismissal.

Public sector workers have security of tenure and full-time contracts. Firing is virtually impossible unless the employee is convicted under criminal law or loses Egyptian nationality. Work in the public sector has long been considered part of the social contract.¹³ Workers in SOEs are also guaranteed security of tenure.

Public sector workers are more likely than private sector workers to be unionized; these are mainly workers in factories or blue-collar jobs, which are the base for the Egyptian Trade Union Federation. Formal private sector workers cannot form independent unions or join the Egyptian Trade Union Federation. Enterprise-specific unions can be formed for companies with 50 or more employees, which renders unionization an unlikely option for most formal workers, due to the small firm size.

Minimum Wage

A council decides the minimum wage and the minimum level of annual bonuses (not less than 7 percent of the basic wage).¹⁴ In 2013, the government set the minimum monthly wage at LE 1,200 (US\$76.7); it was revisited in 2019 and reset at LE 2,000 (US\$127.8)—which came into effect in January 2019 for the public sector. However, at the time, the government did not set a minimum wage for the private sector, for fear of distorting the labor market. The minimum wage is therefore not enforced for the formal private sector, and wage setting is completely left to the market. Given the lack of wage bargaining and a national minimum wage in the private sector, wage regulations seem to be nonexistent, and thus do not pose a key obstacle to formal hiring.

Self-Employed Workers

The self-employed must declare the level of their insurable income, with the monthly contribution set at 15 percent of the declared income. The social insurance system for this group only offers protection against

disability, old age, and survivorship pensions; it does not offer provisions for health insurance. Professional syndicates offer additional benefits—topping pension payments upon retirement and adding a health insurance component. But not all 15 identified groups in the law have syndicates, the financial capacity of the syndicate determines the level of benefits, and syndicates do not allow for pooling of risk with nonmembers. Thus, the law constitutes an exclusionary mechanism where low earners are explicitly excluded.

The pension law for self-employed workers is meant to cover a select few—primarily syndicated workers (such as engineers, doctors, and artists) and business owners (Law 108/1976). Large-scale landowners can also join, but it is not obligatory. The same arrangement holds under the 2019 social insurance regulation. Participants pay 15 percent of their reported income following a predefined set of insurable income categories. The law stipulates 16 categories of income, to which the self-employed are assigned. For employers, the reported income should not be less than that of employees.

Self-employed workers need to pay contributions for 180 months to get a pension, and if the contributor reaches age 60 without the 180 months, he or she needs to continue to contribute until the minimum number of months is reached. This suggests that the law does not provide for a lump sum payment if the minimum years of contributions are not met—this could pose a significant disincentive to contribute. If contributions are made for 240 months or more, payments can be obtained even before the age of 60. The retiree would lose a percentage identified in the law according to the age at retirement. The pension calculation parameters are similar to those of salaried workers in many ways. The pension is calculated as 1/45 of monthly income for each year of contributions, but not exceeding 80 percent of the last contribution wage. The minimum payment is also 50 percent of the last contribution wage.

Noncontributory Social Protection

Noncontributory social protection is important for Egypt since a large share of workers—notably, informal ones—lack access to employment-based social insurance. Most noncontributory social protection programs are targeted to poor and vulnerable households.

One such program is related to health. Those who are uninsured and are assessed to be poor or are unable to pay medical expenses have access to financial support through the Program of Treatment at the Expense of the State, whereby informal workers can access a system of government hospitals and other health care facilities that provide

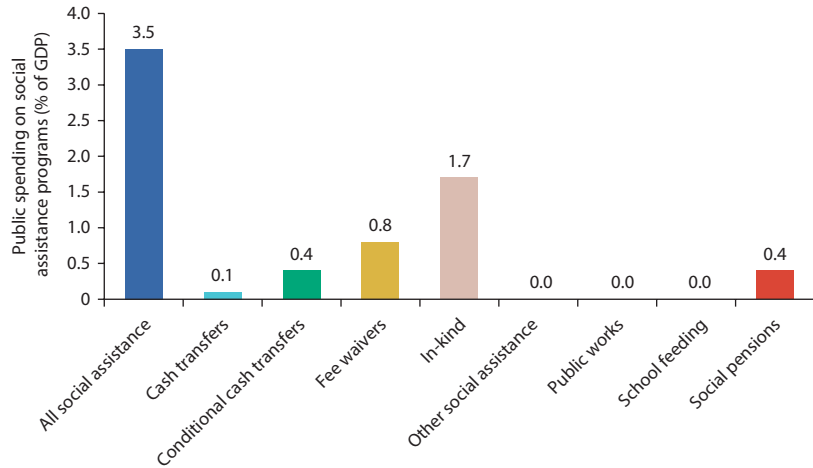
services at highly subsidized rates for a specified list of diseases (Sieverding and Selwaness 2012).

Informal workers who are poor could enroll in Egypt's main noncontributory social protection program, which consists of social assistance in the form of cash transfers targeted to the poor, provided they meet the program eligibility criteria. The cash transfer program Takaful, for families with children, and the Karama social transfers program, for the elderly and people with disabilities, were introduced in 2015. The Takaful and Karama programs were later expanded to include those who participated in the earlier social assistance program (Daman), which covered widowed women and the disabled. These were integrated into the Karama program. Takaful provides income support to increase food intake and reduce poverty, with health and education conditions, for families with children (age 0–18 years). In 2020, about 1.95 million households were covered by Takaful and 1.16 million by Karama.

Until recently, informal workers only received a retirement pension as part of a quasi-noncontributory scheme—the “Comprehensive Social Insurance System”—which provided a fixed pension to informal workers upon reaching age 65.¹⁵ Informal workers needed to contribute for 120 months at LE 0.30 (US\$0.01) (the cost of a stamp) per month, but the scheme did not include health or injury insurance. However, in 2019, new legislation set higher levels of contributions for specific groups. Informal workers are required to contribute at a rate of 9 percent of the lower income bound, while the law commits the government to cover the employers' share of 12 percent of the minimum bound. Enrollment is limited to nine low-income occupations (such as domestic workers and construction workers) and requires complicated paperwork to join.

There is limited public spending on the social sectors. Social protection spending (excluding energy subsidies) has been unchanged, at an average of 4 percent of GDP since the reforms, and cash transfers remain small. In fiscal year 2020, cash transfer spending reached 0.3 percent of GDP, which is below the global average (0.9 percent) and the MENA regional average (0.42 percent). There is a constitutional mandate to increase public spending on health to 3 percent of GDP, but these outlays declined from 1.6 percent of GDP in 2017 to 1.4 percent in the following two years, before reaching 1.5 percent of GDP in 2020.

Prior to 2016, Egypt's tax-financed social protection schemes were dominated by food and fuel subsidies to help low- and middle-income groups afford essentials. These subsidies, mainly food subsidies, continue, despite significant rationalization. In 2015, about 88.6 percent of all families made use of food subsidies through the smart card system. In 2017, the eligibility criteria were narrowed to households earning

FIGURE 5.8**Public Spending on Social Assistance Programs, Arab Republic of Egypt, 2018 (% of GDP)**

Source: Atlas of Social Protection Indicators of Resilience and Equity data, World Bank.

below a specific income threshold. In addition, only four family members are now allowed to be registered under one smart card, although this does not apply to households that were already listed (Machado et al. 2018, 134). More specifically:

- The outlays remain low for social assistance programs, despite being a higher share of GDP (figure 5.8). In 2018, total spending on these programs was 3.5 percent of GDP, with cash transfers at only about 0.5 percent of GDP (including conditional cash transfer programs) (figure 5.8). Spending on the Takaful and Karama programs and Daman increased from about 0.1 percent of GDP in 2010 to 0.4 percent of GDP in fiscal year 2018 (UNDP and MPED 2021). The Takaful and Karama programs cover only about 15 percent of the population, although about 30 percent of the population is poor. However, most of the outlays reach the poor, as the program's targeting accuracy is high.

REALM 2: TAXATION

The realm of taxation is composed of various dimensions that influence the fiscal resources governments have available for public spending toward redistribution and poverty reduction. In addition, the design of tax

schedules, strength of tax enforcement, and existence of preferential tax regimes for firms are determinants of overall tax revenue and incidence. These affect the productivity of firms, number of workers covered by contributory social insurance, and redistributive power of social protection systems, thereby affecting other social and economic outcomes, such as poverty and inequality. Here, the report examines three core elements of statutory tax systems: (1) the personal income tax (PIT), (2) the corporate income tax (CIT), and (3) the VAT.

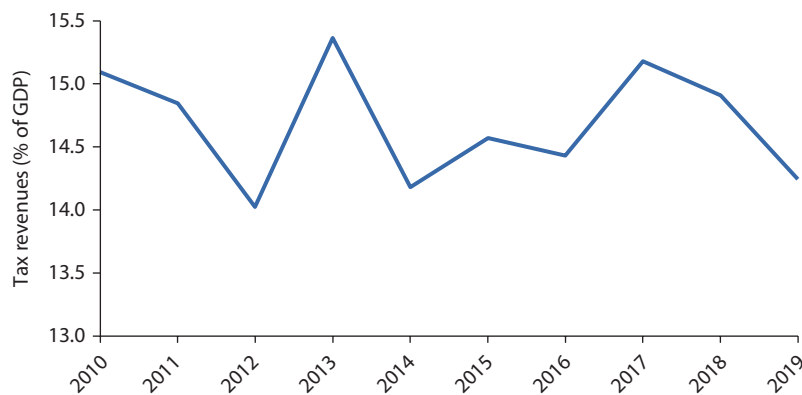
Overview of the Tax System

Egypt's tax revenues are among the lowest in the region—and they have not grown over the past decade, holding between 14 percent and 15 percent of GDP (figure 5.9). This relatively low level of tax collection limits the fiscal resources available for needed public spending to support redistribution and poverty reduction. The tax revenues collected reflect various factors, including the small scale of economic activities, tax loopholes, weak compliance, and evasion. Egypt has stepped up efforts to strengthen enforcement (raising the cost of noncompliance) of tax laws and has introduced measures to reduce the time and cost of complying with tax regulations.

Direct taxes include the PIT and CIT, and indirect taxes include the VAT, excise taxes (“schedule tax”), resource development fees, the trade tax, and the stamp tax. In 2021, indirect taxes accounted for more than

FIGURE 5.9

Total Tax Revenues as a Share of GDP, Arab Republic of Egypt, 2010–19

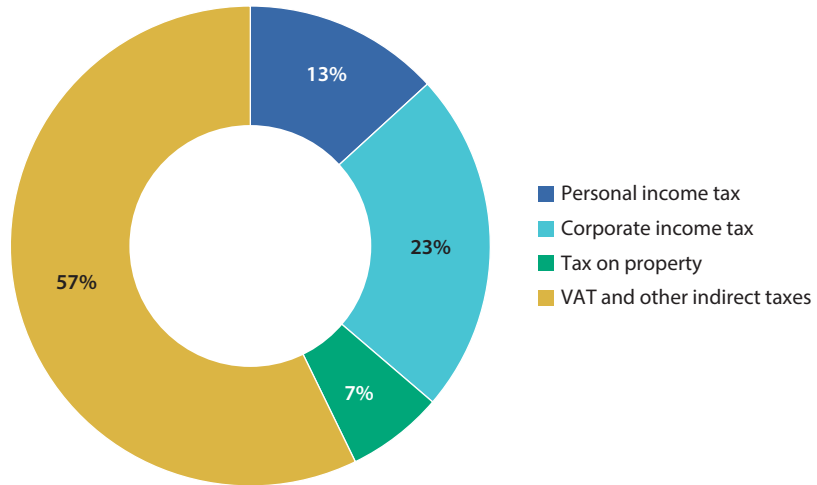


Source: Data from the Organisation for Economic Co-operation and Development tax database.

Note: GDP = gross domestic product.

FIGURE 5.10

Composition of Tax Revenues, Arab Republic of Egypt, Fiscal Year 2021



Source: Ministry of Finance.
 Note: VAT = value added tax.

half (57 percent) of total tax revenues, with the two direct taxes—the CIT (23 percent) and PIT (13 percent)—accounting for most of the rest (figure 5.10). The statutory tax rates for both direct and indirect taxes are among the lowest in the region (Verdier et al. 2022).

Between 2010 and 2021, revenues from indirect taxes fluctuated around 7 percent of GDP, reaching a low of close to 5 percent of GDP in 2014 (World Bank 2022a). In 2021, CIT revenues were about 3.2 percent of GDP—with the main contributors being sovereign sources (such as the Central Bank of Egypt, Egypt General Petroleum Corporation, and Suez Canal Authority). However, revenues from nonsovereign sources are on the rise.

Institutional Framework for Levying Direct and Indirect Taxes, 2010–19

The two main laws guiding tax collection are the 2005 Income Tax Law¹⁶ and the 2016 Value Added Tax law.¹⁷ The 2005 Income Tax Law¹⁸ lays the groundwork for taxing the income of all individuals, enterprises, and corporations (legal persons). It specifies that all taxpayers (legal or natural persons), without any exceptions for size of revenue, are required to notify the Egyptian Tax Authority (ETA) of their activities. For salaried workers, the responsibility of notifying the ETA rests on the

employer or enterprise. The main indirect tax is the VAT, and the 2016 law outlines the various provisions, including exemptions. Prior to the introduction of the VAT, Egypt followed the sales tax regime outlined in the 1991 General Sales Tax Law.

Personal Income Tax

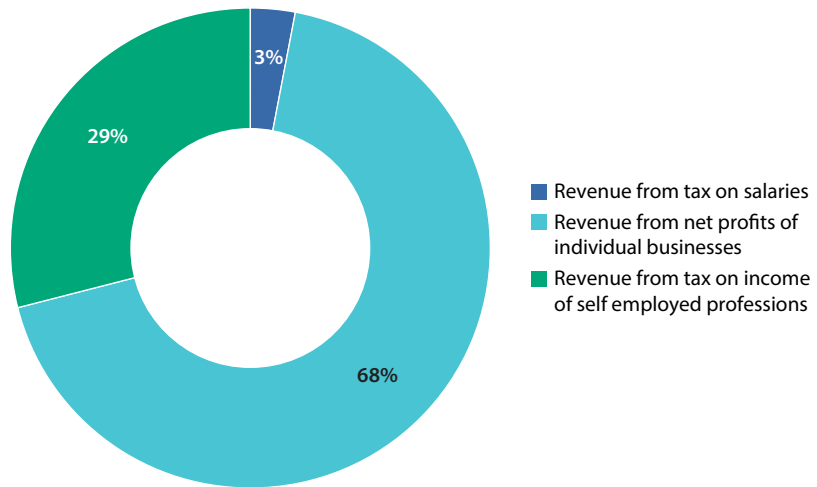
The PIT is levied on (1) salaries of workers (with or without a contract and regular and irregular), (2) net profits of commercial or industrial activities, and (3) net revenues of self-employed professionals.¹⁹ For salaried workers, income subject to the PIT excludes income from pensions, social insurance contributions, and premiums paid for health and life insurance. Firms are required to declare irregular workers to the ETA, even if they do not make social insurance contributions for them (prior to 2019, firms were not required to contribute to social insurance for such workers). Small businesses and businesses engaged in commercial and industrial activities are considered “natural persons” or individual enterprises. They are structured as sole proprietorships and simple partnerships, which are regulated by the Law of Commerce and subject to the PIT schedule.

The extent to which the tax regime poses an additional cost for workers and individual enterprises to be formal is difficult to evaluate due to data limitations.²⁰ However, if it is assumed that only formal workers (salaried or self-employed) pay the PIT and do not evade (or underreport incomes), simulations using the household income, expenditure, and consumption survey data from 2017–18 suggest that 51 percent of all workers would be eligible to pay taxes—with a large share being high-earning workers. As of 2019, salaries accounted for the largest share of PIT revenues, at 68 percent; individual enterprises accounted for 29 percent; and self-employed professionals accounted for only 3 percent, according to data reported by the Ministry of Finance and included in the Organisation for Economic Co-operation and Development (OECD) tax database (figure 5.11).

The marginal tax rate rises gradually from the exempted tier to 10 percent for those earning less than LE 6,500 (US\$415), to 22.5 percent for those with net income greater than LE 200,000 (US\$12,788) (table 5.6). Thus, if a worker’s income increased from LE 6,000 (US\$383.6) to LE 14,400 (US\$920.7) (equal to the minimum wage in the public sector prior to 2019), the marginal tax rate would be 10 percent, and the effective tax rate would be 5.5 percent. The marginal tax rate would stay the same even if the worker earned double the minimum wage. Thus, Egypt’s PIT tax schedule appears to be less steep than Tunisia’s, which tops out at 35 percent.

FIGURE 5.11

Composition of Personal Income Tax Revenues, Arab Republic of Egypt, 2019



Source: Based on data from the Organisation for Economic Co-operation and Development tax database.
 Note: Revenue from tax on salaries includes stamp tax on salaries.

TABLE 5.6

Marginal and Effective Tax Rates, by Income Bracket, Arab Republic of Egypt, 2015–17

| Income bracket (LE) | Marginal tax rate (%) | Effective tax rate at upper limit (%) |
|-------------------------------|-----------------------|---------------------------------------|
| 1 ≤ net income ≤ 6,500 | 0 | 0 |
| 6,500 < net income ≤ 30,000 | 10 | 7.8 |
| 30,000 < net income ≤ 45,000 | 15 | 10.2 |
| 45,000 < net income ≤ 200,000 | 20 | 17.8 |
| Net income > 200,000 | 22.5 | -- |

Source: Original table for this publication.

Note: Values are the personal income tax rates on income after allowed deductions and exemptions (net income), effective from August 21, 2015, to June 21, 2017 (Law No. 96 of 2015).

Individual enterprises are “natural persons” (not incorporated as companies) and are subject to income taxes following the PIT schedule, regardless of their size. They are required to register with various entities (including the ETA). The Law of Commerce of 1999 covers two types of individual enterprises—sole proprietorships and simple partnerships—and requires them to be registered with the Commercial Register; no minimum capital is specified. Each business owner in a simple partnership is required to enroll in the social insurance system

as self-employed. The Income Tax Law allows individual businesses that meet the definition of a micro or small enterprise to be exempt from the requirement to maintain regular accounts (Abdellatif, Tran-Nam, and Ramdani 2021). This exemption is linked to the 2004 Law on Small Enterprises, which defines these enterprises based on the size of their paid-in capital; however, it is unclear how the law's requirements have been verified (El Nagggar and El Nagggar 2020; OECD, EC, and ETF 2018).

Data from the latest establishment census suggest that compliance with the requirements of the tax, business registration, and social insurance law is quite low. The following are a few data caveats.

First, it is not clear whether the institutional setup requires that data reported by employers and businesses to the ETA and the social insurance organization are consistent. If such compliance were not enforced, employers could choose the level of compliance—for example, reporting employees' salaries to the ETA but not to the social insurance authority. Prior to the 2019 reform on social insurance, it is not clear that consistency on reporting to the two agencies was enforced.

Second, administrative data on the number of individual enterprises that file the PIT, are registered for social insurance, or are on the commercial registry are not publicly available. However, there is an indication of whether enterprises have a sound basis for reporting net profits, drawing on the 2017 census of establishments conducted by the National Statistical Offices. The census found that that about 30 percent had an insurance number, 39 percent were registered with the commercial registry, and 22 percent kept regular accounting books. One-person and two-person establishments were the least likely to keep regular accounting books. What makes an activity self-employment or a one-person firm is subject to interpretation, and it is possible for one-person individual enterprises to opt out of social insurance.

Corporate Income Tax

The CIT—whose revenues are nearly double those of the PIT—is levied on incorporated companies. The net profits of these companies are taxed at a rate of 22.5 percent (since 2015). The flat tax rate applies to all types of business activities (except oil exploration companies, whose profits are taxed at 40.55 percent). The profits of the Suez Canal Authority, the Egyptian Petroleum Authority, and the Central Bank of Egypt are taxed at 40 percent.

All companies are required to enroll their regular employees in social insurance and all employees for the PIT. There are special tax regimes and incentives for the CIT, but these are unlikely to affect a firm's

decision to employ workers formally. They apply to priority sectors and businesses in free trade zones—such as manufacturing, banking, financial services, agriculture, and investment in lagging regions.

It is likely that the Income Tax Law has discouraged some enterprises from becoming an incorporated business—given that the flat CIT rate of 22.5 percent has been equal to the marginal tax rate for the highest PIT bracket (until 2019). In 2018, the Companies Law was amended to allow one-person companies, which was reflected in the near-doubling of limited liability companies between 2017 and 2020, according to the World Bank Entrepreneurship database. Still, with 66,614 limited liability companies in 2020, Egypt had the lowest number of such companies, compared to Morocco and Tunisia (table 5.7). In addition, adjusting for the size of the adult population, Egypt’s total business density remains the lowest.

Value Added Tax

For an enterprise—whether an individual or incorporated business—the size of its revenues determines its responsibilities for and costs of processing and paying indirect taxes on the production of goods and services. Until 2016, businesses with revenues greater than LE 540,00 (US\$34,615) for producers and service providers, and LE 150,000 (US\$9,520) for traders, had to register with the ETA and pay the general sales tax (applicable to manufactured goods and 17 services). In 2016, Egypt moved to a VAT regime with a substantially broader tax base. The VAT Law requires registration for all individuals or companies selling goods or services with gross sales equal to or greater than LE 500,000 (US\$31,969). The standard VAT rate is 14 percent. Lower rates can apply on selected goods or services, and 57 categories of goods and services (like basic food products) are exempted. Although Egypt’s VAT rate

TABLE 5.7

Adult Population, Limited Liability Companies, and Business Density, Arab Republic of Egypt, Morocco, and Tunisia, 2020

| Country | Adult population | Limited liability companies in 2020 | Total business density rate |
|------------------------|------------------|-------------------------------------|-----------------------------|
| Egypt, Arab Rep., 2020 | 62,165,379 | 66,614 | 1.07 |
| Morocco, 2020 | 24,222,688 | 572,930 | 23.65 |
| Tunisia, 2019 | 7,856,564 | 158,511 | 20.18 |

Source: World Bank Entrepreneurship database (worldbank.org/en/programs/entrepreneurship).

Note: The new business density is defined as the number of newly registered corporations per 1,000 working-age people (those age 15–64).

is lower than that of a group of regional peer economies, the revenue threshold for VAT eligibility is also one of the lowest (see Verdier et al. 2022, figure 17).

Although, in theory, compliance with the VAT Law should be high for all businesses, as they are able to pass on the tax to their customers, in practice, take up of the law can face obstacles, given that the data show that only a small share of businesses maintain regular accounts. Under the credit-invoice method, businesses pay the input VAT to suppliers on their purchases of goods and services, charge the output VAT on their sales of goods and services to customers (output tax), and remit the balance between the input and output VAT to the ETA.²¹ To implement this system, businesses must issue invoices for sales transactions, keep regular accounting books, and file monthly VAT returns (Abdellatif, Tran-Nam, and Ramdani 2021). Since all businesses are required to issue invoices (as per the 2005 Income Tax Law), they should be able to meet the VAT Law requirements. However, as the 2017 establishment census shows, a vast majority of enterprises do not keep regular accounts—especially one- and two-person establishments.

REALM 3: MARKET CONDITIONS

This section reviews Egypt's institutions that govern the functioning of markets and in turn affect business creation, size, and productivity.²² As in other developing countries, most firms in Egypt are small, and they age without growing in terms of employment or sales (World Bank 2021b). Market conditions and their implications for private sector expansion have been studied extensively. Egypt has made progress in addressing limitations in legislation; however, the state continues to participate in the market in ways that could discourage private sector expansion (World Bank 2021b). This report's focus is on how provisions in this realm interact with Realms 1 and 2, to paint a more comprehensive picture of the determinants of informality and firm growth. This section briefly reviews legislation in three areas: (1) registration procedures and costs, (2) access to credit and contract enforcement, and (3) product market competition.

Registration Procedures and Costs

In 2016, Egypt modified several laws, with the aim of strengthening market conditions. These reforms covered laws on investment and bankruptcy and industrial licensing law.

Egypt has outperformed its regional peers in the areas of procedures and time to start a business. This was mostly due to a reform abolishing the requirement to obtain a certificate of nonconfusion (which limits multiple entities from carrying the same name) and improving the one-stop shop. Starting a business consists of 5.0 procedures, compared to 6.5 in MENA, and takes an average 12.0 days, compared to 19.7 days for MENA. However, the process remains costly—about 20.3 percent of income per capita, making Egypt one of the most expensive jurisdictions to start a business in MENA, where the regional average is 16.7 percent. However, unlike in much of the region, there is no minimum capital requirement to start a business (the MENA average is 9.0 percent of income per capita).

On average, the process for resolving insolvency takes as much time as it does in MENA, but it is costlier than the regional average (these costs include court fees, government levies, and insolvency administrator and lawyer fees, among others). At the end of insolvency proceedings, Egyptian creditors have a recovery rate that is lower than the MENA average and significantly lower than the OECD average.

By contrast, registering a property is comparatively inexpensive in Egypt, costing 1.1 percent of the property value, well below MENA's average at 5.6 percent. Still, the registration process is cumbersome—it takes an average of 76.0 days to register a property, far above MENA's 26.6 days, and there are 9.0 procedures, compared to 5.4 for MENA.

Despite progress in reforming pertinent laws and regulations, business density is lower in Egypt than in Morocco or Tunisia (table 5.7).

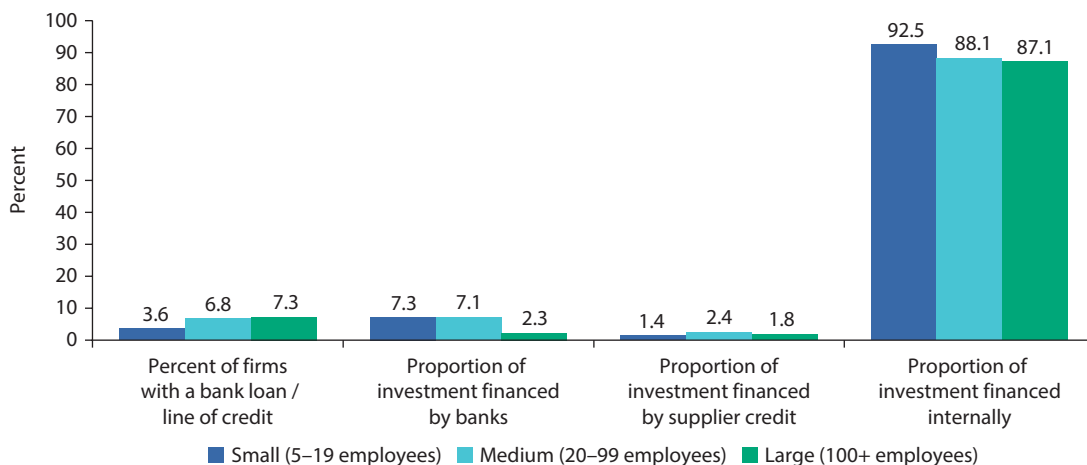
Enforcement of Credit and Commercial Contracts

Egypt performs well in providing creditors access to information about borrowers through credit registries. The provisions for depth of credit information provided are strong, as is the strength of legal rights for creditors. The country also has a comparatively large share of adults under credit bureau coverage relative to MENA, although far less than the share among OECD nations.

However, firms' use of credit is very low, and firms most rely on internal financing, which could constrain growth (figure 5.12). Based on data from the 2017 Findex, the Country Private Sector Diagnostic reports that the share of the population who borrowed to start, operate, or expand a firm or business is lower than the average for lower-middle-income countries. This limited use of credit could be due to a mix of demand- (by firms) and supply-side factors. No direct measures of demand are available; however, there has been progress on at

FIGURE 5.12

Use of Credit, by Firm Size, Arab Republic of Egypt, 2020



Source: Based on data from the Enterprise Survey 2020, World Bank.

least one dimension: the share of firms with accounts increased from 60 percent in 2013 to around 80 percent in 2020 (Enterprise Survey data). Limited supply of credit appears to be a factor—a long-standing challenge for the private sector in Egypt. Growing government financing needs have increased the cost of borrowing and limited private companies' access to finance. The private sector's share of credit has decreased, from over 50 percent in 2010 to 30 percent at the end of fiscal year 2020 (World Bank 2020). Further, a recent study suggests that a 1 percent increase in government borrowing from commercial banks in Egypt diminishes business sector credit by around 1.2 percent, creating further barriers for entrepreneurial activities (Haikal, Abdelbary, and Samir 2021). Betz, Ravasan, and Weiss (2019) show that this rising borrowing by the government limited the amount of credit that banks made available to firms. Overall, firms appear to face constrained access to credit because the government, rather than other firms, competes for available financing.

Contract enforcement is a particular area of challenge for firms. Contract enforcement in Egypt averages 1,010 days, well above the 622-day average across the region. On average, the process for resolving insolvency takes 2.5 years and costs 22.0 percent of the debtor's estate, while it takes 2.7 years and 14.0 percent of the debtor's estate in MENA (these costs include court fees, government levies, and insolvency administrator and lawyer fees). At the end of insolvency proceedings, Egyptian creditors have a recovery rate of merely 23.3 cents per US\$1, which is

lower than the MENA average of 27.3 cents and significantly less than the OECD average of 70.2 cents.

The quality of judicial services for commercial purposes negatively affects domestic firms (especially smaller ones) and foreign businesses investing in Egypt. There are no courts dedicated solely to hearing commercial cases and no fast-track procedures for small claims. Judges are swamped with an excessive number of petty cases and administrative matters, which distract valuable judicial time from more complex cases (World Bank 2020). This may help explain how access to the courts is costly for MSMEs, at 26.2 percent of the claim value, compared to MENA's average of 24.7 percent. Further, outcomes are often not sufficiently predictable, which could incentivize small firms to remain unincorporated.

Competition in the Product Market

Government control of businesses is prevalent, with 297 SOEs operating in 23 of the 24 industry groups (World Bank 2020). These SOEs employ about 20 percent of the public sector workers, representing more than 1 million workers. The widespread presence of SOEs hurts competition and distorts market outcomes.

Egypt's economywide product market regulation score, where higher values are associated with more restrictive regulations on competition, is one of the highest in the world: 2.84 out of 6.00, compared to the 2.34 average for non-OECD countries (World Bank 2020). This score reflects barriers to entrepreneurship in Egypt—notably, complex regulatory procedures and regulatory protection of incumbents, and a restrictive environment where state control has undue influence. Each of these factors can create disincentives for new entrants, particularly in sectors with a more extensive SOE presence (like energy, telecommunications, and air transportation). The Ministry of Communications and Information Technologies owns 80 percent of Telecom Egypt, the country's primary telephone company, and oversees the National Telecommunications Regulatory Authority. Such a structure, in which the regulator and SOE are under the same line ministry, incentivizes favoritism for the SOE over private competitors (Pop et al. 2021).

Protectionist policies have also stymied competition. High external tariffs—the 19 percent average most-favored-nation tariff is the second highest in the world—are applied to countries that do not have a trade agreement with Egypt. Further, high and sometimes unpredictable import tariffs on certain products (like manufacturing inputs) and instances of export duties and bans create uncertainty for firms and limit their access to global value chains. Decisions on tariffs appear unduly

influenced by specific sectors rather than being taken strategically to foster development or diversification of the local economy. As a result, the vast majority of Egyptian firms are nonexporters; only around 1 percent export—and those firms have a smaller number of products and fewer markets than those in comparator countries (World Bank 2020). Between 2009 and 2018, more than half of Egypt's goods exports were primary and resource-based products, and about a quarter were medium- and high-technology exports. Egypt's lack of export competitiveness deters efficiency-seeking foreign direct investors, which could help the country play a greater role as a regional export hub. According to the World Bank Enterprise Survey of 2020, only a small percentage of Egyptian firms have foreign ownership (5 percent reported having at least 10 percent foreign ownership in 2020).

Egypt's value chain is further hampered by cumbersome customs clearance processes, poor connectivity, and poor logistics. Here, the key factors are (1) the efficiency of ports, (2) air cargo capacity, (3) infrastructure that connects the hinterland to the ports, (4) services to carry the goods from the hinterland to the ports, and (5) border control and management (including customs clearance for trading across borders). Despite having the Suez Canal, Egypt struggles to compete with peers like Panama, ranking 67th on the World Bank's Logistics Performance Index (2018), compared to 38th for Panama. Impeding factors include limited data availability (such as on port performance), lack of institutional coordination, and no clear strategy to engage with the private sector.

CONCLUSION

After an in-depth review of Egypt's informality—in particular, through an institutional lens—what are the key takeaways for the country in its pursuit of a sustainable, inclusive growth path?

Realm 1: How the Social Protection Institutions Affect Informality, Poverty, and Inequality

The social insurance system has design features that could contribute to rising informality. Although it is impossible to say conclusively that the social insurance system is a cause of the country's rising informality, this chapter has shown that there are design features that reduce the benefits and raise the costs of formality for both firms and workers. The legal framework governing social protection and labor laws creates scope for legal informality—that is, not requiring certain types of workers to participate in

social insurance. In Egypt, social insurance is not obligatory, nor is it designed to meet the needs of irregular salaried workers and the self-employed. The benefits that come with formal status are limited—primarily access to a pension, health insurance, and unemployment insurance—and there are many conditions. Workers who do not accumulate 120 months of contributions to the social insurance system only receive a lump sum payment calculated at 15 percent of their insured wage, losing the contribution share of their employers. Moreover, health insurance benefits require complicated processing that most small and micro enterprises, even if formal, lack the organizational capacity to offer to employees. Given the high cost of formality and weak enforcement, the incentives to evade are especially high for low-wage workers.

The social insurance system's redistributive impact is limited by the inherent regressivity built into the design. The pension system favors those who contribute at a young age and manage to accumulate as many years as possible. Indeed, the transition to formality at a late age (contributing for fewer than 10 years) is not beneficial. From the point of view of risk protection, permanent workers and high-wage workers are better protected than temporary workers. For those with fewer than 120 months of contributions, the deducted contributions (specifically, the share of the employee and employer) become lost income. The system also discourages participation by low-wage workers—who may be highly taxed when contributing, due to high transition rates into informality. Their incentive to evade is especially high. A fiscal incidence analysis confirms that most social insurance contributions are borne by better-off households that are also the recipients of pension benefits (World Bank 2022a).

Noncontributory social protection is available to informal workers, but it does not appear to be a key incentive to stay informal. The noncontributory health insurance program that informal workers can access provides limited benefits, largely due to low public spending on social assistance as a share of GDP, although outlays have risen in recent years. In Egypt, the flagship programs are Takaful and Karama cash transfers, which are designed for poor families. Thus, although poor informal workers can be reached by noncontributory schemes, they are still faced with situations of vulnerability. Moreover, the social protection system leaves 40 percent of workers who are neither poor nor formal without any risk protection.

Realm 2: How the Tax System Impacts Formal Job Creation, Productivity, and Growth

The tax base is small due to a combination of exemptions, avoidance and evasion, and low tax rates. At about 14 percent of GDP, the effective tax burden on

businesses and workers is the lowest in MENA, and the same holds for the PIT and VAT rates. This study could not adequately verify whether the institutional entities responsible for levying taxes, registering businesses, and taking social insurance contributions are required to or in practice coordinate the verification of taxpayers' reporting. Such data sharing across entities is essential because without it, taxpayers can choose the requirements with which to comply—and firms can choose to register to pay income taxes and the VAT but underreport workers receiving social security contributions (which are a relatively high share of wages).

Although the Income Tax Law does not treat micro and small firms differently, in practice there are factors that could affect firms' incentive to grow. Unlike Tunisia or Morocco, Egypt did not have a special tax regime in place for MSMEs during 2010–19. However, unincorporated enterprises with one or more owners are not required to keep formal accounts and, more importantly, they can file taxes under the PIT regime, which is more favorable than the CIT (the CIT tax rate equals the higher rate under the PIT). Although this does not pose a constraint in terms of diversification of ownership and access to capital and credit, it favors unincorporated businesses by allowing them legally to pay lower taxes compared to incorporated businesses. Taken together, these provisions create an incentive for firms to remain small in terms of net profits and therefore employment size. For workers too, especially low-wage workers, these provisions create incentives to be hired informally so that they are not declared to the ETA.

Since 2019, reforms have been introduced that could affect businesses' incentives to grow and employ workers formally. The 2020 reform simplified the tax regime for MSMEs. It replaced the provisions under the Income Tax Law that did not treat businesses differently by their revenues. The introduction of the option for registered MSMEs to follow the MSME simplified tax regime could discourage firms from expanding revenues beyond the new law's threshold (the 2020 Unified Tax Procedures Law). The ETA now issues one tax registration number for all types of taxes, and the new law streamlines the collection and filing of all direct and indirect taxes. Given that the cost of tax compliance tends to be regressive, the streamlining of procedures could reduce incentives for firms to grow.

Social insurance and tax laws could disincentivize small business incorporation, which, in turn, could dampen risk taking and investment by exposing such owners to legal liabilities. All incorporated businesses, whether one person or more, are required to enroll themselves and their employees in the social insurance system. Their net profits are subject to a higher tax rate (the CIT is a flat 22.5 percent) than those of unincorporated enterprises, who use the PIT schedule. An unincorporated sole business owner could

be considered self-employed and thus not obligated to enroll in social insurance. Thus, it is not surprising that among the three pilot countries, Egypt has the lowest number of limited liability companies—despite its large population and allowing one-person corporations.

Realm 3: How Market Conditions Impact Formality, Firm Size, Productivity, and Growth

The state's presence in the market, along with weaknesses in certain legal provisions and procedures, create conditions that are not conducive to firm entry and growth. The state's borrowing from domestic banks has led to a limited supply of credit for the private sector. In the product market space, the ubiquity of SOEs sometimes crowds out private firms and limits competitiveness. In certain sectors where SOEs dominate (like telecommunications and air transportation), they receive significant favoritism in terms of the regulatory environment and access to credit—which impacts productivity and limits the number of private firms that engage in these spaces. In addition, policies limiting foreign investment in Egyptian firms and disincentivizing exports act as a barrier to growth. Although the number of procedures has been reduced, the costs of both starting a business and resolving insolvency are some of the highest in the region. This matters, because high costs may limit the number of firms that are established and the ability of small firms to operate and grow. Firms are also hurt by Egypt's poor contract enforcement process, which is costly, unpredictable, and extremely slow. Weak contract enforcement creates a risky business environment, especially for small and medium-size firms that have tighter margins and less ability to absorb additional costs—possibly pushing larger firms into more vertical integration, hindering network effects across the economy.

NOTES

1. The analysis of labor market outcomes relies on survey data from the annualized Labor Force Surveys, Egypt Labor Market Panel Surveys, and the Household Income, Expenditure, and Consumption Survey.
2. According to the World Bank's high-frequency phone surveys a year and half into the pandemic, the share of main income earners (MIEs) working is still significantly below pre-COVID-19 levels. MIEs living in poorer households are 2.8 times more likely to transition in and out of employment, conditional on other factors. More than the sector of economic activity, the type of employment, especially informal and self-employment statuses, is an important feature behind the heterogeneous impacts. Informal private sector and self-employed MIEs were about 2.5 times more likely to stop and start work,

- compared to public sector workers, and MIEs who did not lose their jobs saw their incomes decline.
3. Irregular workers include seasonal, casual, and on-call workers.
 4. Based on Egypt Labor Market Panel Survey data for 2018.
 5. In 2019, the monthly minimum wage was raised from LE 1,200 to LE 2,000. In 2021, the minimum wage was raised to LE 2,400; and in 2022, it was raised to LE 2,700.
 6. An establishment is a fixed place where economic activity is carried out.
 7. Irregular workers are defined as seasonal, casual, and temporary workers, with special mention of workers in agriculture, fisheries, construction, and marine ports (Decree 162 of 2019).
 8. The 2019 reform reduced this share to 11 percent, calculated based on the full salary in the more recent regulation (Law 149 of 2019).
 9. The minimum employer penalty for not reporting a worker to the insurance agency was LE 1 per worker, with a maximum of LE 500 (article 181). The new law increased the level of fines for employers (to a minimum of LE 30,000 and a maximum of EL 100,000).
 10. This refers to the ratio of what a retiree receives to what they paid throughout their career. The ratio is calculated by considering the whole of Egyptian legislation for the payment of contributions and the calculation of the pension as well as its method of indexation. Certain assumptions are used at the level of the evolution of salaries throughout the career as well as the regularity of the contributions throughout the career. Then the sensitivity of the results based on career length and salary level is measured.
 11. In addition, by setting a maximum bound, the system effectively lost contributions that could have been collected from high-wage workers (see also Sieverding and Selwaness 2012).
 12. The list of the documents needed to enroll in the system is as follows: (1) form 101 stamped by the social insurance authority showing registration in the system, (2) a stamped copy of a medical check-up certified by both the workplace and the social insurance authority, (3) a stamped copy of the work contract, (4) a declaration from the workplace that they are enrolling the worker for the first time, (5) a delegation letter with the name of the human resources manager responsible for the paperwork, (6) a copy of the social insurance number and the identification card, and (7) a personal photo.
 13. Voluntary early retirement has been offered in various SOEs, with relatively generous compensation packages.
 14. Article 34 of Labor Law 12/2003 mandates the establishment of a national council for wages, headed by the minister of planning assigned to introduce a national minimum wage, taking into consideration the cost of living and ensuring balance between wages and prices.
 15. This was under Law 112 of 1980 (which replaced Law 112 of 1975).
 16. Law 91 of 2005. Another law governing direct taxes is the Stamp Tax Law No. 111 of 1980.
 17. Law 67 of 2016. Another indirect taxation on businesses is governed by the State's Financial Resources Development Tax Law (No. 147 of 1984). A unified law for taxation procedures was issued in 2020 (Law 206/2020).
 18. An English translation of the law can be accessed at <https://wipolex-res.wipo.int/edocs/lexdocs/laws/en/eg/eg067en.html>.

19. Another type of income subject to the PIT is net revenue of self-employed professions and noncommercial professions (which are also supposed to be licensed). Finally, revenues from real estate (agricultural land, constructed real estate, and furnished units) are also subject to the PIT. Notably for agricultural land, only revenues from horticultural activities are subject to the PIT; income from other agricultural activities is exempt. In what follows, taxes on real estate revenues are excluded from the analysis since agricultural revenues are generally not taxable.
20. The Labor Force Survey and Household Survey do not collect data from workers on who pays taxes. Data on employees and enterprises registered with the ETA or with social insurance organizations are not publicly available, making it difficult to assess the overlap.
21. The exception includes providers of certain goods and services, such as professional services and petroleum products, which are subject to a lower VAT rate and are not allowed to offset the input VAT against the output VAT (Deloitte 2021).
22. The report's definition of firm informality—firms that employ all their workers informally—is applied implicitly in the realm of market conditions such that (1) registered firms have a higher likelihood to hire formal workers because they exhibit higher productivity levels than unregistered firms on average, and are also more likely to be caught for hiring informal workers and sanctioned by authorities; (2) strong contract enforcement encourages firms to register with official authorities to benefit from the regulatory environment, including secure and low-cost transactions, and credit contracts, while also allowing registered firms to grow; and (3) contestability drives the natural selection of firms and increases the integrity and benefits of the regulatory environment, encouraging firm registration and growth.

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The long-standing informality debate in the Middle East and North Africa (MENA) Region has taken on a new urgency as it looks for a pathway to more socially inclusive growth that is less reliant on fossil fuels. This is occurring against a backdrop of subpar labor market outcomes, further growth setbacks, and deteriorating fiscal and current account deficits in the aftermath of the COVID-19 pandemic—and in the wake of high inflation and supply chain disruptions triggered by the Russian Federation–Ukraine war.

Informality and Inclusive Growth in the Middle East and North Africa aims to better understand the characteristics and incentive structure that have led to the prevalence of informal employment in three MENA countries—the Arab Republic of Egypt, Morocco, and Tunisia. The report breaks new ground by adopting a comprehensive perspective to focus on the features of, and interrelationships among, different aspects of these countries' institutional landscapes to make sense of the complex incentive structure that workers and firms face when deciding between formal and informal options. Specifically, the report groups these issues in three broad realms: (1) entrepreneur-worker relations, (2) taxes and transfers, and (3) market conditions.

"This report is an extremely welcome addition to the literature on MENA labor markets. By analyzing the incentive structure and institutional factors that have led to the prevalence of informal employment in Egypt, Morocco, and Tunisia, it points the way to policy actions that can be taken to reduce informality and increase social protection for workers. It is a must-read for anyone who cares about greater economic inclusion in MENA."

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"A compelling account of the implications of informality in the workforce and how economies of MENA can design appropriate policy responses. This timely report comes amid multiple social reforms in MENA and is a must-read for policy practitioners and economists in the region."

Karim El Aynaoui, Executive President, Policy Center for the New South

"This report is particularly timely given the negative impact that the COVID-19 pandemic and subsequent crises have had on living standards and poverty rates around the world and especially in MENA countries. While the focus on boosting growth and achieving the Sustainable Development Goals has revolved around financing, the report sheds new light on the benefits that tackling informality through institutional, regulatory, and policy changes could present to achieving these goals."

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