

FORMALIZING THE INFORMAL ECONOMY: A REQUIRED STATE REGULATORY AND INSTITUTIONAL APPROACH EGYPT AS A CASE STUDY

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ABSTRACT

Informality has always been a challenge for Egypt as a developing country. The informal employment has jumped from 30.7 per cent in 1998 to 40 per cent in 2012. The main reasons behind the increasing informality are varied, numerous and different. Moreover, the negative impacts of informality are not only confined to the individuals, households or companies that are working in the informal sector but on the economy of Egypt as a whole. Hence, an integrated regulatory approach must be adopted to rescue Egypt's economy and get it out of the unforeseen future.

KEYWORDS: Informality, Shadow Economy, Economic Growth, Economic Development, Legalist Approach, Integrated Approach

INTRODUCTION

A big number, if not all, of the developing countries, including Egypt, suffer from the large size of the informal sector. With more than a quarter of the population in Egypt living in poor living conditions according to the latest official statistics, it is clear that the harsh and intolerable economic conditions have compounded the more long-standing patterns of social deprivation which contributed to the fall of President Mubarak in 2011. No doubt that this awkward situation deepened the problem of informality in Egypt which negatively affected Egypt's economy.

Definition of the Informal Economy

The informal economy is the diversified set of economic activities, enterprises, and workers that are not included under the regulation and protection of the state. Originally applied to self-employment in small unregistered enterprises, the concept of informality has been expanded to include wage employment in unprotected jobs.¹ The informal sector was variously and differently defined. Keith Hart (1971, 1973), a social anthropologist, was the first one to bring the term 'informal sector' (in a Third World context) into the academic force, which takes place outside of the formal labor market; he considered the 'informal sector' as almost synonymous for the categories of small self-employed.² This was thereafter typically used to refer to ways of making a living outside the formal wage economy, either as an alternative to it, or as a means of supplementing income earned with it (Bromley and Gerry, 1979).³ In addition, Hart distinguished formal and informal income opportunities on the basis of whether the activity entailed wage or self-employment, implying that wage-earning employment is a characteristic of the formal sector only. The 2002 Conclusions added that the term "informal economy" refers to "all economic activities by workers and economic units that are – in law or in practice – not covered or

¹ Women in Informal employment, Globalizing and Organizing, www.WIGO.com, p 1

² Gërkhani, Klarita, (), Informal Sector in Developed and Less Developed Countries: A Literature Survey.

³ Bromley, R. and Gerry, C. (eds.), (1979). "Casual Work and Poverty in Third World Chichester, Wiley and Sons.

insufficiently covered by formal arrangements. Their activities are not included in the law, which means that they are operating outside the formal reach of the law; or they are not covered in practice, which means that – although they are operating within the formal reach of the law, the law is not applied or not enforced; or the law discourages compliance because it is inappropriate, burdensome, or imposes excessive costs”.⁴ Two approaches were identified to define the informal sector, namely, the definitional approach and the behavioral approach. The former defines it as all the unrecorded economic activities, while the latter considers it as a change in the behavior of economic agents in reaction to institutional constraints.⁵ Some economists consider the informal economic activities as illegal and defined the informal economy in accordance. Lemieux (2002), viewed the informal economy (or illegal economy) as the sector of the economy which covers market production of goods and services, legal and illegal, which are traded illegally; It is composed of both the irregular economy, where legal goods and services are produced and exchanged under illegal conditions, and (productive) black markets, the preserve of goods and services that are illegal but satisfy all the parties involved.⁶ Personally speaking, the term informal economy refers to any business activity or enterprise that falls outside the regulations and protection of the governmental concerned agencies. This definition includes all types of informal employment that is, employment which lack labour or social protection both inside and outside informal enterprises, including both self-employment in small unregistered enterprises and wage employment in unprotected jobs.

This paper will, first, give brief information about the informal economy in Egypt, nature and statistics. Second, it will shed light on some of causes of the emergence and expansion of the informal economy in Egypt. Third, it will clarify some of the major negative impacts of the informal economy on Egypt’s economy. Fourth, it focuses on the required regulatory approach to formalize the informal economy in Egypt.

The Informal Economy in Egypt

Egypt is classified as one of the over-populated countries of the world and is the most populous in the African continent as well as the Arab region; the country’s population has exceeded an estimate of 86.6 million, with an annual increase of 2 to 2.5%, women representing 47%. Around 60% of the population (over 51 million people) is under 30 years of age, where 29.1% of the population (around 25 million) is between 15 and 29 years of age.⁷

Table 1: Population in Thousands and Growth Rate (2002-2012)

Year	2009	2010	2011	2012	2013
Population Male	39,327	40,228	41,153	42,058	43,208
Population Female	37,598	38,457	39,377	40,247	41,421
Total Population	78,934	80,695	82,541	84,317	86,642

Source: CAPMAS Egypt in Figures Population 2014

In Egypt, as one of the developing countries, the informal sector represents a large percentage of GDP. According to the electricity approach to measure the size of the informal sector, the informal sector accounts for 68 percent of GDP in

⁴ ILO: Conclusions concerning decent work and the informal economy, International Labour Conference, 90th Session (Geneva, 2002).

⁵ Dell’Anno, Roberto. (2003). *Estimating the Shadow Economy in Italy: A Structural Equation Approach*. Aarhus University Working Paper No. 2003-07.

⁶ Lemieux, Pierre, (2002), *The Underground Economy: Causes, Extent and Approaches*, Montreal Economic Institute, p 5.

⁷ EGYPT COUNTRY REPORT FOR THE 2014 MINISTERIAL CONFERENCE ON YOUTH EMPLOYMENT How to Improve, Trough Skills Development and Job Creation, (21-23 July, 2014 Access of Africa’s Youth to the World of Work Abidjan, Côte d’Ivoire, p.9

Egypt; while the currency demand approach found the informal sector at 35.1 percent of GDP in Egypt.⁸ The different percentages might not reflect a decrease in the size of the informal sector, but may be due to the use of different methods in measuring its size. Besides, ERF (Economic Reform Forum) (2004) states that 65 percent of the jobs taken up by the new entrants to the labor force in 1998 were informal, compared to 40 percent in the mid-1980s. Moreover, some studies found that informal employment accounts for 55 percent of total non-agriculture employment in Egypt (Assad 2006).⁹ Over the past decade the informal sector has increased in Egypt and remains a very important – and expanding – part of the Egyptian economy. According to estimates in 2001, the informal sector comprised 2.4 million workers in 1976, and had reached 4.8 million workers by 1996.; adding on the number of unpaid family workers gives an estimated total of 6.5 million workers in the informal sector in 1998, compared to 4.7 million in 1998, with negative consequences, particularly for females and young people, with regard to social and job security.¹⁰ The public sector employed substantially from 1998 to 2006, from 2006 to 2012, the public sector maintained a quarter share of employment, employing 25 percent of the workforce in 2006 and 26 percent in 2012. Public enterprises continued to contract slightly, from 7 percent in 1998 to 5 percent in 2006 and 4 percent of employment in 2012. Over time formal private regular wage employment has increased slightly, from 8 percent in 1998 to 9 percent in 2006 and 11 percent in 2012. After expanding from 1998 to 2006, informal private regular wage employment contracted slightly in 2012, down to 15 percent of employment from 17 percent in 2006. The largest change from 2006 to 2012 was the substantial increase in irregular wage work (seasonal or intermittent work), while 12 percent of the employed were irregular wageworkers in 1998, this had fallen to 8 percent in 2006, but had more than doubled to 17 percent of the employed in 2012.¹¹ Irregular wage work is associated with poverty and vulnerability. Unpaid family work outside the agricultural sector and self-employment in agriculture each maintained 2 percent shares over the entire 1998- 2012 period, while the share of self-employed non-agricultural workers was also stable at 8 percent. Unpaid family work in agriculture rose from 5 percent in 1998 to 11 percent of employment in 2006 before falling back to 5 percent of employment in 2012. After a slight increase in the share of employers among the employed over the 1998 to 2006 period, in 2012 the share of employers had decreased to 10 percent from 13 percent in 2006.¹²

⁸Ernste, Dominik, and Friedrich Schneider. 1998. Increasing Shadow Economies all over the World - Fiction or Reality? A Survey of the Global Evidence of their Size and of their Impact from 1970 to 1995, The Institute for the Study of Labor (IZA) Discussion Paper No. 26.

Schneider, Friedrich, and Robert Klinglmair. 2004. *Shadow Economies Around the World: What Do We Know?* Center for Research in Economics Management and the Arts, Department of Economics, Johannes Kepler University, Working Paper No. 0403

⁹Assad, Ragui. 2006. "Assessing Informality in Labor Markets of Developing Countries." IZA/World Bank Conference on Employment and Development, May 25-27, 2006, Berlin

¹⁰Ragui Assad & Caroline Kraff, ((2013)), *The Structure and Evolution of Employment in Egypt (1998-2012)*, Working Paper 805, The Economic Research Forum (ERF), pp. 10-12.

¹¹Ibid, p11.

¹²Ibid, EGYPT COUNTRY REPORT FOR THE 2014 MINISTERIAL CONFERENCE ON YOUTH EMPLOYMENT, pp. 18-19.

Table 2: Distribution of Formal and Informal Employment in Egypt (2006-2012)

Year	2006	2012
Public Sector	25%	25%
Public Enterprises	5%	4%
Formal Private Regular Wage Employment	9%	11%
Informal Private Regular Wage Employment	17%	15%
Irregular wage work (seasonal or intermittent)	8%	17%
Unpaid Family Work outside agriculture	2%	2%
Self employment in Agriculture	2%	2%
Self employment non Agriculture	8%	8%
Unpaid Family Work in Agriculture	11%	5%
Employers among the employed	13%	10%
Total%	100%	100%

ELMPS 2006 and 2012

Characteristics of the Informal Economy in Egypt

The informaleconomic sector in Egypt is characterized by a number of features, perhaps the most important are:

- Non registration of the informal enterprises in official records of the state, for example tax systems, government commercial records and public utilities record.
- Individual character of the informal enterprise. About 92% of the small and medium enterprises (SMEs) are individual based enterprises.
- SMEs are characterized by small size in terms of scope of production and number of workers.
- SMEs depend on limited or small capital.
- Most of the work in SMEs is manually performed as the use of technology in these enterprises would be highly costly, 54% of them depend on manual work.¹³
- Most of workers are from rural areas.
- Most of the workers in the informal enterprises are non-educated, disqualified, and lack professional skills.
- A large number of the informal workers is involved in agriculture.
- Low wages is an important characteristic of the informal enterprises.
- The absence of insurance, medical care and social security protection.

¹³ Al Asrag, Hussein, (2010), Reflections of The Non-official Sector on Egyptian economy, Electronic copy available at: <http://ssrn.com/abstract=1618791>, p 3-4.

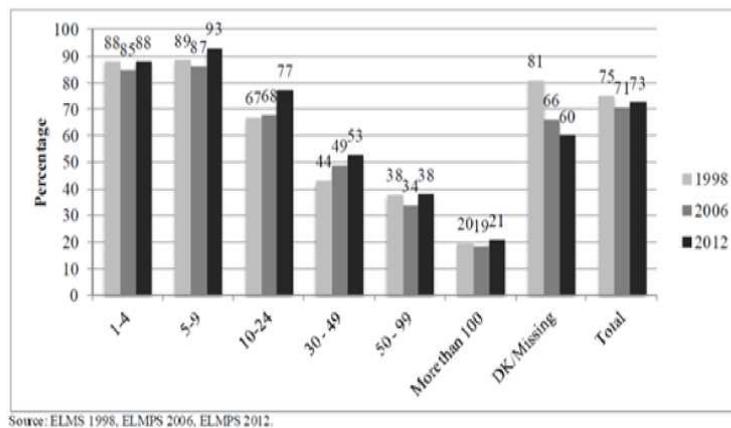


Figure 1: Percentage of Informal Employment in Private Wage Employment by Firm Size, Ages 15-64, 1998-2012

THE CAUSES OF THE EMERGENCE OF THE INFORMAL ECONOMY IN EGYPT

Causes behind the emergence of the informal economy in Egypt could be summarized in the followings:

First, Impediments to Exchange

What are the main impediments that push individuals to the informal economy? Taxes, regulations, and prohibitions are suggested by theoretical and empirical literature. In empirical research, taxes consistently appear as one of the main determinants of the informal economy, whether it is high income tax rates or high rates of indirect taxes.¹⁴ It has been estimated that, in the U.S., an increase of one percentage point in the federal marginal (personal) income tax rate extends the informal economy by 1.4 percentage point.¹⁵ “[t]he smallest underground economies are estimated to exist in countries with relatively small public sectors (Japan, the US, and Switzerland) and comparatively high tax morale (the US and Switzerland)”.¹⁶ Chart 3 shows the correlation between the tax burden and the ratio of the informal economy to GDP. Countries with a lower tax burden (around 35%) like Japan, the U.S. and Switzerland, have an informal economy that hovers around 10% of official GDP. On the contrary, countries with a tax burden over 65% tend to show an informal economy of more than 15% of GDP (like in Scandinavia). With a tax burden of more than 45% in Canada, the informal economy stands at about 15% of GDP. Among OECD countries, 34% of the variance in the level of informal economy seems to be explained by the tax burden.¹⁷ With a tax burden of more than 25% in Egypt, the informal economy stands at about 30-40% of GDP. The Personal Income Tax Rate in Egypt stands at 25 percent. Personal Income Tax Rate in Egypt averaged 23.45 percent from 2004 until 2014, reaching an all-time high of 34 percent in 2005 and a record low of 20 percent in 2006.¹⁸

¹⁴Schneider, Friedrich, and Dominik H. Enste (2000), “Shadow Economies: Size, Causes, and Consequences”, *Journal of Economic Literature* 38-1, p83.

¹⁵Ibid, p 85

¹⁶Ibid, p 81

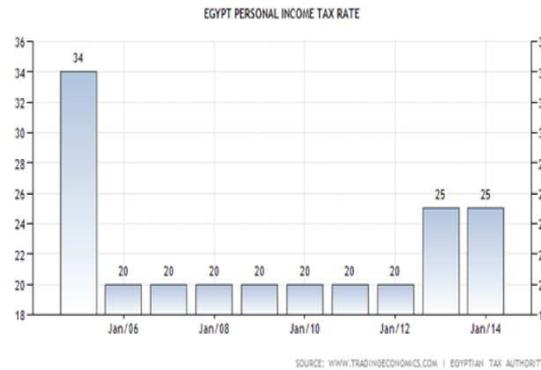
¹⁷Shelley, Donna, et al. (2007), “The \$5 Man: The Underground Economic Response to a Large Cigarette Tax Increase in New York City”, *American Journal of Public Health* 97-8, pp. 1-6. Fleenor, Patrick (2003), “Cigarette Taxes, Black Markets, and Crime: Lessons from New York’s 50-Year Losing Battle”, *Policy Analysis* 467 (Washington, DC: Cato Institute, February 6, 2003); reproduced at <http://www.cato.org/pubs/pas/pa-468es.html>.

¹⁸Personal Income Tax Rate in Egypt is reported by the Egyptian Tax Authority. <http://www.tradingeconomics.com/egypt/personal-income-tax-rate>

Table 3: Distribution of Tax Rates in Egypt

Taxes	Last	Previous	Highest	Lowest	Unit
Corporate Tax Rate	25.00	25.00	25.00	20.00	percent
Personal Income Tax Rate	25.00	25.00	34.00	20.00	percent
Sales Tax Rate	10.00	10.00	10.00	10.00	Percent
Social Security Rate	40.00	40.00	40.00	40.00	Percent
Social Security Rate For Companies	26.00	26.00	26.00	26.00	Percent
Social Security Rate For Employees	14.00	14.00	14.00	14.00	Percent

Source: www.tradingeconomics.com Egyptian Tax Authority

**Figure 2**

As a factor leading to the increasing scope of the informal economy, the tax burden should be understood as including the effective tax rate of welfare recipients. the social welfare system leads to strong negative incentives for beneficiaries to work in the formal economy, since their peripheral tax rate often comes nearer or equals 100 percent". In other words, welfare recipients confront powerful motivators to work in the informal economy.¹⁹

Another important cause which leads to diversion to the informal economy is the number of regulations imposed by countries in their labor markets. In particular, labour market regulations increase labour cost in the official economy, just as taxes do; they thus reduce the demand for labour and the take-homepay of workers.²⁰ Countries which adopt and apply lowerlabour regulation like the US or the UK tend to have an informal economy of about 10% of GDP, while countries with intensive regulation (Iceland and Greece, for example), hover around 25%; Canada is in the middle.²¹ In Egypt, the regulatory and institutional framework in the formal labor market hinders new entrants from finding jobs or working independently. Major characteristics of regulations and procedures could be summarized as follows:

- The necessity of the personal presence of the owner of the work at the headquarters of the governmental agencies.
- Redundancy of procedures at all levels as documents could be required from different governmental agencies more than one time.
- The required approval from enumerated governmental agencies and authorities forcing owners to navigate between several destinations for the completion of the required paperwork.

¹⁹Schneider, Friedrich, and Dominik H. Enste, *ibid*, p.86

²⁰ *Ibid*, p.86

²¹ *Ibid*, Lemieux, Pierre, p. 11

- The required approvals of regulatory and security authorities: one of the things which is more complicated because of the sensitivity of the situation and the need to do a lot of actions and fulfill a lot of procedures.
- The large number of required documents and papers.
- The length and slow export and import procedures: that lead to the obstruction of the efforts of SMEs to gain access to export markets.²²
- In the legal and regulatory necessary set-up in Egypt, a lot of procedures have to be met, for example, in the start-up phase several conditions have to be met:
- The license: Law No. 453/1954³ regulates the conditions for obtaining an operation license.
- Social Security Certificate (SSC): All self-employed, employers and partners in joint liability and simple liability companies are subject to Law No. 108/1976, which regulates the conditions for acquiring the SSC.
- Commercial Registry: Anyone who operates a commercial activity has to register with the Commercial Registry, according to Law No. 34/1976.
- Tax Authority: Any businessman who operates an economic, commercial or industrial activity is required to obtain a tax file and a tax card from the Tax Authority according to Law No. 157/1981.

The second phase: the operation of activity requires meeting several additional conditions:

- Labour Law: Every business that employs workers has to abide by Labour Law No. 137/1981.
- Tax laws: Law No. 157/1981⁴ regulates the tax imposed on income as well as on commercial and industrial profits
- Social Security: At the beginning of activity – and according to Law No. 79/1975 – the business owner has to notify the social security office.²³
- Besides the above-mentioned laws and regulations, each SMEs – according to their types of economic activity – have to obtain permits from other concerned authorities and ministries. For example, a small coffee shop must have permits from certain departments in the Ministries of Health, Tourism, Internal Trade and Industry as well as the District Authority.²⁴

Second: The Declining Role of the State

Devoted to the socialist orientations, values and ideas, the Egyptian government issues law no. (14) in 1964. The law represented a populist economic policy which pursued the achievement and prevalence of social justice and welfare in different and various aspects, for example, free education, free health service and employment for everyone at age of works.²⁵ This law imposes a large burden on the state as it became totally responsible for hiring all universities graduate students and students who finished their secondary school at government offices within two or three years after the

²² Al-Asrag Hussein, *ibid*, pp11-12

²³ El Mahdi, Alia, (2002), *Towards Decent Work in the Informal Sector: The Case of Egypt*, EMPLOYMENT PAPER 2002/5, Geneva, International Labour Office, pp. 3-4

²⁴ *Ibid*, p4

²⁵ Rawaa, Harati, (2012), *Heterogeneity in the Egyptian informal market, choice or obligation?*, _Centre d'Economie de la Sorbonne-Universit_e Paris , p.4

graduation. Nevertheless, this law passed through various modifications and ceased in 1978 as graduates waited more than four or five years to be employed and a large number of them were not even considered by the government. Realistically speaking, no government in an overpopulated county with a great deficiency or scarce resources can guarantee the application of such a law. Moreover, at the time of the issuance of this law and during the 70's Egypt was still instable not concentrating on its own economy but on its wars against Israel and war in Yemen. One of the major drawbacks of this law was the increasing budget deficit from which Egypt has been suffering from for a very long time. In 1986 the country suffered from a variety of serious deficits, deficits in the balance of payments, high inflation rates and high interest rates. Furthermore, the performance of the public sector was very poor and the country was highly indebted. With these shortcomings, economic reforms were highly and urgently recommended.

Due to these concerns, in 1991, the Egyptian government concluded an agreement with the International Monetary Fund (IMF) and the World Bank (WB) to begin the Economic Reform Structural and Adjustment Program (ERSAP) in order to remedy the macroeconomic imbalances privatizes the public sector, liberalize the foreign trade and adjust the exchange rate. Until now, it is the public sector and especially the government the main employer. The reform objective was to reduce the wage bill in order to cut the budget deficit. It is the private sector which has to be open for more job opportunities, and it became harder to find a job after graduation because there is no certainty that the public sector will hire, and the private sector employers started using this advantage to put hard conditions on workers who do not want to be unemployed. The ERSAP achieved good results in reducing the budget deficit and the balance of payments deficit; it also stabilized the exchange rate and privatized most of the public sector units. But the ERSAP had also some negative consequences on employment.²⁶ New entrants with no or low education, also some of those who were working in the public sector and lost their jobs, found no other option but to work informally. Therefore the informal sector was a large job absorber.²⁷

Third: Unemployment

Unemployment Rate in Egypt remained unchanged at 13.40 percent in the first quarter of 2014 from 13.40 percent in the fourth quarter of 2013. Unemployment Rate in Egypt averaged 10.55 Percent from 1993 until 2014, reaching an all-time high of 13.40 Percent in the third quarter of 2013 and a record low of 8.10 Percent in the second quarter of 1999.²⁸

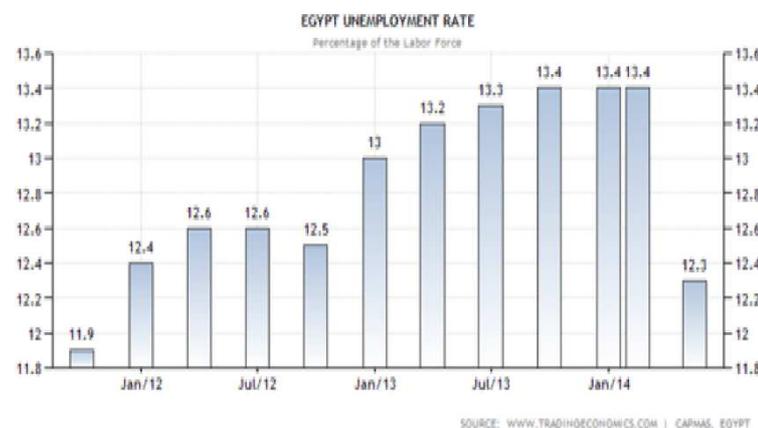


Figure 3

²⁶ Ibid, p 5

²⁷ Moawad, S., 2009, The informal economy as an engine for poverty reduction and development in Egypt. MPRA, p. 7.

²⁸ <http://www.tradingeconomics.com/egypt/government-budget>

In Egypt, the informal sector has played an important role in job creation in the period of economic reforms. In particular, new entrants to the labor market seemed to bear the brunt where by the end of the 90s, some 69 % of new entrants to the labor markets managed to only secure informal jobs.

Table 4

Calendar	Country	Event	Actual	Previous	Forecast
2013-08-21	Egypt	Unemployment Rate	13.3%	13.2%	13.4%
2013-11-27	Egypt	Unemployment Rate	13.4%	13.3%	13.4%
2014-02-19	Egypt	Unemployment Rate	13.4%	13.4%	13.6%
2014-05-19	Egypt	Unemployment Rate	13.4%	13.4%	13.7%

In Egypt, unemployed persons are individuals who are without a job and actively seeking to work.

Table 5

Labour	Last	Previous	Highest	Lowest	Unit
Unemployment Rate	12.30	13.40	13.40	8.10	Percent
Unemployed Persons	3658.00	3695.00	3695.00	2022.00	Thousand
Population	82.06	80.72	82.06	27.90	Million

Causes of unemployment in Egypt are varied and different; these causes represent the major pushing force towards informality. Some of these causes include the tendency of a large number of workers to join the informal sector which continues to be the main refuge for low-productivity, low-income employment, especially for women in addition to the insufficient work capacity as the available formal work does not absorb and contain the large number of workers.

Fourth; Rural Migration to Urban Areas

Internal migration in Egypt has generally been: a) from South to North, b) from South and North to the Canal Zone, c) from Egypt's hinterland to Cairo and Alexandria, and d) from Egypt's center to its peripheries. As numerous studies have shown, the biggest convergence of migration streams is in the Greater Cairo Region, which includes Cairo, Giza, and Qalyoubiya governorates.²⁹

Internal migration in Egypt is caused by the following push factors:

- **Increasing Demographic Pressure:** Mounting demographic pressure is often inferred from the rising population density and rapid population growth in the twentieth century. Demographic pressure is not in itself a cause of migration; it becomes a causal factor when mediated through a relationship with economic resources such as employment, income, or land. In Egypt, high population density is assumed to interact most significantly with the extent of cultivable land. As the pressure increases, a population increment which cannot live off the land has to go somewhere; migration thus acts as a 'safety-valve'.³⁰
- **Decreasing Economic Opportunities:** Declining economic opportunities are explained in the case of rural areas in terms of a) the increasing number of landless families; b) the increasing fragmentation of land-holdings because of inheritance, thus making it progressively more difficult for a family to support itself; and c) the low level of

²⁹ Adams, R. 1986. *Development and Social Change in Rural Egypt*. Syracuse NY: Syracuse University Press.

³⁰ ZOHRY, AYMAN and HARRELL-BOND, BARBARA, (2003), *Contemporary Egyptian Migration: An Overview of Voluntary and Forced Migration* Forced Migration and Refugee Studies Programme American University in Cairo, p. 14

wages for those who can find employment locally.³¹

- Scarcity of Services and Other Social Amenities: Several authors have collected data to show the relative deprivation in some areas of Egypt in terms of education and health services.³²

Although the above mentioned causes led to the expansion of informality in Egypt, other causes such as poverty, according to the Household Income, Expenditure and Consumption Survey (HIECS) for 2012/2013; 26.3 percent of the Egyptian population lived below the National Poverty Line (NPL) of 327 L.E./month per individual; poverty varies across different regions in Egypt; the urban frontier governorates witnessed the lowest poverty rate of 11.4%, while rural Upper Egypt governorates showed the highest poverty rate of 49.4%.³³ illiteracy where 68.6% of illiterate wagers belong to the informal sector³⁴, under-development where inefficient public institutions, burdensome registration processes and a general distrust of the government, decline of the economic performance of the country as a whole urged the creation of a market outside Egypt's formal structures. Moreover what exacerbates the problem is that one can find a combination of these causes, poverty, illiteracy and bad health conditions available in one family. Economic pressures, the feeling that they are unable to fulfill their obligations towards their family and satisfy their basic needs pushed a great and increasing number of these families towards informality. Youth who graduate from universities find that their academic status are no longer beneficial to start an appropriate life; even in the case they are recruited in companies, their salaries are too low for them to subsist. Most of women find that their husbands, although they do their best to make available the required expenses for families, are unable to get along with family requirements; 59.3% of workingwomen are in the informal sector; this rate corresponds to 57.9% for men.³⁵ A great number of these women, if not all of them, are illiterate so when they think to help and support their families, they find no way but the safety valve, informality. Besides, these poor families who can't afford their children's education tuition fees, found themselves forced to get their children out of schools to help them confronting the harsh economic conditions, 87.1% of young workers aged between (15-24) have informal employment.. Of course, there is no way for these children to help their family except informality. No doubt, that informality represents the sole tool for a population, half of which is living under the base of poverty line, to hardly survive.

Even though a great number of those who are involved in informal commercial activities are suffering a lot to fulfill their obligation, this could never be a claim for leaving the informal sector in Egypt unregulated. The unregulated and unorganized informal have serious negative impacts on the Egyptian economy and the Egyptian society as a whole.

The Negative Impacts of Informality in Egypt

The existing and expanding informal sector in Egypt has negatively affected the Egyptian economy and the society as a whole; these will be explained as follows:

³¹Toth, J. 1999. *Rural Labor Movements in Egypt and Their Impact on the State, 1961 – 1992*. University Press of Florida, Gainesville.

³²ZOHRY,AYMAN and HARRELL-BOND,BARBARA, *ibid*, p.15

³³Egypt's Central Agency for Public Mobilization and Statistics - CAPMAS(2012/2013)

³⁴ Egypt Labor Market Panel Survey" (ELMPS) 2012

³⁵Angel-Urdinola, D. F, and Tanabe, K., (2012), "Micro-Determinants of Informal Employment in the Middle East and North Africa Region," Social Protection Unit Study Paper no. 1201, World Bank, Washington DC.

First

one major negative impact on countries with large informal economies like Egypt is the segmentation of markets, with capital intensive production in the formal economy and labor intensive production in the informal economy. This segmentation or division of the economy led to a distorted economic reality where the cost of labor is more expensive in the formal economy and capital more expensive in the informal. Moreover, formal businesses activities rely to a large extent on technology and fail to take advantage of Egypt's most abundant factor of production (labor). On the other hand, informal businesses suffer from underinvestment, which hinders their growth and quality standards.³⁶ This phenomenon, known as the Theory of Labor Segmentation, also creates a wage hierarchy; formal employees have higher wages than informal ones, even when doing the same work, because rewards in different economic sectors differ for workers of equal potential productivity.³⁷ This is due in part to non-commitment of informal employers to minimum wage laws. Besides, informal tasks are more poorly paid because they are often unskilled or involve the earlier stages of production; furthermore, workers have no stable guarantee of work and fewer opportunities for advancement.³⁸

Second

Another standard criticism against the informal economy relates to its usual association with tax evasion. The argument is that the informal economy reduces government revenues, and in turn increases budget deficit which leads to either a decrease in public services or an increase in taxes imposed to other taxpayers in order to make up for the lost revenues.³⁹ In light of the 25th of January revolution and its consequences, the Egyptian budget deficit jumped up during the fiscal year 2010/2011 to post LE 134.5 billion with an increase of 37.2% compared to the previous year and it exceeded the estimated deficit by 23% for the same year in its largest part to the increase achieved during the fourth quarter of LE 40.4 billion. Egypt is expected to record a Government Budget deficit equal to 9.10 percent of the country's Gross Domestic Product in 2013/14 fiscal year. Government Budget in Egypt averaged -9.31 Percent of GDP from 2002 until 2014, reaching an all-time high of -6.80 Percent of GDP in 2008 and a record low of -14.10 Percent of GDP in 2013.⁴⁰ No doubt that this deficit will hinder the government from fulfilling its obligations towards citizens, for example, education, health care and social requirements.

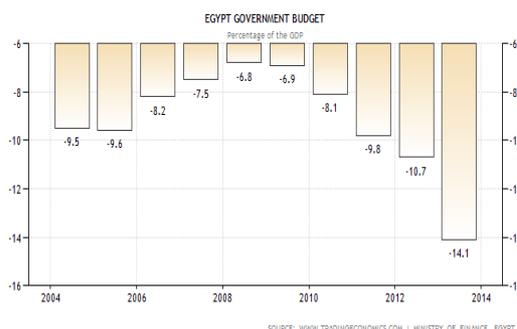


Figure 4

³⁶ De Soto, Hernando, *The Other Path: The Economic Answer to Terrorism*. New York: Perseus Books Group, 2002, p 151.

³⁷ Douglas Marcouillier and Leslie Young, "The Black Hole of Graft: The Predatory State and the Informal Economy." *American Economic Review* 85 (1995): 367-368.

³⁸ De Soto, Hernando, *ibid*, p 151

³⁹ Lemieux, Pierre, *ibid*, p 16

⁴⁰ <http://www.tradingeconomics.com/egypt/government-budget>

Third

A major negative impact of the informal economy is the inability of the Egyptian government to formulate a comprehensive economic strategy. Official estimates of the informal economy are often inaccurate and do not provide an accurate analysis of its impact on the formal economy. Furthermore, it has no representation in GDP or other national economic indicators. Another type of cost often ascribed to the informal economy is production in illegal markets benefits from a reduction in other costs of production, because taxes are not paid and a host of environmental, safety, health and labour regulations do not need to be obeyed. Operation in legal markets roughly doubles the price of goods or, alternatively, that illegal producers save some 50% on production costs. Thus, costs of production and prices in an informal market could be lower than in the legal market.⁴¹

Fourth

Informality, in Egypt, increased the scope of poverty in terms of the numbers of the poor people and in terms of the size of poverty in Egypt as a whole. Of course informality is not the sole reason behind poverty, but it plays an essential role in magnifying the problems. Individuals working in the informal sector earn very low wages. Even though the fact that informal workers do not have work contracts or social security coverage, the differences in the levels of wages is important and harmful to informal workers.

Table 6: Total Daily Wages for Private Sector Wageworkers in 1998

Total daily wage (LE)	Informal			Formal		
	Male %	Female %	Total %	Male %	Female %	Total %
0-<5	26.7	60.6	32.1	7.2	23.1	9.6
5-<10	42.4	29.5	40.4	37.1	40.3	37.6
10-<20	25.3	5.0	22.1	38.7	23.5	36.4
20-<50	5.6	4.8	5.45	15.8	11.4	15.2
50-<100				0.8	1.6	0.9
100->				0.3		0.3
Total	100	100	100	100	100	100

Source: ELMS98 data files.

Fifth

Gender discrimination is certainly more intensified as a result of the existence of a large informal economy. Formal enterprises hire a higher percentage of men and a greater neglect a big number of women who are obliged to work in informal jobs. Because the different economies also correspond to differentiations in terms of wages, there is a stronger incidence of poverty among women.⁴² This discrimination persists within the informal economy because “women are under-represented in the high-income employment categories (notably, as employers), and over-represented in the low-income categories (for example, as home workers).”⁴³ Although there is a wage gap between male and female employees in the formal economy, this gap between the sexes is exacerbated in the informal economy. Female informal

⁴¹ Ibid, p16

⁴² De Soto, Hernando, p 169

⁴³ Reema Nanavaty, (2005), *From Local to Global and Informal to Formal*. Expert Group on Development Issues, http://www.wider.unu.edu/publications/working-papers/discussion-papers/2005/en_GB/dp2005-02/.

employees suffer double discrimination; they receive inferior wages to the formal economy as a whole because they are informal and lower wages than men in the informal economy because of their condition as women.⁴⁴ In addition to wage disparity, women in the informal economy are subject to increased incidence of sexual harassment. The insecurity of informal employment makes them more vulnerable to advances from their bosses. Women lack sufficient tools to persecute sexual offenders because of their condition of informality.⁴⁵

Other negative impacts of the informal sector could be stated as follows:

- Misleading official economic indicators which imply that macroeconomic variables such as Gross National Product (GDP), Inflation rate, and percentage of total labor force are not reliable.
- Unjust competition for formal economy; firms fulfilling higher tax obligations will incur higher production cost to firms working in the informal economy.
- Foreign direct investments have been negatively affected by the informal enterprises which produce their products with low quality and low prices.
- Negative impacts on public reconciliation which leads to negative public opinion on government policies.⁴⁶ The 25th of January Revolution 2011 in Egypt represents a prominent example for this. Due to the harsh economic conditions, social injustice and tyranny, the Egyptians revolted against Mubarak's regime; they raised three major slogans, bread, freedom and social justice.
- Human rights abuses are particularly prevalent in informal business environments.⁴⁷ Informal working conditions are not subject to official scrutiny and can be inhumane. Furthermore, child labor is almost completely limited to the informal economy.⁴⁸
- The use of violence became prevalent. Violence is the only coercive method informal workers possess because of an absence of social justice, dignity and peaceful enforcement mechanisms, such as contracts and access to police and arbitration.⁴⁹ In Egypt, this led, to a great extent, to the emergence of religious extremism. A lot of extremist deviant religious groups were established, for example Muslim Brotherhood, Beit El Makdas Groups, Altakfeer WalHejra and recently affiliated groups to Daesh. These terrorist groups used a great deal of violence and committed a lot of terrorist attacks on both military and civilians.

Due to the numerous and various negative effects of the informal economy on both the macro- and micro-level, the need to address the informal economy and undeclared work properly became urgently recommended and required. Developing countries in which the informal economy represents a high percentage and hence hinders economic growth and economic development, which can't perform their functions well due to the insufficiency of resources, whose informal workers suffer from inhuman practices and discrimination must form and adopt an integrated regulatory and institutional

⁴⁴Chen, Martha.(2005), The Business Environment and the Informal Economy: Creating Conditions for Poverty Reduction. Rep. Cairo, p 25

⁴⁵ Ibid, p 25

⁴⁶Saglam, Necdet,(2007), The Informal Economic Sector and Poverty in The Mediterranean Countries and Turkey. http://www.um.edu.mt/europeanstudies/books/CD_CSP4/pdf/nsaglam.pdf,. p. 158

⁴⁷De Soto, Hernando, ibid, p169.

⁴⁸Decent Work and the Informal Economy.Rep. no. VI. International Labour Organisation, 2002.

<<http://www.ilo.org/public/english/standards/relm/ilc/ilc90/pdf/rep-vi.pdf>>

⁴⁹ Ibid

approach. This approach is comprehensive and integrative; in other words it is multilevel and multidimensional. It is multi-level as it requires the integrated efforts and cooperation from three different levels. The first level includes the government, its agencies, authorities and officials; the second level includes the informal sector, informal enterprises and informal workers; the third level includes domestic non-governmental organizations and society. Moreover, this approach is multidimensional as it comprises legal, legislative, political and economic aspects.

The Recommended Integrated and Regulatory Approach

Due to the above mentioned negative impact, freedom to choose between joining the formal and informal sectors must be eliminated. However, before depriving enterprises from selection, an integrated and regulatory approach should be adopted; an approach which considers the already established formal enterprises and the enterprises to be established in future. This approach recommends mandatory legislative, executive and judicial reforms. Moreover, it includes repression as an additional mechanism to reduce the scope of informality and the negative impacts, associated with informality, on the Egyptian economy and the society as a whole. Concerning the previously established enterprises, in addition to the following recommended integrative approach, a gradual approach should be adopted. This approach grants a five-year grace period to the already established informal entities as granting a five-year grace period to the already established informal entities before they turn into formal entities. During these five years, firms could benefit from financial incentives such as credit facilities and some technical assistance through business incubators that could help nurture small informal entities. Creating a central unit to collect information and provide advice on how to improve productivity would also help these entities.⁵⁰

Legislative Reform

As previously mentioned, one of the major cause of informality is the intensive regulations which are imposed on formal work. In particular, labor market regulations in Egypt increase labor cost in the official economy, just as taxes do; they thus reduce the demand for labor and the take-home pay of workers. The regulatory and institutional framework in the formal labor market hinders new entrants from finding jobs or working independently. Therefore, legislative reforms must be initiated. Lawmakers are obsessively concerned with bureaucratic paperwork and details of authenticity and verification.⁵¹ What needs to be comprehended is whether existing laws and institutions are properly or poorly designed in terms of their impact on the costs and profits to enterprises and workers of becoming and staying formal or informal. Where such laws and regulations are cost effective, are predictable and provide the required business information, people are more probably to conform to and comply with them. Regulations which are poorly designed, are burdensome and involve dealing with corrupt and inefficient bureaucracies increase transaction costs, discourage compliance, impede economic participation and encourage endemic corruption, thus enhancing segmentation between the formal and informal economies.⁵² Improving the legislative framework does not necessarily mean reducing rules and laws, or in other words, deregulation. It is important to remember that laws do not only constrain entrepreneurship and formalization, they can also play a facilitating or enabling role and serve to enforce fundamental principles and rights.⁵³ An enabling legal system can

⁵⁰ Saif, Ibrahim, (2011), Challenges of Egypt's Economic Transition, Carnegie Endowment for International Peace, www.CarnegieEndowment.org/pubs, pp. 16-17

⁵¹ De Soto, Hernando, (1997), *Dead Capital and the Poor in Egypt*. Egyptian Center for Economic Studies, <http://www.eces.org.eg>, p 24

⁵² Ruffer, Tim, Ibid, p 23

⁵³ Ibid.

offer security, motives, safeguards and protections. Reforms should concentrate on the most binding restrictions and take into consideration the interactions between labor regulations and other aspects of the investment climate affecting the incentives to become formal. A well-defined and designed practice in diminishing division between the formal and informal sectors will mostly include the following measures:

- Maintain comprehensive legislative and regulatory reform programs.
- Simplify official administration for business.
- Simplify tax administration.
- Rationalize business registration and licensing regimes.
- Limit licensing to those activities where it is justified.
- Reduce registration fees and statutory requirements.
- Promote labor law reform which, whilst protecting essential rights, makes it easier to hire and fire workers and to employ people on flexible contracts.⁵⁴

Executive Reform

Reforming legislations is only the foundation for reform. Comprehensive reform is more complex. Because the root causes of the informal economy are multifaceted, legalization alone is not enough to promote decent work. An executive or governmental reform is also recommended. Any reform program must include improvements which not only enable informal entrepreneurs to gain access to the formal system, but comprises tools to assist them fully benefit from the opportunities of the system as well. Executive reform comprises rule based and transparent governmental developments and practices. Governmental developments and practices include the following measures:

De-Politicization

De-politicization means the separation between authority and public interests; or in other words, it means preventing political elites from using the authorities vested in their hands for their own interests. In most of the developing countries, regulations and laws are conceived so that certain interest groups benefit from them. These groups, including the government officials as well as private actors, usually have the strongest political power and use their power relations to ensure that they gain privileges from the law. Important political actors will preclude any kind of reform program that would cause them to lose control over the economy because of their desire to maintain their privileges. De-politicization is critical in maintaining the sustainability of formalization reform. De-politicization entails the existence of supervisory bodies which monitor political elites and prevent them from using their authority for their personal interests.

Active Public Monitoring

A legislative authority (the Parliament), acting in accordance with a constitution that monitors and disciplines the government authorities, is necessary to enact measures to confront bureaucracy in its various forms and to issue laws and legislatures needed for administrative reform regarding transformation to formalization. This legislative authority must

⁵⁴Ruffer, Tim, Ibid.

express the people's will and may form fact-finding committees to study the problems that the government employment institution suffers from.⁵⁵

Developing Government Monitoring

Government authorities are also required to determine a methodology for internal monitoring to unveil weaknesses and spot bureaucratic features before they become prevalent. This self-monitoring entails empowering the monitoring authorities such as Administrative Control Authority, Public Funds Investigation Authority, and The Central Agency for Public Mobilization and Statistics CAPMAS, among others. Government monitoring efforts should be integrated with public monitoring to provide a genuine opportunity for society to face corruption head on and mitigate its negative impact on the investment climate and on society as a whole.⁵⁶ These bodies will also monitor the creation and implementation of public policy which serve and facilitate the procedures for all enterprises to join the formal sector. They will, also, ensure and guarantee the legal context which secures greater transparency and fairness for all involved in business transactions.

Simplifying Government Procedures

Complicated procedures and lengthy times for obtaining approvals and permits are among the major signs of bureaucracy. It is important to resolve these impediments by simplifying procedures through the following:

- Fundamental adjustments to the law that remove complications and ensure additional responsibility for employees authorized to issue declarations and approvals.
- Issuing internal regulations that help facilitate procedures and reprimand those who fall short or are too lenient.
- Providing a “one-stop-shop” system for receiving permits to streamline interaction with the public and saves time to obtain paperwork. This falls within the purview of the Decree of the Minister of Administrative Development No. 10 for the year 2009 in Egypt, regarding organizing the work of the government services sector by mandating duties to private companies and NGOs.⁵⁷
- Simplifying procedures for issuing permits and registering projects
- Involving the private sector and civil society's participation in debates regarding adjustments to the laws or the introduction of new bills, to be informed of their opinions prior to issuing or adjusting these laws.
- Preventing corruption charges to be dropped, and increasing penalties on careless behavior from government employees.⁵⁸

A Required Effective Integrating Mechanism between Governmental Agencies

An effective integrating mechanism between governmental agencies is highly recommended. Government is required to work on coordination in order to facilitate transformation to formalization. An electronic integration network is highly required to overcome transaction costs for all enterprises which deal with these governmental agencies..

⁵⁵Tackling the Leviathan: Reforming Egyptian Bureaucracy for Improved Economic Growth, (Center for International Private Enterprise (CIPE) www.cipe-arabia.org, p 39

⁵⁶ Ibid, p 39

⁵⁷ Ibid, p 39

⁵⁸ Ibid, pp. 34-35.

Coordination is imperative to create a balance between the central government and local responsibilities. In order to eliminate bottlenecks, no one governmental level should be responsible for the totality of formalization requirements. In some cases, such as that of Egypt, this calls for decentralization by transferring legal and administrative responsibilities from the central government to local authorities. All levels of government must increase communication in order to coordinate policies and reduce redundancies duplications or repeated procedures. Lastly, the scope of authority of different governmental institutions must be clearly defined so that tasks do not overlap in different bodies.⁵⁹

Judicial Reform

Demands for the reform of Egypt's institutions, including the judiciary, are as old as the institutions themselves. In fact, many Egyptian judges have long called for amendments to the law on judicial authority that regulates the work of the judiciary, in order to guarantee the independence of the judiciary from the executive branch and improve its efficiency as an institution.⁶⁰ The need for reform has become even more crucial in the context of the massive political and social changes that have unfolded in the last three years (the revolution of the 25th of January 2011). However, the major challenge has been how to achieve the desired reforms. To guarantee the independence of the judiciary from the executive branch and improve its efficiency as an institution is very important for the transition to formalization for the following reasons:

- This will secure the separation of powers and enhance the monitoring mechanism on decisions made by political elites and governmental officials to prevent personal interests from influencing public affairs.
- This will define the legal procedures, which are made by the independent judicial authorities followed by all enterprises to join the formal economy.
- In case of disputes between governmental agencies and enterprises, the independent judiciary can settle disputes and issue sentences with immunity from bias.

In this context, the greatest challenging facing the Egyptian judiciary is not achieving judicial independence but rather is increasing "the professionalism of the judiciary." To improve judicial professionalism, the issue of judicial appointments must be addressed. One of the proposals in this regard is the establishment of a judicial academy whose mission would be to select new judges and train them, in recognition of the fact that the current process of selecting judges is influenced by personal connections or status. The appointments process should be reformed to focus on skill and technical ability, in addition to personality. The proposed judicial academy could play an important role in measuring and developing these skills.⁶¹

Repression

In addition to the above mentioned legislative, executive and judicial reforms, violators of new legislations, regulations must be exposed to governmental repression. Repression entails to impose higher penalties to participants in the informal economy. The economic theory of crime postulates that an increase in expected sanction will increase the cost of, and reduce, participation in illegal markets. The expected sanction can be increased through either higher penalties if

⁵⁹De Soto, Hernando, (1997), p 45.

⁶⁰Auf, Yussef, (2014), Prospects for Judicial Reform in Egypt ,*Centre for the Middle East*.

⁶¹ Ibid.

convicted or a higher probability of being caught and convicted, which means better enforcement (more police surveillance and interventions, more intensive investigations, more resources allocated to criminal prosecutions, etc.).⁶² It is generally admitted that allocating more resources to enforcement and/or enacting higher penalties will reduce the informal economy.⁶³ In practice, better enforcement means more bureaucratic and police intervention in the affairs of small businesses, on building sites, in restaurants, in contractual relations.⁶⁴ The economic analysis of crime argues not for maximal repression but for optimal repression. Enforcement has costs (police and legal personnel, equipment, etc.) and it would be inefficient to increase it over the level where the marginal cost becomes higher than the marginal benefit.⁶⁵ The other alternative in repression, increasing penalties, also has costs, if only because of the problem of marginal deterrence: if the penalty for smuggling is the same as the penalty for murder, the smuggler has an incentive to kill the customs officer or policeman who catches him on a dark road.⁶⁶ Another argument in favor of optimal as opposed to maximal repression is that some law-breaking and crimes are efficient in the sense that the benefit to the perpetrator is higher than the cost to the victims—in other words, the perpetrator would be willing to pay the victims a price higher than what the latter evaluate is the cost (or risk) of the crime to them. The standard example is speeding illegally to rush a person to hospital. Penalties and enforcement efforts should be set to maximize net benefits.⁶⁷ The costs incurred by the participants of the informal economy to avoid repression must also be included in the costs of a more repressive policy. So are the (presumably important) costs to third parties if resistance leads to the blockade of bridges, roads or railroads. A complete tally of costs must presumably include the revenue and utility lost by the repression victims, who are often not violent criminals.⁶⁸

CONCLUSIONS

No doubt that Egypt in its endeavor for the economic transition is facing a lot of economic challenges. One of the major economic challenges which faces Egypt and de-accelerate its economic growth and precludes economic development is the increasing scope of informality. Informality ranges from 30 to 40% of the gross domestic Product (GDP). Informal enterprises in Egypt are characterized by being individual based enterprises, small size in terms of scope of production and number of workers, small capital, and manual oriented enterprises, etc.

Informality in Egypt is pushed and motivated by different causes. These causes didn't only initiate the establishment of informality and informal enterprises, but widened their scope as well. Non-sufficiency of legislations and legal procedures to facilitate the establishment of formal enterprises, the declining role of the state in initiating new jobs, the increasing number of the unemployed, the increasing level of rural migration to urban areas and poverty represent the major causes of increasing informality in Egypt.

⁶² Becker, Gary S. (1968), "Crime and Punishment: An Economic Approach", *Journal of Political Economy* 72-2, pp. 169-217.

⁶³ Tanzi, Vito (2000), *Policies, Institutions and the Dark Side of Economics* (Cheltenham, U.K., and Cambridge, MA: Edward Elgar), p 174

⁶⁴ Schneider, Friedrich, and Dominik H. Enste (2000), "Shadow Economies: Size, Causes, and Consequences", *Journal of Economic Literature* 38-1, p. 38 (77-114).

⁶⁵ Becker, Gary S, *Ibid.*, pp169-217.

⁶⁶ Friedman, David D. (2000), *Law's Order. What Economics Has to Do with Law and Why It Matters* (Princeton: Princeton University Press)

⁶⁷ Malik, Arun S. (1990), "Avoidance, Screening and Optimum Enforcement", *Rand Journal of Economics* 21-3, pp. 341-353; reproduced in Fiorentini and Zamagni (1999b), pp. 377-389. Stigler, George J. (1970), "The Optimum Enforcement of Laws", *Journal of Political Economy* 78-3, pp. 526-536; reproduced in Fiorentini and Zamagni (1999b), pp. 427-437.

⁶⁸ Lemieux, Pierre, *ibid.*, p 20

Due to the increasing number of informal enterprises and workers, the Egyptian economy and society as a whole suffered from diverse and enumerated negative impacts. Some of these impacts are the segmentation of markets, with capital intensive production in the formal economy and labor intensive production in the informal economy, association of informality with tax evasion, the inability of the Egyptian government to formulate a comprehensive economic strategy, the increasing scope of poverty, gender discrimination, non-commitment to the rule of law and good governance in addition to other minor negative impacts such as lack of property rights, inaccurate measurement of the GDP, negative impacts on FDI and human rights abuses.

Because of the serious negative impacts of informality on the Egyptian economy and society, the Egyptian government must seriously consider the issue. An integrated, comprehensive and regulatory approach must be adopted and quickly implemented by the government and its agencies to reduce informality and secure the economy and society from the negative impact of informality. This approach is multi-perspective as it includes different types of reforms. These reforms include legislative, governmental and judicial reform. Moreover, this approach includes repression as a complementary element for those enterprises which don't comply with the new reforms. Reforms and repression could be used as the carrot and stick by the Egyptian government to secure the dominance of the rule of law and, at the same time, enhance economic growth and development.

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