

Trade Liberalization in Egypt: Let the Informal Labor Market Take the Strain

Abeer Elshennawy

About the author

Abeer Elshennawy is an associate professor at the Economics Department at the American University in Cairo.

In a nutshell

- *Egypt should embark on trade liberalization as it currently maintains relatively high tariff barriers.*
- *One barrier to further liberalization is the likely impact on jobs in a country where unemployment is already running at 13%.*
- *Egypt should take advantage of its large informal employment sector to reduce any transitional unemployment from liberalization.*
- *The main benefit of informality stems from its role as a shock absorber, providing employment to those who cannot find jobs in the formal sector during difficult times.*
- *Egypt should delay moves to formalize its labor markets until after it has embarked on further trade liberalization to take advantage of its informal sector to cushion the impact on unemployment.*

Egypt should embark on trade liberalization before it takes steps to formalize its labor market, as its large and flexible sector of informal workers will help ease the impact of a likely rise in employment as it opens up to world markets. Opting for formalization first would mean that Egypt would not be able to fully exploit the benefits that its informal sector offers in times of economic change.

Despite efforts to liberalize trade in Egypt since the early 1990s, average tariffs remain high. According to the World Bank, the simple average tariff stood at 17% in 2008. One of the main hurdles facing further reduction in trade barriers takes the form of concerns about transitional unemployment as the economy opens up more to global trade. Unemployment is already running at high levels, standing at 13% in 2013, according to the latest releases by the World Bank.

Periods coinciding with trade liberalization can be particularly difficult for a large segment of workers. Demand for skilled labor increases follow-

ing trade liberalization because tapping into export markets requires upgrading skills. As the demand for skilled labor increases, demand for unskilled labor falls and with rigid wages for unskilled labor, firms that are unable to lower wages to reduce costs to be able to compete with imports find no alternative but to lay off unskilled labor. Wages are typically rigid downwards due to the existence of minimum wages.

This problem is further exacerbated if export-oriented industries and efficient import competing industries expand at a rate slower than the rate of contraction of inefficient import substituting sectors following the liberalization of trade. This means that the first two sectors are unable to absorb released resources from the latter sectors (French-Davis, 1986). Under such circumstances, simulations using an intertemporal general equilibrium model — which takes into account the fact that the economy evolves over time — reveal that trade liberalization in the case of Egypt will be associated with transitional unemployment.

Informal employment can reduce transitional unemployment

This is when informality comes to the rescue. Analysis of the model shows that Egypt should take advantage of its large informal employment sector to reduce any transitional unemployment that might potentially take place if the country adopts trade liberalization. This would produce a better outcome than formalizing the labor market first, followed by trade liberalization at a later stage.

Egypt has a large informal sector. The share of informal firms — defined as firms that are not registered with either an industrial or commercial register — in micro and small enterprises (MSE) stood at 24% in 2004 (Hendy and Zaki, 2012). The informal sector is, generally speaking, associated with lower wages and more vulnerability and is where poor, less educated or less trained and mostly female workers work (Munro, 2011).

This raises the question of what is meant by informal labor. The International Labor Office defines informal labor as “all remunerative work — both self-employed and wage employment that is not recognized, regulated or protected by existing legal or regulatory frameworks and non-remunerative work undertaken in an income-producing enterprise” (ILO and WTO, 2009:53). Based on this definition, the informal economy includes: informal employment in informal enterprises (including employers, employees, own account operators and unpaid family workers); and informal employment in formal enterprises (including domestic workers, casual or day laborers, temporary or part-time workers, industrial outworkers and unregistered or undeclared workers).

Informality has benefits that may at certain times outweigh the costs. With regards to the costs, Galal (2004) has found that, in general, informal firms are usually less efficient, unable to take advantage of economies of scale, more specialization, and division of labor since they are typically small in size. All this undermines the growth potential of an economy.

On the other hand, the main benefit of informality stems from its role as a shock absorber, providing employment to those that cannot find jobs in the formal sector during difficult times. By substituting cheaper informal labor for more expensive formal labor, informality provides firms with a mechanism through which they can adjust to competition from imports. Consequently, the incidence of transitional unemployment that can be associated with trade liberalization in the short run can be reduced.

Embarking on formalization first followed by trade liberalization is not the best option

However, Egypt stands out as an example where the role of informality in relation to trade liberalization has been neither fully understood nor fully exploited. While the existence of a large informal sector in Egypt implies that the benefits of formalization will be high

and will entail higher income, as wages in the formal sector are higher than in the informal sector, opting for formalization first followed by trade liberalization in a later stage is not the best option. Formalization is not socially optimal in the absence of reform in the regulatory environment, and reform in this area, in general, requires time (Galal, 2004).

Therefore, under a scenario where formalization precedes trade liberalization, the economy will be foregoing the gains from trade that are manifested in higher rates of economic growth, as resources are reallocated from inefficient activities to more efficient ones. Foregoing this golden opportunity to liberalize trade now, will mean that Egypt will bear the costs of informality without fully exploiting its benefits.

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ERF Contact Information

Address: 21 Al-Sad Al-Aaly St., Dokki, Giza, Egypt
Telephone: 00 202 333 18 600 - 603 | **Fax:** 00 202 333 18 604
Email: erf@erf.org.eg | **Website:** <http://www.erf.org.eg>

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