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THE SMALL BUSINESS INFORMALITY CHALLENGE: LESSONS LEARNED FROM COUNTRY EXPERIENCES AND THE ROAD AHEAD OF EGYPT

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Abstract

This paper aims to present the lessons learned from country experiences in the area of small business (SB) informality (or extra-legality,) in order to provide Egypt and other MENA countries with a means for possible replication and knowledge for cross-fertilization. The SB informality phenomenon started to gain the attention of economists, politicians, sociologists and anthropologists a few decades ago. A dearth in literature, and its subsequent importance, stems from its 'invisibility' in many nations' underground economies in the developed and, to larger extent, developing worlds. Country experiences show that developed countries have been successful in addressing the phenomenon by undertaking a number of policy instruments, while many developing countries have lagged behind in approaching this issue and devising innovative solutions. The exclusion of the informal sector from the formal economy of nations led governments cognizant of the phenomenon to adopt one of two approaches: SB support policies were either geared towards bringing SB informal entities inside the fabric of the legal economy, or deliberately leaving small businesses relatively unregulated space to grow, with the hope that this allows their innate inventiveness and contributions to local communities maximum stimulation. Valuable as it may be, it is not the intent of the authors to judge these approaches. Rather, the authors hope to look at success vs. failure criteria in state-policy programmatic designs, addressing such phenomenon while taking into consideration acceptable risk margins in policy reforms' implementation. The first section of the paper is an introduction and overview; the second section offers a literature review on some topical, definitional aspects related to SB informality; and section three opens a discourse on adopted government policies in addressing the phenomenon. This is followed by section four containing a diagnostic of the status-quo of SB informality in Egypt together with identified constraints and opportunities. The proposition offered to MENA's authorities is based, in fact, on lessons, pitfalls and experiences captured from country cases. However, this has to be adapted to each country's cultural specificities and unique institutional setup. Finally, the paper closes with section five, a brief commentary for countries considering following a course of SB informality.

ملخّص

إنّ هدفَ هذا البحث هو دراسة ارِبَ البلادِ فيما ص عمومية (أو مشروعية إضافية) ا شروعات الصغ ةِ غ الر ية بدف إستخلاص دروس منها صر وبلدان الشرق الأوسط و ال أفريقيا الأخرى فيما ص التكرار ا تمل للتجربة والإعتماد على تبادل ا عرفةِ .تُوضح ارِبَ البلادِ بأنّ البلدانِ ا تطورةِ كانتْ ناجحة ديد الظاهرةِ خلال تب عدد مِنْ الأدوات السياسيةِ، بينما تبقى العديد مِنْ الدول الناميةِ الأخرى متأخرة ا التَعَلّم والإبداعِ .و قد قاد تقسيم وإستثناء القطاعِ الغ ر ى مِنْ الإقتصادِ الر ي للأممِ ا كوماتَ ا دركةَ ذه الظاهرةِ إ تَبنّي إحدىْ النظرت : تسخ سياسات دعمِ ا شروعات الصغ ة بدف جَلْب كياناتِ الصناعات الصغ ة الغ ر ية ضمن نسيجِ الإقتصادِ القانو ، أو عدم التدخل و ترك ا شروعات الصغ ة تشق طريقها بنفسها. وبغض النظر عن أ ية الأمر، فلَيسَ نيةَ ا ؤلف ا ُكْم على النظريت و مدى تأث ا السل أو الا ا على عمليةِ التشكيلَ و إضفاء الصفة الر ية على هذه ا شروعات، و لكن ا دف هو بالأحرى أنْ توضع معاي النجاح مقابل معايِ الفشل تصميمِ بر يات سياسةِ الدولة ال تدرس مثل هذه الظاهرةِ، آخذين الإعتبار نسبة ا خاطرة ا قبولةِ تطبيقِ الإصلاحاتِ السياسةِ. يستند العَرضَ ا قترح على سلطاتِ الشرق الأوسط و ال أفريقيا، على الدروسِ وا خاطرِ والتجاربِ ا كتسبة مِنْ ارب البلادِ، إلا أنه كل الأحوال فإنه سوف يَجِبُ تكيّيفَ هذه النظرية حسب ا واصفات الثقافية لكُلّ بلد وتنظيمها ا ؤسسى الفريد.

1. Introduction and Overview

A. The Problem Statement

The informal small business (SB) sector is characterized as both mercurial and amorphous. The informal sector represents a substantial segment of the micro, small and medium enterprise (M/SME) sector; nonetheless, literature regarding the sector has yet to establish a clear-cut definition of it and a thorough understanding of its true identity. The enormity of the sector and its potential contribution to the national economies where it exists are presently drawing the attention of many researchers and academics.

Street vendors, garbage collectors, parking men, petty traders, casual labors, shoeshine boys, rickshaw pullers, unlicensed small producers, service providers, retail and wholesale traders, kiosks owners—what do these actors have in common? All of them are small operators who are productive and sometimes innovative. Often they are able to generate employment opportunities for extra workers, whether family members or others, and they usually serve their local communities. However, one of their most common features is that they all face and struggle with cumbersome, expensive and complex entry regulations that are primarily imposed by governments and their affiliate legal apparatuses. Therefore, these individuals make the conscious and deliberate decision to avoid complying with these procedures and operate informally.

According to Enste and Scheinder (1998), nearly US$9 trillion are generated by the informal sector and are not recognized in the global GDP. For emerging economies, this figure represents one-third of their overall output value. Annex 1 shows the enormity of the informal sector in developing countries, transitional economies and central Europe.

In Egypt, studies of the informal sector started in the early eighties when the international research community became interested in its role, especially with regard to developing countries. Several studies and surveys were conducted to gauge the size of the informal sector, measure its contribution to economic activities in the GNP and propose some guidelines for positive policy strategies affecting the sector. Efforts were initially devoted to defining the informal sector and determining its main characteristics and criteria. However, the task was not easy.

The complexity of the informal sector stems from its diversity. The inform sector is composed of various actors, locations and behavioral patterns. Furthermore, it is as diverse in its terminology, as it is in its form across countries. Researchers, thus, tend to use various definitions according to their research objectives, scope and approach. This lack of consensus adds one more complex dimension to studying the informal sector phenomenon.

One of the other complexities that perpetuates the problem of studying the informal sector is the myriad of terminology used to define it. For example, all of the following terms may be used in reference to the informal sector: *irregular sector, marginal sector, black economy, hidden economy, unobserved economy, unregistered economy, extra-legal economy, underground economy, parallel economy, second economy, concealed economy, moon-light activities, hot-sun sector, shadow economy, invisible economy* or *gray economy*. The terminology used often denotes specific connotations. Some terms underscore the illegality, such as the *underground economy* or *second economy*. Other terms emphasize the dual nature of the economy, such as the *parallel economy* or *secondary economy*. Other expressions refer to activities that are not statistically recorded and/or excluded from the tax registry, such as the *unobserved sector* or the *irregular sector*, where it is easy to enter and exit, exist within the family clan and rely on local resources. Terms like the *hot sun sector* designates the location of the activities which are operating in the streets or in open-air areas. The terms *marginal* and *black economy* are rather evaluative and involve negative connotations, reflecting reflect the presence of a sector that constitutes a hazard to the national economy (Halablab, p. 6).

The width in the actual scope of the informal sector economy adds yet another complexity. Without a list of recognized and unrecognized activities that constitute the informal sector, some researchers tend to widen the scope so much as to include illegal criminalized activities, such as prostitution, bribery, the production, distribution and smuggling of alcohol, heroine, etc.). Legal activities in production, trading and services that are not criminalized, but have one or some of characteristics hidden from the public authorities in efforts to avoid paying taxes are also included in these broad scopes. These activities can be visualized, flexible or fixed, seasonal or permanent in nature and/or non-visualized, such as home-based or near-home activities (Livingstone 1991, p. 653).

Most studies confirm that the informal sector represents an inseparable and massive portion of the small business sector of the national economies in many countries around the world. The vital contribution of the micro, small and medium enterprise sector in solving many macroeconomic maladies encountered is noted and recognized everywhere, in both the developed and developing worlds. In the UK, for example, a national survey recently estimated that the contribution of small businesses (including *solo* traders) represents more than 99 percent of the country's enterprises, 44 percent of non-government employment and 37 percent of sales turnover. Estimates show that small and medium enterprises provide employment for 12 million persons out of a total non-government workforce of 21.7 million, produce 40 percent of the UK's GDP and have aggregate annual turnover of £1 trillion (M/SMEs National Survey 2002, p. 17).

Micro, small and medium enterprises (M/SMEs) plan an equally critical role in the Asian Pacific countries (APEC). Their contribution significantly promotes trade and investment activities among different economies, constituting over 90 percent of all enterprises and representing 32 to 84 percent of employment in individual APEC countries. The employment role of M/SMEs varies across APEC nations; M/SMEs in Brunei, China, Japan, Chinese Taipei and Thailand represent at least 70 percent of employment, while M/SMEs in other economies have a lower employment contribution (APEC Survey 1994, p. 2).

In Egypt, the contributions of M/SMEs have been thoroughly evaluated. The Establishments Census of 1996 demonstrated that M/SMEs contribute 99.7 percent of the total private productive units in the national economy. Considering that the private sector's contribution to total the GDP increased from 61.2 percent in 1991/92 to 66.4 percent in 1996/97, the influence of M/SMEs has become even more prominent. Additionally, small and micro enterprises provide 77 percent of the jobs in the non-agricultural private sector establishments (more than three million jobs in the 1-9 employees enterprises size in 1996) and create nearly 80 percent of the value of that sector (SME Statistical Information, p. 2). The Government of Egypt (GOE) has projected that over the next 20 years, S/SMEs will employ half of the new entrants to the labor market (Handoussa 2002).

The significant contribution of the M/SMEs has motivated governments, not only in Egypt, but also across the globe, to seek a more precise conception of its size and to draft appropriate policies that will either boost or shrink the presence of the informal sector. This paper in its qualitative and quantitative analysis seeks to support these efforts.

B. Scope, Approach and Research Layout

The aim of the paper is to study country experiences in the area of small business (SB) informality (or extra-legality) in order to draw lessons for Egypt and other MENA countries for possible replication and to stimulate knowledge cross-fertilization. The SB informality phenomenon started gaining the attention of economists, politicians, sociologists and anthropologists in recent decades. Its importance emanates from the fact that it has been a neglected area in the literature due to its 'invisibility' in the underground economy of many nations of the developed and, to larger extent, developing worlds. Country experiences show that developed countries have been successful in addressing the phenomenon by making use of a number of policy instruments, while many developing countries have been left behind in this regard. The exclusion of the informal sector from the formal economy of nations led governments cognizant of the phenomenon to adopt one of two approaches: SB support policies were either geared towards bringing SB informal entities inside the fabric of the legal economy, or deliberately leaving small businesses relatively unregulated space to grow, with the hope that this allows their innate inventiveness and contributions to local communities maximum stimulation. Valuable as it may be, it is not the intent of the authors to judge these approaches. Rather, the authors hope to look at success vs. failure criteria in state-policy programmatic designs, addressing such phenomenon while taking into consideration acceptable risk margins in policy reforms' implementation. The first section of the paper is an introduction and overview; the second section offers a literature review on some topical, definitional aspects related to SB informality; and section three opens a discourse on adopted government policies in addressing the phenomenon. This is followed by section four containing a diagnostic of the status-quo of SB informality in Egypt together with identified constraints and opportunities. The proposition offered to MENA's authorities is based, in fact, on lessons, pitfalls and experiences captured from country cases. However, this has to be adapted to each country's cultural specificities and unique institutional setup. Finally, the paper closes with section five, a brief commentary for countries contemplating to follow suit.

2. Definitional Aspects of SB Informality

Currently, no single universal definition of M/SMEs, informal sector entities or even the more hybrid concept of SB informal entities exists. The present section investigates different country experiences and approaches to M/SMEs and informal sector entities. The diversity in definitions indicates stakeholders' recognition of the vital importance of the sectors. Furthermore, it represents stakeholders' efforts to devise methods of measuring their actual size of the sector, whether their ultimate purpose is to support activities in the sector or eliminate them.

A. Criteria for Defining M/SMEs

Upon investigating different countries' operational definitions of M/SMEs, the paper will give definitions for both M/SMEs, as they represent the umbrella under which the informal enterprises operate, and informality in its broadest sense (see Annex 2 for a summary). It is apparent in the analysis that three main quantitative parameters are commonly used in the M/SMEs definitions. In addition to these quantitative parameters, a few countries have added qualitative criteria into their definitions of the M/SME sector. It is important to cover both the quantitative aspects and the qualitative measures.

Quantitative Analysis

Quantitative analysis of M/SMEs primarily consists of the following criteria:

1) *Number of employees*: This is the most widely used criterion to define M/SMEs. Normally, micro-enterprises are defined as those entities that employ between one to nine workers; small enterprises employ from five, ten or 15 up to 49 workers; and medium enterprises usually employ from 50 up to 250 workers in some countries. It obvious that the literature contains different definitions for micro, small and medium enterprises, and this difference depends primarily on the degree of development of the countries in question. Out of a total of 41 definitions of M/SMEs in many foreign countries, the *number of employees* as a criterion appears in 31 (see Annex 2).

In Egypt (see Annex 3), *number of employees* as criterion appears in 9 out of 13 as the sole measure. Four definitions recognize the segregation of the size (Micro/Small/Medium) of the enterprise (Ministry of Foreign Trade (MOFT), DANIDA, ABA and USAID). Three of those definitions (DANDIA, ABA and USAID) define a micro-enterprise as having from one to five employee and the small enterprise as having from six to 15 employees. No definition appears for the medium enterprises as it is out of their institutional scope of work. In 1998, MOFT proposed a different definition, classifying a micro-enterprise as a firm with one to five employees, a small enterprise as one with four to 14 employees and a medium enterprise as one with 15 to 49 employees (Lerch 2001, p. 32). Two of the nine definitions (Ministry of Industry and Technological Development (MOI&TD) and the Federation of Egyptian Industries (FEI)) that used *number of employees* as a classification criterion also link it to other quantitative measures.

2) *Value of fixed assets*: This criterion is also used by a number of countries. However, it is not used as commonly due to the difficulty for some enterprises to determine a precise value of their fixed assets and hesitance of some enterprise owners to reveal this type of information to the outside world. Classifying enterprises by this criterion differs not only from one country to another (according to its stage of development), but also from one sector to another. Annex 2 shows that this criterion is used in eight out of 39 countries other than Egypt. In Egypt, the MOI&TD, the Ministry of Planning (MOP) and USAID all set the *value of fixed assets* as a measure for the size of enterprises. In all cases where the *value of fixed assets* is used, it is linked to the *number of employees* criterion.[1]

3) *Turnover per enterprise*: This criterion may also be referred to as the *value of sales*, *gross receipts* or *output per establishment*. This criterion for defining M/SMEs appears in 11 out of the 44 countries and, in all cases, is correlated to other quantitative criteria, such as the *numbe*r *of employees* or the *value of fixed assets*. This criterion is not used; however, among the operational definitions of M/SMEs in Egypt.

Qualitative Criteria

Of the international and local country definitions, only Australia and the United States include qualitative criteria in their official definitions of a small business. The qualitative measures tend to focus on particular characteristics of M/SMEs that are inherent in their nature. Gibson (2001, p. 8) discusses some of the M/SMEs qualitative criteria, including: (a) management and ownership are rarely separate; (b) control over business operations and decisions reside with one or two persons who are usually family members; (c) project's equity is not publicly traded; (d) personal security of the owners is required to secure debt acquisition and repayment; (e) the level and number of formal contractual relations are kept at a minimum level; and (f) personal objectives of the owners guide and influence business decisions directly.

Examples of qualitative definitions in the US include those of the US Congress and the Committee for Economic Development. The US Congress defines a small business as being one that is owned independently and does not carry a dominant market position (Recklies 2001, p. 2). The Committee for Economic Development defines a small business as having at least two of the following features: (a) independence in management since the manager usually owns the business; (b) the supply of capital and ownership is controlled by an individual or a few individuals; (c) the area of operation is primarily local, although the

[1] In the new SME draft law, an SME enterprise is defined as every company or one-man institution performing an economic activity in production or services with a paid capital of no more than LE1 million (LE1=US$6.16) and no more than 50 workers. A micro-enterprise is defined as an entity performing an economic activity in production or services and employs the services of its owner or members of the family (SMEs Draft Law-2004, p. 3).

market is not necessarily domestic; and (d) the presence of a business is seen as being small when compared to larger competitors in the industry (ibid).

Qualitative measures cannot be used aloof of quantitative measures. This can be clearly seen in the Wiltshire's definition (see Annex 2), which provided the first clearly stated Australian definition of a small business. The Australian committee was primarily initiated to provide guidance to small business management and enable them to be more efficient with a specific focus on small manufacturing. The committee suggested that a small business should be defined as: 'A business in which one or two persons are required to make all the critical management decisions: finance, accounting, personnel, purchasing, processing or servicing, marketing, selling, without the aid of an internal specialist and with specific knowledge in only one or two functional areas.' The definition incorporated a quantitative guideline that small businesses would normally employ 100 employees (Gibson 2001, p. 8).

Other researchers have also support linking quantitative measures to qualitative ones. Osteryoung and Newman (1992) evaluated the most commonly used quantitative criteria in the United States and found the *number of employees* to be the most frequent criterion for defining a small business. According to such criterion, small businesses are loosely defined from having fewer than 50 employees to fewer than 1,000 employees. They argue that the *number of employees* does not reflect the real meaning of a small business. Furthermore, they suggest that the small business should be defined as a business in which there is no public tradability of share ownership; and a business in which owners must personally guarantee any existing or planned financing.

The most widely known qualitative element in M/SME definitions is the independent ownership of the enterprise. Other qualitative measures, such as non-dominance in the industry or the relative size of the enterprise compared to other enterprises, can be criticized as they fail to take into consideration that many M/SMEs are highly specialized niche players that often dominate their special market or their unique industry segment. According to Recklies (2001, p. 2), these criteria would require defining the scope of the industry and, thus include more subjective elements *vis-à-vis* the quantitative criteria discussed above (Abdelhamid 2002e).

B. Criteria for Informal Sector Definitions

The criteria used for defining the informal sector vary widely across countries and studies and can be used separately or collectively to identify the informal sector. El Mahdi (1995) classifies informal sector definitions into three different kinds:

<u>The Functional Definition</u>: This definition assumes that there is a <u>link between the formal and informal sectors</u> in which the informal sector supplies the formal one with incubated manpower and absorbs surplus labor (complimentary relationship). Additionally, he informal sector lowers the cost of goods and backward services needed for the consumption of low-income groups in a society.

<u>The Operational or Plurality of Criteria Definition</u>: This method was used in the ILO report on Kenya other criteria were involved for more accurate description of the sector (Charmes 1995, p. 3). The inclusion of <u>one or more of these criteria</u> in the description of the economic unit is considered sufficient to regard it as belonging to the informal sector (El Mahdi 1995, p. 3).

<u>The Empirical Definition:</u> This method uses a <u>single criterion</u>, such as the lack of registration or the size of the establishment, to define the informal sector. This definition depends on the identification of the informal units in *a priori* form so that they can be easily recognized and censured (Charmes 1995, p. 3). The Empirical definition is the most widely used definition

and includes using the size, registration, legal status, etc. (The following paragraphs discuss the two most important types of these criteria.)

The size of the informal sector refers to the scale of the economic unit. The informal sector is characterized by being small in terms of the size of the enterprise, number of workers it employees and the amount capital it generates. As for the *number of workers*, some define informal enterprises as the ones with less than ten workers (Hopkins 1991, p. 116). Others refer to informal enterprises as those with less than five workers. Many studies show that the economic unit in the informal sector is mostly found as 'one-man workshop' or, at most, employs two or three workers. The ILO holds that 62 percent of the informal sector is composed of enterprises with less than five workers; 33 percent of the informal sector is composed of enterprises with five to ten workers; and only 5 percent of the informal sector is composed of enterprises with more than 10 workers (ILO 1985). The types of the enterprises vary; they can be found in one of the houserooms, the house yard or a small workshop. It is also possible that there is no establishment at all (as in the case of street vendors). Regarding the *size of capital*, the informal enterprise is usually described as being mainly based on personal or family savings. In Egypt, there is a consensus that it is one with less than LE10,000 in capital (El Mahdi 2003, p. 20). Some studies have; however, argued that the *size of capital* criterion increases usage according to the changing needs for capital and technology (ibid, p. 22).

With relation to legal informality, Most researchers view the informal sector as an *irregular sector*. In part, this is attributed to its non-compliance with legal procedures, such as licensing, registration, tax payment, etc. The informal sector is, thus, defined as being comprised of activities that are not registered according to standard accounting systems (such as formal registration and payment of taxes and social insurance). Some economic units may abide by some formal procedures, such as obtaining an activity license or providing insurance for the enterprise workers. Nonetheless, they are still considered informal, for non-conformity with at least one single legal procedure leads to the inclusion of the activity under the informal sector umbrella (ibid, p. 11-38).

Abdelghany (1999, p. 3) provides some characteristics that describe this type of informality. He considered the activity as being informal when it: (a) is an unregistered unit or activity that operates outside the framework of law; (b) does not comply with employment and trade unions regulations; (c) provides no social protection; and (d) is a temporary establishment or a household unit.

In addition, the informal sector definitions vary according to the type of research (economics, sociology, anthropology, etc.) addressing it. In economics, informal sector definitions mainly revolve around the type of the enterprise or project, the economic performance of the informal sector and issues related to production, commodities and services, wages and income (Charmes 1991, p. 24). Of these definitions: 'The informal sector is that sector that includes the economic units – production, service and trading – that do not abide partly by registering its activity in a precise and regular way according to the common accounting procedures. Accordingly, the economic unit does not provide precise data on the size of the activity and does not pay taxes on profits' (Mashhour and El Mahdi 1994, p. 9). It is also composed of narrow scale units that are involved in the production and distribution of services and commodities, with special emphasis given to job and income generation for the participants irrespective of human and physical capital constraints (Sethuraman 1981, p. 17).

The sociological and anthropological definitions are more human-centered. The sociological definitions are mainly concerned with informal sector workers and the socio-economic relations relating to working conditions and family workers (Abdelmoty 1988, p. 24). Anthropological studies are mainly concerned with analyzing the socio-economic facts by studying the living units – as they considered clues to the understanding of the functions of the informal sector – and studying the enterprise or the economic unit – as a place for work and social life that cannot be detached from each other. Additionally, attention is devoted to the cultural dimension that is being taken care of; this refers to the type of work that suits men, women, adults, child labor, etc. Some anthropologists view the informal sector as an accommodating tool for the economic and social life of the local community (Stuath 1991, p. 86 and p. 98), or as a playing field that people create and choose without complete freedom in order to generate income depending mainly on their personal relationships (Hopkins 1991, p. 105; and Abdelhamid 2002f).

C. Observations and Remarks

Most of the M/SMEs definitions presented in this section focus mainly on employment, fixed assets and turnover criteria. This hinders the true estimation of the M/SMEs size distribution and affects the conceptualization of the real role of M/SMEs in solving macroeconomic problems.

It is obvious that there are several criteria and standards that can be used to describe the various forms of the informal sector. However, the various forms and associated criteria result in having a wide variety of definitions across countries and regions and perpetuate the difficulty in attaining a clear understanding of the sector. What then is the solution?

It might appear that the solution lies in having a single universal definition for the informal sector. Countries vary in their stages of development and have different political, economic, social and cultural conditions that inhibit the existence and the effectiveness of one single definition. Having a unified country operational definition of the informal sector and allowing for country comparisons through case studies that consider the inherent nature of each in its domicile context appears to be a much better solution.

If drafted and crafted properly, a unified operational country definition may generate answers to several questions, such as: To what extent does the inclusion of the informal sector in the national income accounts help to attain a more accurate and realistic estimate of GDP? What is the country-specific distribution of informal sector activities? How should the unrecorded, but legal, activities and illicit ones be distinguished? What is the relationship between the informal and the formal sector? And, what policy actions should be undertaken by state governments to solve the problem of SB informality? In other words, a unified country definition cannot exist in vacuum; it is a means to an end in solving many aspects of the policy questions faced by a nations' decision makers.

3. Government Policies Addressing the Informality Phenomenon

A. Country Studies Focusing on Shirking Informality

The rationale for those who recognize the problem of informality and the dire need to tackle it, for no other reason than handling its adverse impacts, believe that the existence of an informal sector within an economy is a cause and result of macro, micro-economic and social distortions that are tied to hefty opportunity costs. To illustrate:

1) Macroeconomic Issues

Fiscal sustainability equation is the balance between public revenue and expenditure. With regard to the revenue side, the presence of an informal economy results in forgone revenues and an underestimation of the revenue base, therefore leading governments into an inescapable trap of increasing tax rates. The opposing perspective is that the already existing high tax rates compel micro and small entrepreneurs to operate informally. Thus if the tax rates were lowered to reasonable levels, more enterprises would be willing to act formally.

Employment and productivity: Although the literature on the informal sector activities reveals that the sector plays a vital role in generating employment opportunities, which reduces the pressure of unemployment on the government and large private sector companies, it must be noted that a large segment of these enterprises are of a low productivity nature. Integrating the informal activities into the formal economy would help improve their productivity levels by offering them necessary technical support programs.

Inaccurate indicators for macroeconomic policy decisions: The presence of the informal sector leads to the provision of inappropriate indicators for macro-policy decisions (see Tanzi 1999, p. 338-47; Schneider and Enste 2000 in Eilat and Zinnes 2000, p. 33-4). For example, an increase in recorded employment rates may not indicate a true need for fiscal stimulus, rather it may reflect a shift of economic activity into the shadow economy.

Weaker macroeconomic effects: Macro-policies are less effective given the existence of an informal economy. As an example, the impact of monetary policy is weaker because the informal economy is less connected to the banking sector and capital markets and, therefore, less qualified to access such indispensable services for enterprise growth. Moreover, fiscal policies also have a weaker stimulating or depressing effect since informal enterprises do not pay taxes; thus producing a shallow effect on the revenue side of the economy's fiscal sustainability (ibid, p. 33-4; Eilat and Zinnes 2000, p. 26; Abdelhamid 2002c; and Abdelhamid 2002d).

2) Microeconomic Issues

The presence of an informal economy provides an opportunity for distortions in resource allocation. The labor market, for instance, is distorted since informal firms are not subject to labor regulations and can, therefore, pay higher wages than formal ones. In addition, informal firms can draw demand away from formal firms since they are likely to offer goods and services at a lower price (formal firms pay VAT and other forms of taxes). Other distortions relate to the inability of informal enterprises to access credit on a level playing field with formal ones due to their inability to attain sufficient collateral. Firms operating in the informal sector are characterized as innovators that are willing to undertake excessive risks. Yet, despite of the rather established standard textbook principle in corporate finance advocating 'the higher risk, the higher the return,' the vulnerable ventures of firms in the informal sector make them likely to have difficulties accessing capital markets while being able to cover the related transaction costs and secure a higher rate of return for investors. Investors prefer rather prudent, guaranteed return vehicles.

As a result of the credit dilemma that firms in the informal sector face, these enterprises tend to focus on short-term, working capital financing and become negligent to large scale/term sophisticated investments. This may drive investment away from the informal economy towards the formal sector (Abdelhamid 2002d). Furthermore, on a costs that the informal enterprise may incur. Despite the evasion of taxes and regulatory costs that raise the average cost of production, additional costs involve the time spent in bribing, avoiding licensing and taxation, and seeking private sector alternatives to public services (Kaufman and Kaliberda 1996). These tendencies allow the informal sector to affect the composition and growth of the GNP. The extent to which it actually affects it; however, depends upon which sectors are most amenable to the informal economy activity.

3) Social Issues

Schneider and Enste (2000) view the informal economy as contributing to the disintegration of social norms. In this respect, the impact on the official institutions, norms and rule-of-law is important. A question that is often asked is whether or not the shadow economy is actually a cause or an effect of unacceptable morals. This is a cultural inquiry. On one hand, poorly paid, over-taxed, incompetent public servants, in addition to the often profoundly insufficient use of tax revenues collected, result in an atmosphere where avoiding state predation can appear as being morally just. On the other hand, free-riding public services that are subsidized by few may lead to further opting out attitudes from contributors, which could then lead to a 'race-to-the-bottom' in public service delivery (Abdelhamid 2003b, chapter 3). The possibility of reduced eligibility of social safety net services (e.g., health and unemployment) for workers in informal firms, constitutes yet another important problem. While this is not a serious problem in some countries that have a tradition of state-provided services to all citizens, independent of employment status (or in the case where a firm operates both officially and unofficially), it is however an important concern for other countries that do not have such massively covered safety nets (Schneider and Enste 2000, p. 77-114; and Abdelhamid 2003a).

4. Country Cases from The Developed World in The Direction of Formalization

1) Germany: The German authorities have dealt with the informality problem through sanctions and controls. During the past decades, controls and sanctions have escalated. The law against the undeclared work (*'Gestz zur Bekapfung der Schwarzarbeit'*), which was put into effect in 1957 and has been amended several times since then, regulates these sanctions and controls. The German government was mainly concerned with undeclared work. Currently, the country is undertaking a package of measures along the same direction by implementing tax reforms and lowering tax rates and social security contributions; however, it is still too early to judge the consequences of the undertaken measures.

Germany has also adopted an important measure whereby employers' associations and unions work in unison with government efforts to provide employment opportunities. This policy measure is dubbed as the *'Bundis fur Arbeit'* (Alliance for Labor). The alliance is primarily geared towards combating mass unemployment via the promotion of new jobs and the permanence of existing ones. The German policy against undeclared work does not qualify as, nor does it seem to be, a mix of policy measures to discourage undeclared work by encouraging or facilitating formal work. Undoubtedly, a number of policy measures have been taken on this front, yet they do not comprise fully rounded comprehensive measures (Mateman and Renooy 2001, p. 55-6).

2) Italy: The Italian government has drawn up a catalogue of policy measures against undeclared work, which involves measures to discourage undeclared work while encouraging formal work. The package of policy measures is coherently constructed. The main ones are highlighted as follows: (a) the creation of the National Committee for the 'exposure' of undeclared work. The Committee has a significant role in ensuring integration and coordination among individual policy measures to reduce undeclared work; (b) the establishment of more than 40 local commissions to stimulate and back local-level initiatives against undeclared work; (c) in coordination with above-mentioned Committees, control activities have been boosted and more information symmetry is recognized via the improved information exchange between several control agents; (d) reduction of tax rates (mainly in income tax, corporate tax and value-added taxes). While tax cuts have been mainly proposed for the purpose of increasing employment, they act as catalysts to discourage market players to seek undeclared work; and (e) employment relations have been made more flexible by expanding the opportunities for casual work and other hybrid contracts, accordingly. An important issue that characterizes the Italian policies against undeclared work is that most of the adopted measures are of a regional or sectoral nature.

Many of the measures are catered to regions or sectors in Southern Italy, where unemployment is higher and undeclared work is on the rise. The measures taken in this respect include: (a) employers hiring new workers are allowed a greater access to tax credits and deferrals; and (b) employers recruiting the services of new workers are offered a reduction in social security contributions (ibid, p. 66-7). Despite its embedded incentives and integrity, the Italian policy package has not produced sufficient fruition thus far; therefore, its effectiveness remains subject to the test of time.

3) The Netherlands: The Dutch approach is integrated and coherent; though it is not explicitly directed towards combating informal work. It mainly rests on a group of fiscal policies that encourage employment and combat fraud. These two aspects are the foundation of any informal sector policy seeking the incorporation of the extra-legal informal sector within the legal economy. The adopted policy measures include: (a) reducing the VAT rate for some labor-intensive services; (b) reducing income tax. Since 1990, the fixed labor cost reduction, a lump sum for the employed, has been regularly increased. This measure deals with the poverty trap and creates an incentive to take formal jobs; (c) creating special fraud-busting teams; (d) increasing the exchange of information between administrative bodies; (e) simplifying the administrative burden on enterprises; and (f) offering subsidized job opportunities. These policy measures have led to significant reductions in undeclared work, as informal work is severely punished if caught (ibid, p. 67-8).

4) Spain: The Spanish government has used a mix of fiscal and social security measures, and increased sanctions and controls to tackle the informality phenomenon. The Spanish approach has aimed to increase the employment rate, which is thought to have a direct relationship on the reduction of informal work. Nonetheless, this relationship was not originally envisioned as the main policy objective. The policy has addressed informal work as follows: (a) social security costs for new service contracts have been reduced; (b) income taxes have been reduced; (c) new employment contracts have been devised, enabling more flexible employment relations within the formal economy, hence, encouraging work within the formal economy; and (d) sanctions have been sharpened and controls fortified by constantly increasing information exchanges between the authorities (ibid, p. 68). As a result we can conclude that the Spanish government encourages formal work by discouraging its informal counterpart.

5) Sweden: In 1998, the National Audit Office (*'Riksrevisionverket'*) reported a set of recommended policy measures in a study on the informal economy. Until July 2000, none of these measures were implemented. A few policies aimed at reducing undeclared work have undertaken. According to Mateman and Renooy (2001, p. 68-9), these policies are: (a) Control activities have been stepped up. Institutional bodies focusing on different business lines have started to cooperate, and tax authorities, benefit agencies and the police are increasingly performing field checks. Also, trade unions have started to undertake *ad hoc* checks on undeclared work; (b) coordination between institutions on regional basis; and (c) a subsidized job creation project (*Hunlan*) that considers the unemployed as its target beneficiary and is geared towards sectors where undeclared work is undertaken most has begun. In addition, tax authorities have played an expanded role. The country has established a special task force via a group project that aims to deliver methods and recommendations on how to work and simplify bureaucratic procedures in branch offices.

6) United Kingdom: In its 2000 budget, the British government presented a balanced mix of policies that reflected its deep concern about uncollected taxes, the lack of social protection for informal workers from a human rights perspective and the general problem of extra-legality. The policy measures spelled out in the budget comprised of: (a) the introduction of National Minimum Wage (NMW); (b) the introduction of Personal Advisors (PAs) intended to convince key benefit recipient groups to move to formal employment. The PAs have worked to advise and assist their targets, along with offering of training opportunities, job searches and in-work benefit entitlements; (c) control measures have increased; e.g. legal requirements for starting up a business, fostering cooperation between government departments and the founding of a joint investigation agency to tackle tax, benefit and VAT fraud; and (d) seven campaigns have been launched, including one help-line for those seeking

to egress the informal economy and another hotline to report undeclared work (ibid, p. 69). The reduction of informal work is considered one of the policy objectives of the UK government. The main aim of the policy mix is to encourage employment and combat fraud.

7) France: In France, a policy to fight informal work has been introduced on both local and national levels. It is mainly concerned with reducing the demand and supply of informal work using taxation and labor regulations, public awareness and information campaigns. The country has implemented a number of policy measures: (a) introducing one-stop shops (*'Centre de formalites des enterprises (CFE)'*) to deal with all administrative procedures required for entry, expansion or exit of a business entity; (b) introducing the Unique Employment Declaration ('*Declaration Unique d' Embauche,*' or *'DUE'*), that obliges all employers and requires a series of formalities. The DUE enforces the measures that require employers to pay Union for Collective Social Insurance fees and Family Welfare payments before any new recruitment is made. Any exclusion of the DUE can be a proof of the informal work; (c) creating an inter-ministerial corpse for the fight against undeclared work; (d) increasing the registration requirements for employees; (e) providing more flexibility for employment contracts; (f) increasing the cooperation and information exchange between the different administrations involved; (g) reducing income tax and VAT; (h) introducing service vouchers that help and promote the hiring of legal workers for family and domestic jobs by limiting administrative burdens. The policy mix introduced in France represents a package of prevention and repression. The introduction of different committees that work against informal work is important in the coordination and integration of policy measures. In practice, this cooperation does not; however, seem to be as efficient as it should be (ibid, p. 69-70; and Abdelhamid 2002b).

5. Country Cases from The Developing World In The Direction of Formalization

1) Peru: The Peruvian experience represents one of the most remarkable cases tailored to integrate the informal sector into the legal system. The Peruvian model adopts a one-dimensional approach, which is the *institutional approach*. Its focus rested mainly on removing the institutional impediments that hinder the informal sector from being incorporated within the formal economy. In this respect, the Institute for Liberty and Democracy (ILD) proposed an institutional reform package for the government. This package removes the major impediments that hinder informal sector participants from formalizing their assets and businesses.

In 1988, the ILD drafted the Property Registry Law and presented it to the Peruvian parliament for approval. The ILD's legislative bill was enacted by parliament ('*Ley Registro Predial'*) that same year. This law laid the foundation for the process of integrating informal assets within the formal economy. In other words, it has reduced the administrative time required to license informal businesses for more than a dozen years to one month, and has cut registration costs by 99 percent.

To assure that extra-legal assets were registered and licensed in the most proper and efficient way, the ILD enacted Decree Law No. 803 of March 1996. This Law created the Commission for the Formalization of Informal Property (COFOPRI), which is devoted to the formalization of informal assets. Additionally, the Decree Law introduced start-up programs and an operational strategy for that COFOPRI. The scope of the organization involved handling all of the requirements and steps needed for formalizing informal sector entities. Once the Law was enacted, the organization was established under the direct supervision of the government.

In order to deal with the intensive paperwork and excessive bureaucratic procedures that push economic participants toward the underground economy, especially those which are small in sized, the ILD prepared an administrative draft strategy to streamline the bureaucratic maze and facilitate the formalization of informal businesses. In June 1989, the ILD's draft strategy was approved by the Peruvian parliament and was passed into Law No. 25035 for

Administrative Simplification. The new law rested on four pillars: (1) substituting most *ex ante* requirements that created legal bottlenecks with *ex post* controls; (2) keeping the costs of operating legally below those of operating illegally; (3) decentralizing decision making procedures; and (4) promoting user participation and involvement. This Law has largely empowered the government with the necessary mandate and means to decrease or eliminate bureaucratic burdens, streamline public administration, and reduce registration and licensing costs substantially.

The ILD signed an agreement with the government in 1989 to design a unique mechanism called 'The Administrative Simplification Tribunal' to gather and evaluate proposals from citizens for deregulating and simplifying bureaucratic procedures. This set into motion a mechanism to determine and mobilize the rules of best practices. Over the Tribunal's first year of operation, more than 200 bureaucratic steps were unified, cutting the hundreds of official steps previously required to attain a business licensure by at least 75 percent.

In September 1990, the ILD presented a legislative bill to the government that attempted to reduce the time required for an informal business to obtain a license. In the same year, the president enacted Supreme Decree No. 118-90-PCM, establishing the United Business Registry. The existence of this new government agency significantly reduced the red tape and chunky transaction costs.

All these reforms have reduced the delays and red tape that informal sector entrepreneurs were faced with in order to legally register their business entities. In response, registration time span has been reduced from about 300 days to less than a single day. This has also led to an increase in the number of registrants by over 670,000 enterprises in the formal sector. The incorporation of these enterprises has generated more revenue to the government through taxes that had been previously evaded. Needless to say, the said enterprises have opened up additional employment opportunities for the population. To illustrate, over 500,000 new jobs were created in the course of the formalization process. Because entrepreneurs were successfully transformed into legalized business owners, they were able to market their output without having to incur illegal costs (e.g. bribes) in order to remain invisible among the underground economy's umbrella (ILD, 2001). The latter factor, *inter alia*, represented a strong impetus towards the sustainability of the Peruvian government's formalization program (Abdelhamid 2002b).

2) Ecuador: In Ecuador, the legal framework emphasizes particular factors pertaining to the SME informal sector, i.e., taxation and labor regulations. Ecuador possesses special laws and regulations, which promote the development of informal micro-enterprises, in general and of crafts, in particular. The three main laws are: (1) the *Ley de Defensa del Artersano*; (2) the *Ley de Fomento Artesanal*; and (3) the *Ley de la Pequena Industria*. The laws afford a certain degree of economic protection for informal M/SMEs once they hold a formal status, by decreasing micro-enterprises' costs of production, and thus improving their capacity to compete with other firms and expand their activities in local markets.

Regarding the tax policy, and with respect to personal income tax in particular, exemptions are offered for firms with annual profit below US$2,600 band and 60 percent tax shield on profit reinvestments derived from artesian activities. In addition, all products manufactured and sold by craftsmen are exempted from value-added taxes (VAT). As for labor regulations, the laws and regulations for M/SMEs, especially those pertaining to artisans, are different from those which apply to other firms. Craftsmen receive special treatment for labor obligations. Normally, employers are obliged to pay a minimum wage of US$30 per month, plus a contribution of 20.2 percent of minimum wage upon recruitment in social insurance (10.85 percent payable by the employer and 9.35 percent by the worker). The minimum wage which applies to crafts is 25 percent higher than it is for other firms. However, artisan entrepreneurs have no obligation to pay annual bonuses, two additional monthly salaries every year, or social costs, which for formal firms amounts to 43 percent of the real wage.

Registration is but a step in the chain of requirements that aim to support the growth of M/SMEs. In order for small and micro-entrepreneurs to qualify as beneficiaries of the supportive laws and regulations that are directed towards the activities of M/SMEs, especially those for craftsmen, they must first register. In other words, the government links the formalization of enterprises to economic benefits. Operating informally is mainly related to the absence of benefits, plus the difficulty in acquiring that status in terms of time, procedural complexity and costs.

The preferential treatment provided for M/SMEs in Ecuador has generated a conducive business environment under which they can grow in size and activities and compete as fully legalized entities within the market. Taxes and labor regulations are two major factors that affect the performance of M/SMEs and are a driving force for them to operate as underground economy enterprises in order to evade compliance (Klein and Tokman 1993). They add considerable costs that are unaffordable to M/SMEs due to their limited capital, lack of access to credit and low levels of technology. Indeed, the modification of tax and labor regulations, taking into account the special conditions of M/SMEs, is a major achievement that helps in creating a pro-business environment. In turn, this moves the majority of M/SMEs from operating in the shadow economy towards being formal economic participants, and thus adds to the overall development of the visible economy (Abdelhamid 2002b).

B. Country Studies Focusing on Fostering the Presence of the Informal Sector

Those who argue that governments should intervene in the informal sector to promote its presence and enable it to grow argue that government intervention is justified to: 1) increase the productivity and growth of informal enterprises – with the purpose of increasing their contribution to the economy. This can be addressed by providing enterprises with the very same kind of incentives afforded to formal enterprises; 2) create more jobs: the labor-intensive nature of informal entities provides more opportunities to create more jobs; 3) furnish a natural habitat to breed entrepreneurship as informal enterprises provide a solid platform for the training of entrepreneurs; 4) provide social protection since most of the jobs are not subject to labor legislation and are therefore not entitled to secure contracts, minimum wage floors, worker benefits or social protection. This is saves the costs of health insurance and payment schemes shared by the informal sector worker; 5) support M/SMEs activities that are mostly found in the informal sector by providing training, credit and marketing support by governments; 6) maintain equity, poverty reduction and efficiency. Informal sector workers represent a large percentage of vulnerable social groups as they lack market power and adequate insurance against myriad risks. These workers are more susceptible to market shocks and, hence, to poverty than those participants in the formal economy. Without addressing the employment needs and vulnerabilities of the informal sector, efforts to reduce poverty, which is in part generated via the presence of the informal sector in many developing countries, will not be successful. The lack of attention to employment needs will ensure that poverty issues will stay at the forefront policy reform agendas of developing countries governments (see 'Addressing Informality' 2001, p. 4-5).

<u>1) India:</u> The Indian government has followed a deliberate route to promote artisans for more than 40 years. The bulk of government assistance has gone to master crafts persons who market their production in domestic and international markets. State efforts to encourage artesian production have involved establishing ministries for handicrafts, reserving raw materials and markets for designated products, undertaking R&D efforts on improved designs and technologies and providing special support budgets and target subsidies. The sector doubled in size between 1991 and 1998, when India adopted liberalized economic policies

and artisans were able to delve into and benefit from international markets. Currently, nearly 10 million skilled crafts-persons in India exist, contributing around US$5.6 billion to the GDP and representing a key supporter to the country's export base and foreign currency earnings.

In the early 1970s, India started to promote small-scale industries. The adopted policy measures involved: offering preferential excise tax rates, easing restrictive labor laws and allocating scarce market factors of production to the craftsmen primitive, high-value added sector. The sector has thus become more developed than the formal large scale and the micro-industries ('Addressing Informality' 2001, p. 7-8; and Abdelhamid 2003a).

<u>2) Kenya:</u> The informal sector in Kenya has a large absorptive capacity for new job market entrants. The 1972 ILO study on the Kenyan economy confirmed the existence of an informal economy that was dominated by small businesses. This category of enterprises managed to generate numerous job opportunities, which might otherwise represent a major part of the unemployed population. This sector consisted of: '… all small-scale activities that are normally semi-organized and unregulated, and use simple labor-intensive technology … undertaken by artisans, traders and operators in work-sites such as open yards, market stalls, undeveloped plots, residential houses and street pavements … not registered with the Register of Companies, they may or may not have licenses from local authorities for carrying out a variety of businesses.'

While the government and NGOs have been satisfied by the ability of the informal sector to absorb excess labor force in the country, there has been concern that most of these enterprises do not show signs of growth towards being medium or large-scale enterprises. Some of the difficulties that small and informal businesses face are caused by the restraining legal structure and the unavailability of the capital needed for expansion. Other factors relate to owners' lack of appropriate skills to operate a business. The government has indicated that its role in the development of the informal sector is one of a facilitator, rather than that of an interventionist. According to this progressive reform version, the ILO Kenya Employment Mission reached a coherent policy package for the promotion of informal sector activities. The main issue that the ILO Kenya Employment Mission report expressed was a positive attitude by the government to promoting informal sector activities. This approach included the following: (a) eliminating unnecessary trade and commercial licensing and substitute health and safety inspection/standards for licensing; (b) directing government procurement policies and construction contracts towards informal sector enterprises where possible; (c) creating special credit schemes that would suit the special needs and conditions of informal sector participants; and (d) reorienting formal and informal training facilities to improve existing apprenticeship systems.

The fostering environment established by the Kenyan government included: the provision of capital funds for starting up new factories on the outskirts of major cities, such as Nairobi and Mombassa; customs duty exemptions for the purchase of machinery for small enterprises located in rural areas; market incentives to encourage subcontracting with small enterprises; and reduction of trade barriers faced by small entrepreneurs operating in public land or sites. In addition to these measures, several NGOs and local banks have attempted to assist small-sector entrepreneurs by making credit for either start-up or expansion purposes accessible.

Due to the fact that the informal sector in Kenya absorbs a large percentage of the country's labor force, there has been more emphasis on developing apprenticeship systems. The two systems of apprenticeships that have evolved result from the presence of British and Indian craftsmen. The British attempted to use a schooling system in which skilled workers were trained, while the Indians inadvertently and informally created a skilled worker base through an on-the-job training approach. An important contribution of the informal apprenticeship system allowed large numbers of youth to obtain skills training at a low cost for both the trainee and employer and at no cost to the taxpayer. However, it has to be recognized that it would be impossible for any training system to possess an infinite capacity and/or to absorb all employable youth who obtain training from the informal apprenticeship system. Therefore, the supplement of government programs must work hand-in -hand in order to achieve a market development impact on the SME informal sector.

In 1989, the Entrepreneurship Education (EE) project was established and has been responsible for providing higher levels of management training. The project provided basic training in entrepreneurship. In addition, the EE project was responsible for holding numerous workshops and seminars in Kenya to promote leadership in the area of entrepreneurship. Small Business Centers were established in all Vocational Training Institutes. Their purpose was to guide those wishing to start up small businesses and to coach others who had existing businesses, helping to develop growth strategies. A special emphasis was given to small business development.

In addition, the Ministry of Research, Technical Training and Applied Technology (MRTT&AT) was assigned the responsibility of developing both the informal sector and technical training programs in general. The 1990s government initiative to articulate an official policy to this matter is one in which it collaborated with the World Bank to implement a Micro and Small Enterprise Training and Technology Project (MSETT). The agreement was signed between both parties in 1994. This furnished the Kenyan government with US$24 million loan from the World Bank. The objective of the project included: providing skill upgrading for about 60,000 small enterprises, increasing the access of small scale entrepreneurs to technology, marketing information, and attendant infrastructure, and improving the policy and institutional environment necessary for their operation. The SME Training Program was initiated effectively in 1997, and by mid 1998 about 4 thousand small and micro-entrepreneurs had attended an array of training programs that ranged from technical to managerial skills acquisition (Tokman 1992; and Abdelhamid 2002b).

3) Columbia: Colombia was one of the first developing countries to devise a program addressing informal sector activities into its national development plans. The Plan of National Integration of 1979-1982 avoided consciously incorporating the informal sector within the formal one. The plan aimed at formulating a policy to promote informal viable economic activities to raise the productivity of their employees. Under this plan, a three-pronged approach was proposed: (a) to develop financial intermediation mechanisms that would take account of the special needs of the SME informal sector; (b) to encourage the transfer of technology to informal sector enterprises; and (c) to arrive at better integration of informal sector producers into the market. For facilitating credit intermediation, a guaranty fund was financed by an interest surcharge, and soft loans were provisioned to intermediate credit institutions in partial compensation for higher costs of administering loans destined to informal sector businesses. In addition, training and technical cooperation services were extended to the informal sector, and legal measures were adopted to facilitate the creation of associations comprising small enterprises for the better articulation of sectoral interests. Moreover, Colombia's National Integration Plan proposed also the gradual extension of social services to informal sector participants. This was intended to lower the minimum wages and eliminate the minimum capital required for an informal enterprise to adhere to Colombia's social insurance funds (Smith 1990).

Colombian plans did not demonstrate much success upon their implementation. The country's program lacked the necessary delivery mechanisms to outreach the large majority of M/SMEs. In addition, informal sector producers resisted joining their relevant associations since this would reflect on them as being subject to additional fees, taxes and quotas (Abdelhamid 2002b).

C. Observations and Analysis: Lessons Learnt and Issues of Caution

The section has provided a synoptic coverage of some country experiences pertaining to the formalization of the informal sector. While the Peruvian and Ecuadorian governments adopted policies which aimed at formalizing those enterprises which belonged to the underground economy, other countries, such as India, Colombia and Kenya have decidedly promoted the growth of the informal sector as it evolved.

Country studies on formalizing or de-formalizing the informal sector have shown dissimilarities as much as similarities in ample measure. In all of the countries studied, governments attempted to provide waivers from tax and labor law requirements without exception. The Colombian and Kenyan governments showed an interest in expanding marketing outlets, transfer of technology, specialized training and credit offering to the M/SMEs informal sector. On the other hand, the Peruvian, Colombian, and Kenyan governments' programs were distant from this approach in a number of ways. To illustrate, the Peruvian government offered a program which rested on legislative reforms of the main institutional impediments facing the integration of the informal sector within the formal business framework, the Colombian government incorporated informal sector development within its national plans, whereas the Kenyan government introduced the issue of allocating a certain percentage of annual government procurement to SME sector products. Many countries have chosen to reduce taxes (on income and /or VAT) and social insurance contribution as a common factor in most, if not all, of their policy reform packages.

In general, all of the countries reviewed did not design a comprehensive reform package, and those countries which attempted to formalize their informal sector were by and large more successful than those which selected to sustain the status quo of their informal sector among their policy sets.

Therefore, the lessons drawn from this study is that in order to develop a successful government strategy targeting the formalization of the informal sector in Egypt or any other country, the following prerequisites are worthy of being taken into consideration in program design phases: 1) review tax-related obstacles; 2) alleviate heavy registration and licensing procedures and establish an institutional umbrella with defined mandate to foster the formalization process; 3) review labor regulations; 4) increase access to micro-credit guaranties and related services; 5) develop sectoral associations for M/SMEs whereby they could articulate their interests (advocacy groups); 6) increase access to human resource development and training facilities; 7) increase access of formalized M/SMEs to market and factors of production; and 8) encourage the transfer of modern technology.

Besides the above proposed issues, efficient delivery mechanisms to outreach SB informal enterprises and the availability of sustainable public/private funding to support the effort remain key components to the success of any government-backed formalization policy package.

4. The Egyptian Case

A. Diagnostics

1. Accepted Criteria for the Identification of the Informal Sector

The accepted criteria used for the identification of the informal sector used by the Central Agency for Public Mobilization and Statistics (CAPMAS) is as follows: CAPMAS defines the informal sector as the 'unorganized private sector,' which includes: 1) retail trading activities (four employees or less per establishment); 2) manufacturing industries and repair services (nine employees or less per establishment); or 3) business entities that are not covered by law 159/1981, Investment Law 230/1989, and unregistered in the Commercial

Registry nor its equivalent. The above definition gives an indication that based on CAPMAS economic census' definitions and results, the informal sector in Egypt leans towards small and micro enterprises (M/SMEs).

Another criteria recently used in a study entitled "The Extra-Legal Economy Where the Majority of Egyptians Live and " (2003/04) conducted by the Egyptian Center for Economic Studies (ECES), the Institute of Liberal Democracy (ILD) and the United States Agency for International Development (USAID) under the auspices of the Ministry of Finance (MOF), sets the following definition: 'The universe of the extra-legal business sector can be defined as the total of active, non-government and non-farm businesses with one or more workers. Also, legal or formal businesses are those complying with all requirements to be legally organized and operated. Thus, in order to estimate the dimension of extra-legality, informal or extra-legal businesses are those operating out of legality, for they do not comply in whole or in part with such requirements.' (ILD/ECES 2003, p. 6). According to the study, the definition used by ECES/ILD is consistent with the one used in the Egyptian Labor Market Survey (ELMS 98), which differentiates between the formal and informal status of businesses surveyed in observance of the degree of compliance to legal requirements. Of course, these definitional criteria involve a wider scope of businesses than CAPMAS does. However, after conducting interviews and drawing policy proposals, the study preferred to limit the sample to those firms which did not acquire an operating license (i.e. unregistered in the Commercial Registry, thus limiting the definition again to that of CAPMAS 96), which is the terminal step to legality. The study concluded that most informal sector businesses are concentrated in small enterprises based on findings from CAPMAS survey that 98.9 percent of the business entities in Egypt fall within this domain. All in all, the study took a legalistic approach towards addressing the informal sector challenge, in a similar fashion to that previously taken by the Peruvian government.

2. Importance and size of the SB informal sector

To assess the size of the informal sector in Egypt we relied on the latest available data in this respect. Based on the results deduced from ELMS98, it was be possible to derive two estimates of the size of the informal sector. The first estimate is derived from using the definitions applied in the study (El Mahdi, 2001, p.25). Accordingly, the informal worker is one which is not bound with the employer by a contract. As for the informal enterprise, it has been defined as a unit that does not have a license, is not registered and that does not keep regular books. If one or more of these conditions are absent than the unit is not considered informal.

Based on the definitions in Table (1), the estimated size of the informal sector was close to 6.5 million individuals in 1998. As seen, the informal sector, including both the private informal workers and the informal self-employed, along with employers, has achieved the following:

- The private formal wage-workers have grown at the highest rate during the ten years in question (46 percent approximately during 1988-1998).
- The informal economic units have grown at a slower pace, but remain faster than the formal private units (around 44 percent).
- The informal sector (in the wider sense) has witnessed a growth rate that is equal to 38.4 percent.
- The informal sector in absolute terms is close to 5.3 times larger than the formal private sector.

However, another segment remains unaccounted for—the informal workers in the public sector and the government. These workers were estimated to be more than 140,000 in 1998 and 330,000 in 1988. If this segment is added, the size of the informal sector workers, self-employed and employers would reach more than 6.65 million persons in 1998.

The second estimate has been derived from the ILO definition of the informal sector (see Table 2) to include the own account workers, the employers employing less than ten workers, workers in establishments with less than ten workers and the non-paid family workers. Using these definitions new estimate of about 5.447 million individuals can be estimated. It is also clear that this estimate is somewhat smaller than the previous one of 6.5 million. This difference is understandable given the fact that, according to the last definition, the workers were considered informal only if they worked in small sized economic units (less than ten workers) and the same applies to the employers. The deviation between both estimates (first and second) is miniscule and confirms the argument that the majority of SMEs are informal entities or that the major part of the informal sector is fueled by M/SMEs.

B. Methodology, Sampling Techniques and Selection Criteria

Returning to the ILD/ECES study, a number of primary data sources were collected and analyzed. These sources included the Egyptian Census for Economic Establishments (ECEE 96), the Egypt Labor Market Survey (El Mahdi 2002) performed by CAPMAS, the survey on Socio-economic Conditions of Work in Greater Cairo (El Mahdi and Powell 1999) by the Social Research Center of the American University in Cairo and the Friedrich Ebert Stiftung Foundation, and a survey of the Informal Sector in Maarouf district in Cairo (Mashhour and El Mahdi 1994) sponsored by the National Research Center for Social and Criminological Studies.

The first study was part of a national census and provided a fair indicator of the total universe of establishments at the national level and for Greater Cairo governorates; the second undertook a representative sample of 4,800 households and a sub-data set of economically active self employed and employers representing a sample of 1,614 economic units; the third carried out a representative sample of 3,300 households in Greater Cairo and a sub-sample of 577 self-employed and employers in the same region; and the fourth covered 665 enterprises in a downtown neighborhood of Cairo. Cairo is the capital city and the major urban hub in a country with massive daily labor migration and concentrations of a diversity of businesses (60 percent of nationwide enterprises are in Cairo). One hundred cases of M/SMEs (with four to five workers in each) participated in in-depth interviews, out of which 60 percent were housed in Cairo and 41 business concentration areas in this city. The remainder of the sample was drawn from other cities, including Damietta, Sharkeya, Assiout, Aswan, Alexandria and El Dakahlia governorates. Sectoral coverage was 12. Accordingly, the sample was stratified and was neither random nor large. The purpose was to closely observe the type of obstacles faced at the expense of generalized results. This approach is commendable on preparation of prescriptive policy measures.

The criterion used by ILD/ECES for calculating the magnitude of extra-legality involves compliance or non-compliance with the following requirements, which establish a business as 'legal' or 'informal:' 1) license (normally from local administrative units); 2) registration (commercial and industrial); 3) social security subscription; and 4) paying taxes on the basis of regular accounts bookkeeping. If and when a business or an economic entity complies with all of the mentioned criteria, thus it is considered as 'formal' or 'legal.' Should it miss out one or more of the criteria, the firm is considered as 'informal' or 'extra-legal.'

C. Results of Social Cost-Benefit and Institutional Assessments

The objective of the SCBA and institutional assessments are to quantify the costs and benefits of formality versus informality, while the policy reform recommendations are aimed at reducing the costs of formality during the spectrum ranging from entry, to operation, expansion and exit in order to attract the informal sector to legality. The prescription targets increase in benefits as a result of formality; e.g. access to lower credit cost of funds.

The specific findings of the study demonstrate that: 1) in order to <u>enter</u> the legal threshold (license acquisition), 372 man days are needed, 12 stages must be completed, and 127 administrative steps passed before 50 public entities; 2) in order to <u>operate</u>, renewal of registration and licenses and compliance with tax, labor and social security obligations are needed. This costs LE8,148 per year for a small business entity, amount equivalent to 27 average monthly salaries of a worker in the country; 3) as for business <u>expansion</u>, the following was witnessed: (a) state-owned land: there is no stock of state owned land. The acquisition of private state-owned land is allowed in few cases and involves 174 administrative steps and takes over 460 days; (b) subdivision permits in urban areas involve 358 administrative steps and takes 1,371 days to complete; (c) building license will engage the business entrepreneur in 45 administrative steps during an estimated period of 343 days; 4) <u>import and credit access</u> systems are prohibitive; 5) with respect to business <u>exit</u>, the following was found: (a) dissolution and settlement procedures take 25 bureaucratic steps during some 244 days and cost an average of LE9,963; (b) bankruptcy process takes 53 bureaucratic steps, 653 days and costs around LE18,804; and (c) preventive compromise is not commonly known and its set of documents are complex and expensive. It is obvious that the non-incurring of such costs through the process of administrative and legal streamlining would be the benefit of the exercise, though unfathomed as clear as should be in the study.

D .Observations and Analysis: Constraints and Opportunities

The main observations of the diagnostic study on the status of informality in the Egyptian economy were grouped by the authors follow: 1) <u>Legal Challenges:</u> (a) Informal sector entities are subject to a legal web; (b) public servants are allowed wider discretionary powers that are either given by law or contrived due to lack of coverage in the letter of law; (c) a special law is needed to address the informal sector/M/SMEs problems; (d) design an alternative dispute resolution mechanism such as civil conciliation, mediation and arbitration that are rarely used; 2) <u>Administrative Challenges:</u> (a) numerous rules and procedures governing the organization, authorization and operation of the different types of companies; (b) the cost of procedural and time for undergoing formal administrative procedures is high; (c) fragmentation of control and supervision of business entities among numerous public agencies; 3) <u>Social Accountability Challenges:</u> (a) public servants are not accountable to the citizens by offering and improving on public service delivery; 4) <u>Informational Challenges:</u> (a) a complete database on business entities and properties (GIS) in Egypt is not available; (b) no set of required information by each government department is made available to the public through widely accessible means.

We wish to add to the above challenges the following:

1) there are no information dissemination laws that guarantee information sharing between the different public agencies and citizens;
2) no formalization agency is in place to provide the necessary incentives to attract informal entities to the formal economy (Abdelhamid 2002a);
3) capacity building efforts destined to public officers using modern customer servicing approaches is needed;
4) all government entities should be obligated by law to maintain updated, up-and-running websites containing the procedures, forms and fees for service;
5) government payment systems should be improved;

6) a 24-hour helpline at each government agency should be in place, staffed with a sufficient number to take the volume of calls and trained on the means to respond to customer queries by being provided sufficient information to meet remarks;
7) evaluation sheets for each government agency and front office responsible should be designed and sent to the Ministry of Local Development for evaluation and sharing results with the public on quarterly basis;
8) providing rewards and incentives to top-performing government agencies dealing with businesses; and 9) standardization of information needs of the formalization agencies has to be agreed on with government authorities, formalization agency and the public in general.

5. Conclusion

The five conclusions drawn from the Egyptian experience are: 1) tentative figures show the informal SB sector in Egypt is very large and dynamic in terms of its generated employment opportunities, size and role in the economy. Furthermore, the M/SMEs sector is an integral part of the informal economy; 2) the government of Egypt is strongly committed to the formalization process, and is currently evaluating the different components of the formalization program (Statement by HE Dr. Medhat Hassanein 2004); 3) integrating the informal sector within the formal economy would cut across several government agencies, and would require an enormous redrafting of 'the rules of the game' from institutional, regulatory, administrative, fiscal and monetary perspectives; 4) the formalization process is a challenging, heady task and is expected to encounter a number of obstacles and pitfalls at its early stages. This needs to be examined and resolved in a collaborative, participatory manner by all formalization program stakeholders; and 5) despite the reliance of the Egyptian experience on the Peruvian orientation on addressing the issue of the informal sector, much of the heat of the ongoing debate has resulted in a reverse reform sequencing program.

The Egyptian government has seen the program in the cultural- and institutional-specific setup of the country. This involved the start up at the doors of administrative, organizational, then legislative changes. The country possesses a legacy of intricate bureaucratic maze, an issue that is given supremacy to the institution of a novel organization for formalization. The Government also sees that the necessity for the promulgation of a formalization law should come at a terminal stage of the dynamic reform process once proven successful.

At the present, the investment climate is overburdened by many laws, each of which offers tax and custom concessions. However, many enterprises are inclined to evade the formal government apparatus for its complexity and cost. Fiscal reforms in the area of taxation, customs and social insurance move in tandem with the progress of the formalization program. However, it must be admitted that the Egyptian approach stands in sharp contrast to the Peruvian experience, which initiated at the outset a formalization law, followed by a formalization agency, and, ultimately, administrative streamlining. Time will be the arbiter to the success of the Egyptian approach. That said, the positive public and official responses to the off-take of the program has so far been remarkable (Motamed 2004, p. 6; Shama, et al. 2004, p. 9; Sobhi 2004, p. 16; Abdelfattah 2004, p. 13; and Fayed 2004, p. 1). This is expected to work as an impetus towards the formalization implementation program over the coming two to five years.

Country experiences show that while all of the above modes of reform have been seen as necessary, it is also obvious that the approach needed for the success of the SB formalization process is to adopt an *institutional approach* to reform to guarantee efforts' sustainability, rather than strictly implementing policies that are purely legislative. The other lesson learned from country experiences is to aspire and head for upside policy reforms—adopt a holistic approach to SB formalization, rather than a piecemeal, fragmented one. The growth potential of the sector lies in enhancing its competitiveness and pushing forward productive quantity and quality frontiers through active participation in the reform program. Such a reform program should be designed to provide technical, credit and marketing guideline, as well as quality benchmarks, in order to facilitate domestic and international market penetration.

It is a national duty towards societal welfare for each and every entrepreneur to shirk informality and affirm social responsibility. The formalization reform program should seal a new social contract between national governments and their, now, global constituencies. It is a reiteration of a vote of confidence for freedom of will and commitment to socio-economic development for a larger, visible community of inventive entrepreneurship that stems from the grassroots. The belief in the cause of SB formalization should be deep-rooted, and therefore, requires faith and embossing the cultural and institutional setup. Unsurprisingly, many MENA countries are in a similar stages of economic development as Egypt, and they should too look into country experiences thoroughly and thoughtfully in order to embark on similar reforms in the same direction.

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Table 1: The Size of the Informal Sector according to the definition used in ELMS98 Study

Type of Sector	Total 1998	Males 1998	Females 1998	Total 1988	Males 1988	Female 1988	%Change in 1998 over 1988
NAWW	9.8	7.8	1.998	6.74	5.378	1.365	45.5
PRNAWW	4	3.625	0.411	2.79	2.435	0.357	43.3
PRINFNAWW	**3.26**	**2.961**	**0.302**	**2.272**	2.019	0.253	**43.6**
NPFW	**0.45**	**n.a**	**n.a**	**n.a.**	n.a	n.a	n.a.
PRFNAWW	0.773	0.664	0.108	0.52	0.416	0.103	**48.6**
Small EU	3.3	2.7	0.613	2.934	2.432	0.502	12.5
Informal EU	**2.776**	**2.231**	**0.545**	**2.432**	2.031	0.401	14.4
Formal EU	0.546	0.477	0.069	0.502	0.401	0.101	08.7
Informal Sector	**6.486**	**5.192**	**0.847**	**4.695**	4.05	0.654	38.1
Formal Private Sector	**1.319**	**1.141**	**0.177**	**1.022**	0.817	0.204	29.0

Notes: NAWW = Non agricultural wage workers; PRNAWW = Private NAWW; NPFW= Non-paid family workers; PRFNAWW = Private formal NAWW; EU= Economic Units, which are taken as a proxy to represent the number of employers; Informal Sector = PRINFNAWW + NPFW+ Informal EU; Formal Sector = PRFNAWW + Formal EU

Source: ELMS98 data files

Table 2: The Size of the Informal Sector and the Distribution of its Participants by Economic Activity in Enterprises Employing less than Ten Workers (Using the ILO Definition) in 1998

Econ. Act.	Wage Workers	Employers	Self employed	Non-paid Family workers	Total
Mining	3,567	-	-	-	3,567
Manufacturing	628,477	162,438	191,170	73,726	1055811
Const	742,920	70,455	48,316	12,197	873,888
Trade	611,014	489,277	765,629	325,958	2191878
Transport	357,076	57,480	120,924	2,810	538,290
Finance	67,786	25,949	27,182	1,308	122,225
Services	433,909	99,514	92,169	36,482	662,074
Total	2,844,749	905,113	1,245,390	452,481	5,447,733

Source: Data used in this table is derived from the ELMS98 data files. (El Mahdi 2001a).

Annex 1

Average Size of the Shadow Economy as a Percentage of GDP (1990-93) for Developing, Transitional and Central European Countries

Countries	1990-1993
Developing Countries:	
Africa:	
Nigeria and Egypt	68-76%
Tunisia and Morocco	39-45%
Central and South America:	
Guatemala, Mexico, Peru and Panama	40-60%
Chile, Costa Rica, Venezuela, Brazil, Paraguay and Colombia	25-35%
Asia:	
Thailand	70%
Philippines, Sri Lanka, Malaysia, and South Korea	38-50%
Hong Kong and Singapore	13%
Transitional Countries:	
Former Soviet Union:*	
Georgia, Azerbaijan, Ukraine and Belarus	28-43%
Russia, Lithuania, Latvia and Estonia	20-27%
Central Europe:	
Hungary, Bulgaria and Poland	20-28%
Romania, Slovakia, and the Czech Republic	7-16%

Notes: *According to Radio Free Europe Radio Liberty (March 29, 2000), the amount of informal sector activity is estimated at one-third of GDP in Armenia and Georgia, one-fourth in Russia, Kazakhstan and Azerbaijan, and one –sixth in Moldova and Kyrgyzstan.
Source: Kuchta-Hebling (2000).

Annex2: International Operational SME Definitions

	Country	Entity	Criteria	Definition		
				Micro	**Small**	**Medium**
				Counties in Transition 1. Central and Eastern European Counties		
1	Albania		No. of employees	Less than 10 employees	10-40 employees	50-250 employees
2	Bosnia and Herzegovina			No definition exists		
3	Bulgaria		No. of Employees		Less than 50 employees	
			Maximum assets in balance sheet		BGL 20 million	Does not exist
4	Croatia		No definition exists			
5	Czech Republic		No official definition exists. However, the state supports enterprises with employees less than 500 employees, except those working in primary industries, such as agriculture and forestry.			
6	Hungary		No accepted definition exists			
7	Poland		No. of employees		11-50 employees	51-250 employees
			Maximum turnover		Less than HUF 500 Million	Less than HUF 2 billion
			Maximum balance sheet total		Less than HUF 200 Million	Less than HUF 1.25 billion
8	Romania		No. of employees		1-20 employees	21-200 employees
			Turnover		Between LE 10 million and 2 billion	Between LE 10 million and 2 billion
9	Slovakia		No. of employees		1-24 employees	25-500 employees
10	Slovenia		Activity		Industry, mining and construction	No definition exists
			Other criteria		Craft cooperatives and individuals carrying out business activities	
11	The former Yogoslave Republic of Macedonia		No. of employees		Less than 50 employees	No definition exists
			Maximum turnover		Either maximum turnover less than MD 8.000 or max. balance sheet total less than MD 6.000	
			Maximum balance sheet total			
				2. Baltic States		
12	Estonia		No. of employees		Less than 80 employees	No definition exists
			Maximum turnover		Less than Eek 15 Million	
13	Latvia		Maximum turnover		Less than Lats 200,000	No definition exists
			Maximum balance sheet total		Less than Lats 70,000	
14	Lithuania		No. of employees		Less than 50 employees	
			Maximum turnover		Less than Lats 500,000	

Annex2: Continued

	Country	Entity	Criteria	Definition		
				Micro	Small	Medium
3. Commonwealth of Independent States						
15	Azerbaijan		No. of employees		Less than 50 employees in industry	51-250 employees
					Less than 15 employees in transport	16-75 employees in transport
					Less than 25 employees in construction	26-150 employees in construction
					Less than 10 employees in retail trade and servicing	11-50 employees in retail trade ad servicing
16	Belarus		No. of employees activity and maximum turnover		Less than 200 employees in industry with maximum annual turnover of less than RBl 20 million	No definition exists
					Less than 100 employees in innovation with maximum turnover of less than Rbl 5 million	
					Less than 50 employees in construction and other production spheres with maximum turnover less of than Rbl 5 million	
					Less than 50 employees in catering and public services with maximum turnover of less than Rbl 2 million	
					Less than 25 employees in retail trade	
					Less than 25 employees in other no-production spheres with maximum turnover of less than Rbl 1.5 million	
17	Georgia	No definition exists				
18	Kazakhstan		No. of employees activity		Less than 99 employees in industry and construction	No definition exists
					Less than 50 employees in science	
					Less than 25 employees in non-production spheres	
					Less than 15 employees in retail trade	
19	Kyrgyzstan		No. of employees activity and capital		Less than 200 employees in industry and construction with maximum capital less than som 100.000	
					Less than 100 employees in science with maximum capital less than som 5.000	
					Less than 50 employees in other production industry, transport and servicing with maximum capital less than som 10.000	
					Less than 25 employees in catering, retail trade. Health care and education with maximum capital less than som 50.000	

Annex2: Continued

	Country	Entity	Criteria	Definition		
				Micro	Small	Medium
20	Moldova		No. of Employees	ess than 20 employee	Between 20 and 75 employees	No definition exists
21	Russian Federation		No. of employees activity		Less than 100 employees in industry and construction Less than 60 employees in agriculture Less than 60 employees in science Less than 50 employees in wholesale trade Less than 30 employees in retail trade Less than 50 employees in other production and non-production spheres	No definition exists
22	Tajikistan		No. of employees activity		Less than 50 employees in industry and construction Less than 15 employees in other economic spheres	No definition exists
23	Ukraine		No. of employees activity		Less than 200 employees in industry and construction Less than 50 employees in other production spheres Less than 100 employees in science Less than 25 employees non production spheres Less than 15 employees in retail trade	No definition exists
24	Uzbekistan		No. of employees		Less than 300 employees	From 300 to 1,000employees
4. Asia Pacific Economic Cooperation (APEC) Counties						
25	Australia	Australian Bureau of Statistics (ABS)	No. of employees and activity (service and manufacturing activities)		Small businesses (excluding agriculture) employ: less than 20 people in service industries and less than 100 people in manufacturing industries	Medium business services are defined as having between 20 and 499 employees
			Activity (agricultural activities)		A small business that has an estimated value of operations (EVAO) of AUD $20,000 are excluded from the ABS statistics because their contribution to the community is insignificant. EVAO is based on the area of crops sown, the number of livestock and crops produced and livestock turn over (mainly sales) during the year	
			Management or organizational characteristics		A business is small if it is independently owned and operated, closely controlled by owners/ managers who also contribute most or all of the capital and when the principal decision-making functions rest with the owners/managers.	

Annex2: Continued

	Country	Entity	Criteria	Definition		
				Micro	Small	Medium
25	Australia	Wiltshire Committee	Ability to make management decisions and No. of employees		A business in which one or two person are required to make all the critical management decision: finance, accounting, personnel, purchasing, processing or servicing, marketing, selling without the aid of an internal specialist and with specific knowledge in only one or two of the functional areas. The business will normally employ 100 people.	
26	Brunel Darussalam	The Economic Planning Unit, Ministry of Finance	No. of employees		1-10 employees	10-100 employees
27	Canada		No. of employees		Less than 50 employees (100 in the manufacturing sector)	More than 50 employees (100 in manufacturing sector)and less than 500 employees
			Sales Volume		Less than $5 million	Between $5 million and $20 Million
28	The People's Republic of China		The breakdown of industrial enterprises is mainly based on the major product capability of a given enterprise rather than the No. of employees or amount of capital. For those enterprises with diversified products, they are classified according to their original Value of fixed assets (ie. the final account of the last year).		Classification of large, medium and small enterprises is based on unified standards in different industrial sectors.	
29	Hong Kong			No definition exists		
30	Indonesia		Class		Lower class: 0-4 persons, Medium class: 5-19 persons, Upper class: 20-99 persons	
			Total amount of assets		Rp. 0.60 B (US$ 227, 100)	
			Sales volume		Sales Volume: Rp. 2.00 B (US$ 923, 700)	

Annex2: Continued

	Country	Entity	Criteria	Definition		
				Micro	Small	Medium
31	Japan		Activity, capital and no. of employees		* Mining and manufacturing: Enterprises with up to 100 million yen in capital or with up to 300 employees *Wholesalers: Enterprises with up to 30 million in capital or with up to 100 employees *Retailers and service industries: Enterprises with up to 10 million yen in capital or with up to 50 employees	
32	The Republic of Korea		No of employees and activity		*300 or less employees in the manufacturing, mining and transportation * 200 or less employees in construction *20 or less employees in commerce and other service business	
33	Malaysia		Shareholders' funds		The country focus in on the manufacturing sector. They use therefore the term "small and medium scale industries(SMIs). They are manufacturing entities with shareholders' fund (Paid-up share capital: Capital (US$1=MR2.58). Once they have 75 or more workers, hey are asked to have a manufacturing license under the Industrial Coordination Act of1975.	
34	Mexico	Ministry of Trade and Industrial Development	No. of employees in the manufacturing sector	1 - 15 employees	16 -100 employees	101 - 250 employees
			Annual Net Sales (Dlls) in the manufacturing sector	15,300,000		
35	New Zealand				There is no official classification of what constitutes a small business. New Zealand; however, is an economy of small businesses with firms employing 5 or less staff, representing 85 percent of the total enterprises.	
36	The Republic of the Philippines		Total assets including those arising from loans and excluding those of land on which the particular business entity's office, plant and equipment are situated	P 100,000 and below Cottage – above 100.000 – P1.0M	Above P1.0 m – P10.0 M	Above P10.0 m – P40.0 M

Annex2: Continued

	Country	Entity	Criteria	Definition		
				Micro	**Small**	**Medium**
36	The Republic of the Philippines		No. of employees	Cottage: 1-9 employees	10 - 99 employees	100 - 199 employees
37	Singapore		Business sector local equity fixed assets at net book value No. of employees		Business Sector Local Equity fixed Assets at Net book Value Number of Employees: * Service & Commerce30<% > S$12 Million > 100 *Manufacturing 30<% > S$12 Million	
38	Chinese Taipei	Ministry of Economic Affairs, 1991 which issued the "Recognition Standards for Small Business"			1) Manufacturing or construction business with paid – in capital below NT $40 Million. 2) Mining or quarrying business with paid-in capital not exceeding NT $40 million. 3) Service industries including the areas of commerce, transportation , storage and communications with a sales volume for the pervious year not exceeding NT$40 million. 4) Business other than those above with a pervious yearly sales volume not exceeding NT$40 million	
39	Thailand	Ministry of Industry of Thailand, 1987	No. of employees		Small Scale Industry: Less than 50 employees	Medium Scale Industry: More than 50 and less than 200 employees
			Invested Capital		Small Scale Industry: Less than 10 million Baht	Medium Scale Industry: More than 10 but less than 100 million Baht
			Classifying SMEs by industry		* Manufacturing: Same as 1) and 2). Mining and Quarrying: no SMEs classification. * Service industries: No SMEs classification. * Business other than those mentioned before: No SME classification	
		Other institutional criteria definitions for small scale industry				
		Bank of Thailand	Net fixed assets for small scale industry		Or = not more than 20 million Registered capital Baht	
		Industrial Finance Corporation of Thailand (IFCT)	Net fixed assets for small scale industry		= not more than 20 million Baht	
		Small Industry Finance Corporation (SIFC)	Net Fixed assets for small scale industry		= not more than 20 million Baht	

Annex2: Continued

	Country	Entity	Criteria	Definition		
				Micro	Small	Medium
39	Thailand	Commercial Bank	Sales amount, net fixed assets and other various O.D. credit or outstanding small scale industry		= not more than 10 million Baht	
5. Other Countries						
40	The United States				Various laws and regulations throughout the United States provide different implicit and explicit definition of small business (or at least business for which size is deemed a basis for differential treatment).	
		The Saving Incentive Match Plan for Employees (SIMPLE) Pension Plan			Allows firms with fewer than 100 employees to offer a less administratively burdensome pension plane	
					To run as a delegate for the 1995 White House Conference on Small Business an individual must have been an owner, corporate officer or employee of a business employing fewer than 500 people.	
		White House Conference on small Business			An employer for purpose of act is one who is engaged in commerce and employs 50 or fewer employees for each working day in 20 or more weeks in the current or proceeding year.	
		Family and Medical Leave Act			Any employer with 100 or more employees is required to monitor and alter employee commuting activities to reduce ozone pollution.	
		New Jersey Travel Demand Management Program			Any employer with 100 or more employees is required to monitor and alter employee commuting activities to reduce ozone pollution.	
		Nevada Child Care Study			A 1997 amendment requires employers with 300 or more employees at one location to study the desirability and need for child care as well as the feasibility of providing on or near-site child care, reimbursing employees for their child care expenses and furnishing child care for persons with disabilities.	

Annex2: Continued

	Country	Entity	Criteria	Definition		
				Micro	Small	Medium
40	The United States	The Small Business Administration	Independence, dominance and the standard industrial classification (SIC) codes		* The U.S. SBA follows the definition of the small business ACT of 1953 (US congress) which recognizes the small business as the one that is independently owned and operated and not dominant in its field of operation. The definition varies from industry to industry to reflect the industry differences. The SBA further defines its general definition of small businesses and uses the North American Industrial Classification System (NAICS) in determining size standards; which as of October 1, 2000, replaced the Standard Industrial Classification (SIC) codes. The following definitions represent for example the specific Sic codes:	
					Industry and size: *retail and Service: $305 to $13.5 million. ** construction: $7.0 to $ 17.0 million ***Agriculture: $0.5 to $3.5 Million. ****Wholesales: No more than 100 employees. *****Manufacturing: 500 to 1.5000 employees	
		Small Business Deregulation Task force	Independence, turnover and number of employees		A small business should be independently owned and operated, has the owners and mangers contribute to most (or all) the capital, that is closely controlled by owner/mangers and that have a turnover of less than $ 10 million. It also suggests that most small businesses have fewer than twenty employees in non-manufacturing industries and fewer than 100 employees in manufacturing.	
		Committee for Economic Development (USA)			Industries are small business if having two of the following features: 1. Independence in management since the manager usually owns the business. 2. The supply of capital and ownership is controlled by an individual or few individuals. 3. The area of operation is primary local, although the market is not necessarily local. 4. The business is seen as being small when compared to larger competitors in its industries.	

Annex2: Continued

	Country	Entity	Criteria	Definition		
				Micro	Small	Medium
41	U.K	UK Department of Trade and Industry (DTI)	No. of Employees	Under 9 employees (The DTI definition of micro enterprises includes self-employment).	0 - 49 (the DTI definition of small enterprises includes micro enterprises)	50 – 249 employees
42	Turkey		No. of Employees	Under 10 employees	10 - 49 employees	15 - 49 employees
43	Bangladesh		Activity and Total fixed investment	The term “cottage enterprise” is used for an industrial unit engaged in manufacturing or servicing that is generally run by family members on a full or part-time basis and while total investment does not exceed taka 500.000	A “small enterprise” in defined as an industrial undertaking engaged either in manufacturing or in service activity and whose total fixed investment including initial working capital but excluding the cost of machinery, and duties and taxes (doesn’t exceed Taka 30 million).	
44	India		Level of investment in plant, machinery or other fixed assets whether held by ownership, lease or hire purchase basis.	Units with investment are not exceeding Rupees 2.5 million	Units with an investment limit of Rupees 30 million on plant and machinery	No definition exists

Sources:
* Item no (1-24) – - UN-ECE Operational Activities: Small and Medium-Sized Enterprises in Counties in Transition: Government Policy, Legislation, Statistics, Support Institution,. October 1996
* Items (25-39) – except the definition of the Wiltshire Committee in Australia): APEC Survey on Small and Medium Enterprises
* Items (25-39) - except the definition of the Wiltshire Committee in Australia): APEC Survey on Small and Medium Enterprises
*In Item 40, Definitions for the ‘Saving Incentive Match Plan for Employees (SIMPLE) Plan’, the White house conference on Small Businesses’, ‘Family and Medical leave Act’, ‘New Jersey Demand Management Program’ and ‘Navada Child Care study’ are from: Barbari, D. Legislative Definitions of small Business. NFIB, Washington, D.C., 1998.
*Item 40 – Definition of the Small Business Administration (SBA) is from the SBA’s website: www.sba.gov
*Item 40 – Definition of Small Business Deregulation Task Force is from: Bell, C (chairman). Small Business Deregulation taskforce: Time for Business. November, COA, 1996.
*Item 40 – Definition of the Committee for Economic Development is from: Recklies, Dagmar, March 2001. www.themanager.org/pdf/small%business.PDF
*Item 41: – the definition of the UK department of Trade and Industry is found in several sources: 1) Martin, chris. International and Strategic Networks: An SME Perspective, September 2000, 2) Department of Trade and Industry website and 3) Recklies. Dagmar, March 2001. www.themanager.org/pdf/small%20 business.PDF
*Item 42– the definition of Turkey is documented in Lerchs, George. The Study of an operational Definition for Micro, small and medium Sized Enterprises in Egypt. The Ministry of Foreign Trade in Egypt and the IDRC, September 2001.
* Item no. 43 and 44 – (definitions of Bangladesh and India)are from: Definitions of SMEs in some of the Asian Countrie

Annex3: Operational Definitions of SMEs in Egypt

	Ministry/ Organization	Affiliated Project or Program	Criteria	Definition
1	Ministry of Industry (MOI)		Fixed Assets	Not more than LE 500,000
			No. of Employees	Between 10 - 100 individuals
2	Ministry of planning (MOP)		Fixed Assets	Less than LE 50,000 including land and buildings
	* Ministry of Economy and Foreign Trade (MOEFT) in its 1998 draft policy document (Proposed definition)		No. of Employees	Micro enterprises are 1 - 5 employees, small are 5 - 14 and medium are 15 49
3	Ministry of Rural Development	The Handicraft Industries and Productive Cooperative Organization (HIPCO) of the Ministry of Local Administration and the Central Productive Cooperative Union*	Legal Definition/ Formality	Every enterprise that is a member in a primary cooperative belongs to the scope of the organization target group. No economic criteria. The enterprise must be formal.
4	The Federation of Egyptian Industries (FEI)		Investment Cost	An enterprise with a maximum investment cost of LE 500,000
			No. of Employees	Not more than 100 workers
5	Institute of National Planning (INP)	The project of “Development of Small Scale Industries in Egypt”	No. of Employees	Projects employing 10 - 49 workers in the manufacturing sector
6	Central Organization for Mobilization and Statistics (CAPMAS)/ Industrial Development Bank of Egypt (IDB)		No. of Employees	Enterprises employs 50 – 100 employees
7	National Bank for Development (NBD)	Small Enterprise Credit Program	No. of Employees	Manufacturers employing between 1 - 5 employees.
			Type of Enterprise	The clients can be informal sector artisans or small businesses.
8	Egyptian American Bank		Capital outstanding (Personal Assets)	Those enterprises having capital outstanding of up to 250,000
9	Danish International Development Agency (DANIDA) in Egypt.		No. of Enterprises	Defines micro enterprises as having 1-5 employees and small enterprises as having 6 -15 employees.

Annex 3: Continued

10	The Credit Guarantee Company for Small Scale Enterprises (CGC)		Type of Activity	Small scale enterprises are projects that function in any of the economic sectors, except trade.
			Investment Cost	A total investment cost ranging between LE 40,000 and LE 7 million including the requested loan amount and excluding the value of the land and building.
			Formality	The Small scale enterprise must be a legal entity.
11	The Small and Micro Enterprise Project of Alexandria Businessmen Association (ABA)		No. of Employees	Micro-enterprises are defined as those enterprises employing up to 5 employees. Small enterprises are defined as those enterprises employing up to 15 employees.
			Type of Activity	Enterprises can be engaged in manufacturing activities, services or trade.
12	The United states Agency for International Development (USAID)		No. of Employees	Micro-enterprises are defined as enterprises having 1-5 employees. Small enterprises are defined as having 6-15 employees.
			Fixed Assets	Small enterprises are defined as having less than LE 25 thousands in fixed assets, excluding land and building.
13	The Association for Developing Small Scale Industries in New Cities.		Geographical Classification	Small industries are enterprises in the "Small Industry Complex" built by the Ministry of Industry in the 10th of Ramadan City. The industries in that complex, as well as in other complexes, are heterogeneous. Compared with the large-scale industries in the new cities, they are certainly small, but on a nation–wide average their size is medium. Common criteria is the non-diversified management. The Association has developed a demand driven definition: "all enterprises which need the association's services and which are active members are small".

Notes: * All information is taken from Friedrich Ebert Stifung directory except the proposed definition of MOEFT (Soruce: Lerchs, 2001).
Item 10: The Definition of the Credit Guarantee Company for Small scale Enterprises is updated from the company's website.

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