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Palestine Economic Policy Research Institute (MAS)

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The Informal Sector in the Occupied Palestinian Territory

بلال الفلاح

Belal Al-Falah

2014

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- ♦ Promoting knowledge-based policy formulation by conducting economic and social policy research in accordance with the expressed priorities and needs of decision-makers.
- ♦ Evaluating economic and social policies and their impact at different levels for correction and review of existing policies.
- ♦ Providing a forum for free, open and democratic public debate among all stakeholders on the socio-economic policy-making process.
- ♦ Disseminating up-to-date socio-economic information and research results.
- ♦ Providing technical support and expert advice to PNA bodies, the private sector, and NGOs to enhance their engagement and participation in policy formulation.
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Foreword

Since its establishment in 1994, the Palestine Economic Policy Research Institute (MAS) has researched the informal sector as one of the most important segments of the Palestinian economy. Several studies addressing various aspects of the informal sector were conducted over the years. The present one focuses on the main characteristics of the Palestinian informal sector, the reasons behind its expanding size, and the obstacles which formalization encounters. The major goal of this study is to propose measures and policy recommendations which would remove impediments that hinder formal business registration in accordance with existing laws. The underlying assumption is that registering businesses enhances their growth opportunities and increases their share in production and job creation. The rationale behind this assumption is that regulation enables businesses to access available sources of finance, financial intermediation, and government services, while also allowing them to conduct commercial operations in a more orderly manner. Formal registration discourages businesses from breaching tax, labor, and other laws.

The lack of readily available quantitative data on the value of Production of the informal sector made it difficult for this paper to come up with quantitative assessment of the negative impact of this sector on the economy. However, the paper has managed to put together useful qualitative conclusions and recommendations that could direct policy formulation in that matter.

This study benefited greatly from the reviews of referees and from the comments of participants in the launching workshop which was held by MAS. I commend the main researcher and his team for their efforts. Finally, I thank the IDRC for funding the study.

Nabeel Kassis, Ph.D.
Director General

Executive Summary

- ✧ Throughout the past few decades, economists documented a significant contribution of the informal sector to the economy. For example, by the end of 2003, the informal sector production contributed 20-80% of GDP in developing countries. The substantial size of the informal sector has attracted attention to its linkages to economic development ills with a focus on fiscal deficits due to tax evasion, productivity losses, and weakened government ability to enhance economic growth.
- ✧ The main objective of this paper is to estimate the size of the Palestinian informal sector and investigate its characteristics and the obstacles to formalization. Specifically, it aims at estimating the number of informal firms and the work force employed by them as well as comparing their features, including human resources, wages, size of firms, and type of economic activities, to those of formal firms. This paper also explores the pros and cons of joining the Palestinian formal sector and discusses policies that reduce the size of the informal one.
- ✧ Informal firms are defined as those with no tax registration and (part of) whose production is sold in the market. Informal workers, meanwhile, are defined as those (paid or unpaid family member workers) employed by informal firms. This study utilizes the PCBS labor force survey data for the fourth quarter of 2008 and shows that the size of the informal sector in the Palestinian Territory is substantial. Particularly, there are 62,493 informal firms, constituting 49.7% of the total number of companies during that period. Regionally, 45.3% of firms in the West Bank are informal compared to 65.7% of enterprises in the Gaza Strip.
- ✧ The study also shows that the overwhelming majority of informal entrepreneurs (86%) are self-employed (own account workers) relative to 63.3% of formal entrepreneurs. In terms of gender, female entrepreneurs represent 13.6% of all informal entrepreneurs, relative to 9.4% of entrepreneurs in the formal economy. Overall, informal entrepreneurs are less educated. While the share of informal entrepreneurs with tertiary education is about 10%, the corresponding figure among formal entrepreneurs is 21%. Firm size also tends to differ between the formal and the informal sector. In particular, about

60% of informal firms hire only one worker (including self-employed) relative to 42% of formal firms.

- ✧ In terms of the type of economic activities, the results show substantial differences. Agriculture, hunting, and fishing is one of the dominating activities in the informal sector, while it accounts for a negligible share (less than 2%) in the formal economy. Moreover, constructions constitute around 10% of the informal sector as opposed to 3% of the formal one. On the other hand, transport, storage, and communication activities represent 20% of the total formal firms compared to 5% of informal ones.
- ✧ As for the number of workers in the informal sector, the study shows that there are 152,262 informal workers, representing 36.3% of total employment in the private sector. According to the analysis two-thirds (66.5%) of informal workers are unpaid family members. The corresponding figure for the formal sector is starkly different at only 6%. The data analysis also reveals interesting disparity with regards to gender. The share of female workers in the informal sector is 40% relative to 19% in the formal sector.
- ✧ Regarding the differences in human resources, the results show that educated employees are disproportionately concentrated in the formal sector: 29% of formal workers have earned tertiary education compared to 17.5% of informal workers. The same trend is also evident when considering the share of employees with low education qualifications. Particularly, about 70% of informal workers have less than secondary education as opposed to 55% of formal workers.
- ✧ Next, the study explores the wage gap between formal and informal workers. The results show that the average daily wage of informal workers is 60 NIS, which is about 27% less than that of formal workers. Using an OLS regression model yields that this wage gap is mainly attributed to differences in workers' economic and demographic characteristics in the two sectors as well as inter-governorate wage differences. This finding indicates that, unlike in many developing countries, being a part of the informal sector in Palestine does not impose wage penalty, holding workers' characteristics constant.
- ✧ This study also investigates the relationship between workers' demographic characteristics and their decision to work in informal firms. Utilizing a probit regression model highlights the role of

education. Specifically, less educated workers are more likely to join the informal sector: workers with elementary or lower level of education are most likely to join the informal sector with a probability of 40%. Workers with primary or secondary education come second with a probability of 30%. The results also emphasize the impact of gender. In particular, male workers are 5% more probable to join the informal sector. Meanwhile, the age and place of residence (urban, rural, or refugee camp) are not important determinants.

- ✧ The probit model is also utilized to estimate the relationship between entrepreneurs' demographic characteristics and decision to establish informal firms. The results show that the effect of education is similar to that in the workers' model but with a smaller size for entrepreneurs. As for age, younger entrepreneurs are more likely to establish informal firms. Moreover, male entrepreneurs and urban dwellers are less likely to establish an informal firm. This finding can be explained by the PNA's weak control over rural areas and refugee camps which increases the chance for entrepreneurs to evade taxes and adds little pressure to formalize.
- ✧ Due to the lack of data, the study could not estimate the economic cost of the Palestinian informal sector, mainly in terms of tax evasion and productivity losses. However, the significance of these costs can be inferred from the characteristics of informal firms. In particular, the large size of the informal sector implies that the magnitude of the tax evasion is substantial. Similarly, the negative impact on productivity can be inferred from the low level of human resources and the absence of economies of scale in the informal sector. These expectations are enhanced by the findings of a large number of cross country studies that examined the economic cost of the informal sector.
- ✧ In light of the large size of the Palestinian informal sector and the probable imposed cost, this paper discusses several policy recommendations related to reducing the size of the informal sector. However, this task is challenging as simply eradicating the informal sector would cause a severe economic repression, mainly a decrease in GDP and an increase in unemployment and poverty levels. Therefore, the policies discussed in this paper target gradually downsizing the informal sector, by focusing on increasing the economic incentives to join the formal sector.
- ✧ Utilizing data from the PCBS informal establishment survey of 2008, the study discusses a number of issues affecting the size of informal

such as the cost of formalization, the incentives to formalize, the challenges which informal entrepreneurs face, and willingness to join the informal sector. The results show that only 18% of informal entrepreneurs consider formalization costs, such as registration cost and lengthy registration procedures, repelling factors. Meanwhile, the majority of informal entrepreneurs (75%) indicate that there is no need to join the formal sector.

- ✧ The results also show that the majority (about two-thirds) of informal entrepreneurs believe that there is no benefit to join the formal sector, while 26% do not know the benefits of formalization. Moreover, the overwhelming majority of informal entrepreneurs stated that they are not willing to join the formal sector. These findings clearly indicate that, from the point of view of informal entrepreneurs, the benefits of joining the formal sector do not outweigh the entry cost (registration cost) and other costs such as direct and indirect taxes or employees' benefits and minimum wage. Thus, staying in the informal sector is a profit-maximizing decision.
- ✧ The policies proposed by the study aim at easing the challenges which informal entrepreneurs face in order to increase the incentives to formalize. The study focuses on two policies. The first is related to access to credit. Specifically, the source of funding for the majority of informal entrepreneurs (57%) is personal savings, while 23% rely on personal (non-bank) loans with no interest. The fact that less than 1% of informal entrepreneurs utilized bank loans demonstrated the obstacles to access credit. Therefore, an effective policy to increase the formalization rate would be to enhance access to credit for those willing to formalize. This is particularly important as most informal entrepreneurs, who are mostly sole proprietor, indicate the access to credit is a challenge.
- ✧ The second policy recommendation is related to market linkages. The main consumer market for the informal sector is households, followed by small firms. In general, informal firms do not have market access to the public sector or large firms. This might explain why most of the informal entrepreneurs indicate that there is no need to formalize since selling or rendering services to households does not entail formal transactions. The analysis also shows that creating market linkages with the public sector would be another vital incentive. More than half of informal entrepreneurs indicate that they face market demand challenges.