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TRANSITIONING TO FORMALITY

**A Handbook for Policy Makers
and Business Enterprises**

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INTRODUCTION

This Handbook is designed to provide a comprehensive and realistic roadmap for integrating the informal sector¹ in the formal economy. It is intended to serve as a resource to provide a foundation for facilitating consensus-building between informal enterprises and state entities relevant to the process of formalization.

In preparing the Handbook, balanced consideration was given to protect the interests of formal enterprises, especially small ones and their employees, and ensure their right to fair competition. This dictated caution in addressing the phenomena. As such, the Handbook avoids a myopic view of informal enterprises. It looks at informality through a wider lens- not merely viewing informal enterprises through the lens of tax evasion. Moreover, the Handbook does not disproportionately blame informal enterprises for all problems on account that they are tax evaders. With that in mind, the research team adopted a solid research design and methodology to develop practical and actionable measures to formalize the informal sector.

With an eye on incentivizing formalization, the research effort focused on developing an effective roadmap which maximizes benefits for all stakeholders, increases the costs of informality, and reduces the costs of formality. This entailed developing a clear and comprehensive understanding of the nature, dynamics, and modus operandi of informal small and medium-sized enterprises (SMEs). Adequate attention was also given to better understand the fears of informal SMEs in transitioning to formality, in addition to examining the high costs associated with establishing and maintaining business continuity in the formal sector.

While SMEs represent the vast majority of investors and face the biggest challenges and obstacles, yet, their voices continue to be underrepresented

¹ *The informal sector is broadly characterized as encompassing economic activities that are unrecorded – or insufficiently accounted for-and the state cannot accurately estimate. The informal economy can be defined in a broad sense as referring to the portion commercial and economic transactions that occur outside the boundaries of the financial transactions known to the state. The informal economy is a global phenomenon and includes a range of activities such as street vending, street trading and other unregistered economic services exchanged between individuals. These transactions fall outside the boundaries of traditional economic activities. In most cases, income generated in the informal sector is not accounted for by the state, it goes untaxed and is not included in the gross domestic product.*

in key matters affecting their business. Thus, FEDA held a number of focus group discussions with representatives of SME business associations as a step toward increasing their voice and agency, and informing the development of this Handbook. The discussion groups included representatives from both the informal and formal sector, with the latter representing no more than 10 percent of the participants. The study used a sample representative of 100 SMEs with no more than 20 employees, and drawn from five governorates from Egypt's seven Economic Regions. The represented governorates included: Minya, Beni Sueif, Kafr El Sheikh, Cairo, and Port Said.

Focus group discussions were guided by two sets of well-formulated research questions to inform the task at hand-integrating informal enterprises into the formal economy. The first set of questions revolved around the current situation of informal and formal SMEs, while the second focused on obstacles and incentives for transitioning to formality.

Specifically, the first set of questions addressed the following key elements:

- Relationships and interactions with medium-sized and large businesses
- Labor relations
- Position on formality
- Prospects for business expansion
- Training

The second set of questions explored SME perspectives on two critical to formalization:

- The costs and benefits of transitioning to formality versus remaining informal
- The most important reforms, which if taken by government, would prompt informal businesses to formalize

Views and concerns voiced during the focus groups were shared with representatives from the Ministry of Trade and Industry, the Ministry of Finance, the Ministry of Manpower and Migration, in addition to representatives from the National Authority for Social Insurance, as well as representatives from the SME Initiative of the Central Bank of Egypt.

Furthermore, FEDA arranged several meetings with representatives of political parties in four governorates, as well as members of the Egyptian House of Representatives. The purpose of the meetings was to present the perspective of FEDA member SMEs on the impact of the informal enterprises on the national economy, and make a case for integrating the informal sector in the formal economy.

The Handbook is structured into four major sections and a supporting Annex. **Section One** outlines the required steps for formalization under the applicable legal and regulatory framework. **Section Two** presents the specific measures for formalizing the informal sector as agreed to by the business owners and the relevant government officials. **Section Three** provides an overview of the recommendations put forward by SMEs and which, were rejected by the relevant government entities on ground that they are not appropriate at the time being (note: informal enterprises will be held accountable in the instance they violate current laws). **Section Four** presents a detailed roadmap to integrate the informal enterprises into the formal economy. The Annex contains the views of FEDA member enterprises, both formal and informal, regarding the major problems and challenges they face under the current legal and regulatory framework and the economic context in which they operate. It also provides a detailed overview of the government's views regarding the integration of the informal enterprises, highlighting the recommendations that are acceptable to the government, and those that are unacceptable.

SECTION 1:

HOW TO FORMALIZE YOUR BUSINESS UNDER THE APPLICABLE LAWS AND REGULATIONS

Obtaining a license entails two stages, each involving a number of steps as follows:

Stage 1:

Step 1.1: Certificate of Commercial Registration. You must submit a copy of the current lease agreement for your shop to the Commercial Registry in your respective. In the instance you are in the manufacturing business, have ready with you all the relevant approved, signed, and dated official documentation authorizing the use of your business premise for industrial operations. Upon submitting these documents, and paying the required fee, you will be able to receive your business registration number.

Step 1.2: Tax Card. Upon receiving your business registration certificate, you should submit the certificate to the Egyptian Tax Authority to receive a Tax Card. For issuing the card, first, you need to meet with a tax officer to discuss your business. Upon the conclusion of the consultation with the tax officer, a tax record for your business will be created at the Egyptian Tax Authority. The tax record number will be stamped on your Tax Card, which will be issued a month after your meeting with the tax officer. In the instance you need proof that that you have submitted a request for a Tax Card, you may request that the tax officer issue you a letter stating that your Tax Card is being processed.

Stage 2:

Now that you have obtained your Certificate of Commercial Registration and your Tax Card you are close to being fully registered, to complete the registration process you must:

Step 2.1: Tax Registration Number. In the instance your annual sales exceed EGP 500,000, you must submit a request to the Egyptian Tax Authority to receive a registration number.

Step 2.2: Business Operation License. In the instance that you have registered as a commercial business, you must obtain a license to operate your business. You must submit your documents to the licensing department in the district² in which your business is located. You should be aware that in some instances, the issued license is “temporary and time-bound”, with the permanent license issued upon fulfilling all registration requirements.

Step 2.3: Industrial License. In the instance, you are in the manufacturing business- a factory or a workshop- you must submit to the city or district council in which your business is located all engineering designs and machinery and equipment specifications relevant to your business. At this step, you must pay the required licensing fees.

Step 2.4: Technical Inspection. Depending on your business location, relevant authorities will carry out a technical inspection of your premises. In the instance that your business is located in one of the industrial zones in a governorate, the Department of Industrial Districts at the Governorate level will carry out the inspection. In the instance the business is located in one of the new urban communities, the inspection will be carried out by the Industrial Development Authority (IDA). Upon the satisfactory conclusion of the inspection, you will be issued the license.

You should note that the inspection step in the registration process is prolonged. It involves 8 government entities, and consumes approximately 635 days before your license is issued.

² District is a tier in Egypt's five-tier local administration system.

SECTION 2:

KEY REFORM MEASURES AGREED UPON BY SMES AND GOVERNMENT ENTITIES

During the focus group discussions, small and medium-sized enterprise (SMEs) generated many creative ideas and proposed a series of reform measures to address the problems and challenges they face in conducting their operations. Further discussions with government entities revealed that, at this point in time, they are reluctant to readily embrace all recommendations put forward by SMEs. This section presents key reform measures agreed on by SMEs and government entities along with proposed control measures to safeguard compliance³:

³ *The details on integrating the informal economy are provided in Section 4.*

Reform the Small Enterprises Development Law (Law No. 141/ 2004)

- Control Measures to safeguard compliance**
- Make access of SMEs to benefits contained in the law contingent on whether or not the enterprise provides social insurance coverage to its workers.

The reform should target a number of elements: 1) developing a standardized definition for SMEs to facilitate their access to funding schemes, 2) improving the administration of the Industrial Development Authority, and enhance its role, and 3) restructuring of industrial districts at the governorate level.

Along with reforming the law, attention should be given to developing an investment map database that includes industrial investment opportunities at the governorate level. Investment maps should further complement and reinforce the incentives contained in the reformed law towards promoting investment.

Enact the new Industrial Licensing Law

The draft law regulating industrial licensing, currently at the House of Representatives, aims at facilitating the procedures of obtaining industrial licenses. The draft law shortens the time period for issuing industrial licenses, and allows for the issuance of permanent licenses, instead of the preliminary temporary licenses. In addition, the draft law streamlines the bureaucratic and technical requirements for licensing safe factories and puts in place controls to limit the cumbersome inspection processes associated with issuance of licenses. According to draft law, the industrial registration certificate is to be issued along with the industrial license.

- Control Measures to safeguard compliance**
- Suspension of the license in the event the business commits a violation in the course of carrying out its operations.
 - For suspended licenses, notices of suspension are to be posted on a designated website. During the period of suspension, the business shall not be able to take advantage of available preferential treatment for SMEs, such as special customs and tax incentives.
 - In the event that the activities carried out are not relevant to the activities specified in the license, the business will be subject to shut down.

Enact the law for regulating bankruptcy and preventive conciliation

The law should focus on clarifying and easing processes available for enterprises whose financial conditions are deteriorating, thereby improving market exit procedures.

Introduce simplified tax procedures

Simplify the procedures for tax collection and record keeping.

- Control Measures to safeguard compliance**
- Harshen the tax evasion penalties.
 - Deny business that evade taxes any tax exemptions.

Facilitate access to finance

Reforms should aim at improving credit guarantee schemes. Efforts should focus on making available new financial services venues and going beyond the banking sector and the Social Fund for Development, the latter widely perceived as having failed its mandate. In creating new financial services venues, consideration should be given to introducing innovative and flexible solution to collateral issues to better serve informal enterprises and also micro and small enterprises, and respond to their needs. Equally, consideration should be given to mutual guarantee schemes, as well as expanding the role of SMEs development associations and facilitating their registration with the Egyptian Financial Supervisory Authority.

SECTION 3:

RECOMMENDED REFORM MEASURES REJECTED BY THE RELEVANT GOVERNMENT ENTITIES

As noted earlier, focus group discussions with business owners generated a number of specific recommendations, viewed as critical to enabling transition to formalization, and at the same time supporting formal SMEs. Besides the recommendations noted in the earlier section that enjoyed government agreement, a number of the recommended measures were rejected by the relevant government entities on account that they are not feasible for the time being. It must be noted that government entities stressed that enterprises failure to comply with these laws will subject to the sanctions contained in the laws as appropriate.

The following are the key recommended measures which were rejected by the relevant government entities, with some discussion:

1. TAX EXEMPTIONS

- Relevant government entities rejected the recommendation to grant enterprises time-bound grace periods (during the process of formalization), thereby relieving them of the requirement to pay income and sales taxes. Concerns about corruption was cited as the main reason for rejecting this recommendation.
- In lieu of granting SMEs income and sales tax exemptions, the government entities offered to address issues related to the Value-Added Tax (VAT). They proposed harmonizing VAT procedures and rules for SMEs, codifying these improvements in the law governing SMEs, along with standardizing VAT rates. SMEs welcomed the suggestion that VAT be levied on the different stages in the supply chain, including the supply of raw materials.
- On the other hand, SMEs objected to a proposal that would require businesses with EGP 500,000 in total value of sales to register with the VAT register. SMEs recommended that the limit be set at EGP 1 million, considering the devaluation of the Egyptian Pound.

- A November 2016 decree issued by the Supreme Investment Council was widely viewed as a setback and a real disservice to informal enterprises seeking formalization. Instead of lessening the tax burden on such enterprises, the decree, while allowing for tax reconciliation with SMEs that do not have official tax records, required enterprises to pay back a purely symbolic amount, for five years retroactively.

2. SOCIAL INSURANCE

- Relevant government entities rejected the recommendation to fully or partially relieve enterprises that formalize from paying the employer's share of social insurance payments.
- Not only did government entities reject this proposal, in fact, the state adjusted the monthly wage on which social insurance premiums are based, significantly raising the cap. This adjustment is considered an added burden on enterprises seeking formalization.

3. PROPERTY TAX

- Relevant government entities outright rejected the recommendation to exempt enterprises from property tax.

SECTION 4:

THE ROADMAP TO FORMALIZATION

The Roadmap to Formalization presents practical and well-targeted measures making formalization simple and desirable. The roadmap addresses five core areas that are viewed as crucial to the process of formalization: licensing, the SME legal framework, preventive conciliation and bankruptcy, taxation, and access to finance. Following are the guiding principles and details for each of the core areas:

1. ENACT A NEW LAW TO REGULATE INDUSTRIAL LICENSING AND EXTENDING UTILITY SERVICES TO FACILITIES

- Licenses should to be issued within a week.
- License fees should be reasonable and not represent a burden to SMEs.
- Introduce decentralized procedures for licensing and approvals, and provide support to the local level offices of the Industrial Development Authority to ensure their efficiency.
- Speed up the process of identifying and selecting consulting offices at the local level to facilitate the licensing process.
- Require the Industrial Development Authority to post bulletin boards with detailed information on the requirements, timeframes, and fees for obtaining licenses. Bulletin boards should be placed prominently in licensing offices.
- Simply the technical procedures and requirements related to the license issuance.
- Introduce a well-defined risk classification scheme based on recognized safety principles. Under this scheme, high-risk activities must fulfill specific technical requirements to be approved for licensing, while no-risk activities would be licensed via notification.

- Streamline and standardize licensing procedures so that the certificate of industrial registration be issued simultaneously with the industrial license.
- Designate the Industrial Development Authority as the sole entity responsible for issuing industrial licenses.
- Allow for the issuance of permanent licenses, instead of the preliminary temporary licenses.
- Facilitate the procedures for expanding activities. Enterprises should not be required to seek additional licenses as long as the additional activities do not involve new technical considerations.
- Award the Industrial Development Authority jurisdiction over industrial land allocation. Linking the licensing process to the process of allocating industrial land use, and providing it with infrastructure and utility services should facilitate the process for investors.



***Control Measures
to safeguard compliance***

- Suspension of the license in the event the business commits a violation in the course of carrying out its operations.
- For suspended licenses, notices of suspension are to be posted on a designated website. During the period of suspension, the business shall not be able to take advantage of available preferential treatment for SMEs, such as special customs and tax incentives.
- In the event that the activities carried out are not relevant to the activities specified in the license, the business will be subject to shut down.

2. REFORM ALL LAWS RELEVANT TO REGULATING SMALL ENTERPRISES, INCLUDING ACCESS TO FINANCE AND GOVERNMENT SET-ASIDES FOR SMEs

- Adopt a unified definition of SMEs across government entities.
- Ensure that the government entities meet their obligation with regards to procuring a percentage of their goods and services from local SMEs.
- Set aside at least 10 percent of small and medium contracting jobs, at the local level, to SMEs.



Control Measures to safeguard compliance

- Make access of SMEs to benefits contained in the law contingent on whether or not the enterprise provides social insurance coverage to its workers.

3. ENACT A LAW TO REGULATE BANKRUPTCY AND INSOLVENCY

- Introduce a system for the financial restructuring of distressed businesses which, allows debtors to proceed with financial restructuring in addition to developing debt management plans.
- Ensure that the new bankruptcy and insolvency law simplifies the procedures of bankruptcy, shortening the liquidation period for distressed business, and abolishing the imprisonment penalty.

4. SIMPLIFY TAX COLLECTION PROCEDURES

- Simplify the procedures for tax collection and record keeping.
- Develop a separate law to govern SMEs income tax and VAT. The law should introduce an efficient and effective system aimed at simplifying the rules and procedures applying to these taxes.
- Improve on the tax refund scheme and the account reconciliation system related to income tax and sales tax.



Control Measures to safeguard compliance

- Harshen the penalty of tax evasion
- Deny business that evade taxes any tax exemptions.

5. FACILITATE ACCESS TO FINANCE

- Expand the financing venues for SMEs beyond the banking sector and the Social Fund for Development. At the same time, revisit the rationale and mandate of the Social Fund for Development, and link entities providing financing to micro enterprises to the Egyptian Financial Supervisory Authority and the Central Bank of Egypt, rather than the Social Fund for Development.
- Promote mutual guarantee schemes and support micro and small enterprises associations' access to finance so as they are able extend loans to member enterprises. These loan programs should be subject to the oversight of the Egyptian Financial Supervisory Authority.

ANNEX*

A. FORMALIZATION REALITIES AND CHALLENGES: PERSPECTIVES OF THE ENTERPRISES

While some of the focus group participants had somewhat different perspectives, nevertheless there were general themes repeated throughout the session that represented the main barriers to formalization. Following is a summary of the discussion with the major views, ideas, and observations expressed by the participants:

1. LABOR ISSUES: EMPLOYMENT, SOCIAL INSURANCE AND TRAINING

Since the late 1990s, Egypt's labor market has been characterized by a trend toward an expansion of employment in the informal economy, with a corresponding decline in public sector employment. Additionally, the formal private sector has not been able to generate employment. While unemployment rates have declined from 11.2% in 2004/2005 to 8.7% in 2007/2008, this decline was a result of a growth in informal employment in the non-agriculture private sector. Such trends beg questions such as "why has unstructured employment in Egypt, especially during the past decade, beginning in the year 2005/2006, witnessed such an overwhelming growth?", "what is the nature of the relationship between the informal enterprise and its workers" and "what are the critical problems informal enterprises face with regards to providing social insurance and training to their workers?"

The group discussions provided answers to these questions and great insight into the reality of operating as an informal enterprise. Admittedly, the views expressed by the surveyed enterprises agreed with the findings and conclusions in numerous governmental studies which focused on exploring the exponential growth in informal employment. Following is a summary of these views of the participants:

* This Annex presents different perspectives on formalization. The first part includes the perspective of the enterprises that participated in the focus groups. The second part presents the views of the concerned government entities. All these views together informed the development of the Roadmap. The views and opinions expressed in this Annex do not necessarily represent the views of FEDA.

ON FINDING AND RETAINING SKILLED WORKERS

- There is a preference for hiring skilled workers, even if this entails incurring slightly higher costs.
- Workers rarely demand their right to social insurance benefits. Instead, workers usually demand higher wages which, invariably exceeds their productivity levels. In addition, enterprises frequently suffer from extremely high workers turnover rates. For the most part, workers, once upskilled, usually leave for another job.
- Some participants stated that the informal enterprises often poach workers from the formal sector. Informal enterprises are able to offer higher wages due to higher net profits compared to formal enterprises.

ON SOCIAL INSURANCE

- Some participants viewed the current system as unfair, offering no real benefits to either the business owner or the worker. As a result, they do not provide their workers with social insurance coverage.
- The perceived instability of the market influences the way business owners approach the issue of social insurance. In light of the high workers turnover rate, there is an overriding concern that once the business owner completes the cumbersome paper work for extending social insurance coverage to the workers, workers are likely to leave to new jobs. Another concern voiced by business owners was the potential employment-related disputes they are likely to encounter in the instance they close their business or face financial distress.
- Reports issued by social insurance inspectors were viewed as biased, arbitrary and favoring the interests of workers. Imprisonment penalties associated with violating the law discourage formal businesses from enrolling their workers in the social insurance system. In the words of one employer: “Once the social insurance inspector visit the business, he completes a report as evidence of the visit. During the inspection, if he finds out that one worker, of the twelve insured workers, is not enrolled in the social insurance system, he notes this finding in his report, without giving any consideration to our explanation. Sometimes the uninsured worker is a trainee, or an intern, or is yet to bring in all the required documents for us to insure him.”

- Many participants viewed the law-mandated cap on the pensionable wage as unfair. For example, a worker with a salary of EGP 4000 is required to report up to the maximum bound for insurable wage, set at EGP 1,600. Calculated as such, on retirement, the worker ends up receiving a meager pension that does not provide a decent living on retirement, while at the same time, funds continue to accumulate in the social insurance trust funds.
- Since the pension of a worker is higher than that of a formally registered business owner, many business owners noted that they prefer to declare themselves as workers, rather than business owners, on their national identification cards. On the other hand, for obtaining a business license, the current law requires a mandatory business owners insurance with, this status, “business owner”, clearly declared on the licensing request. Consequently, and because many business owners identify themselves as workers in their national identification cards, they are reluctant to formalize their business.
- Related to the above concern, and because the mandated retirement age for business owner is 65 while that of workers is 60, business owners prefer to identify themselves as workers rather than business owners. By doing so, they avoid paying social insurance premiums, basically considered as a waste, for an additional five years especially that the pension of the worker is higher than that of the owner.
- Many participants noted that the current social insurance system does not adequately address the issue temporary workers. This deficiency, along with the bidding requirements that obligates bidders to provide all workers with insurance coverage, place unnecessary burdens on business owners. Together, these two limitations work against the interest of business owners especially, in the instance they chose to use their own employees, who are already insured, for bidding on contracts. Participants attributed this situation to the cumbersome and inflexible bureaucracy of the manpower bureaus of the Ministry of Manpower and Migration which, do not even attempt to review this system to make the requisite corrections.
- Uncertainties regarding job security, in addition to the scarcity of job opportunities make workers reluctant to enroll in the social insurance system especially that the expected benefits are perceived as meager.

ON TRAINING

- Most business owners do not depend on the state provided training to upgrade the skills of their workers. One participant said: “We do not seek outside sources for training our workers. The business owner himself is the one who trains the workers.”
- Many complained that the state-offered training is inappropriate to the realities and needs of businesses. More so, training is often provided in distant facilities, not in proximity to large concentrations of businesses or villages in which workers reside which, poses considerable challenges for trainees to maintain attendance.

2. LICENSING AND ACCESS TO UTILITY SERVICES AND INFRASTRUCTURE

Obtaining licenses and accessing utility services and infrastructure remain one of the major obstacles facing formal enterprises. The Local Administration Law -No. 43/1978- and its amendments- vest in the chief of the local unit licensing authorities, the final step in the process for formalizing a business, in addition to the approval authority for providing utilities to enterprises falling within his jurisdiction.

Multiple and overlapping jurisdictional powers over land was viewed as complicating matters, opening the door for corruption, and undermining the effective allocation of land. Murky lines between local units jurisdiction and central agencies jurisdiction was cited as a leading cause for undermining the role of the Industrial Development Authority, reducing it to a mere facilitator for registering land, and undercutting its intended role as the supreme “administrator” of industrial land.

ON LICENSING

Both formal and informal business owners agreed that acquiring a license is crucial for a number of reasons including facilitating financial transactions, engaging in export and import operations, securing raw materials, and accessing finance.

That said, informal enterprises noted that they are able to circumvent the formal system by going through a third party. Specifically, informal enterprises “outsource” many of their transactions to formal enterprise. For example, invoices, procurement of raw materials and sales tax reporting are processed in the name of that third party, who in return receives a portion of the revenues. Such practices expose business owners to high legal risks.

Licensing was described as a process fraught with difficulties and impediments. Enterprises face many common interlocking challenges

which they shared with the group. Several examples include:

- The unduly complex technical requirements impose additional burden on businesses seeking licensing. For example, the General Directorate of Civil Protection requires businesses to install fire protections safety systems which, in the view of business owners, are technically inappropriate to the nature of the business. This situation is further aggravated by the insistence of local units officials on these requirements regardless of appropriateness. Additionally, the current activity coding system for determining the safety requirements is inflexible and does not adequately address the wide range of activities in the Egyptian market.
- Bribe solicitation by local administration employees poses constant challenges for businesses.
- A fragmented inspection system, and an ever-changing composition of inspection committees result in inconsistent inspections, and a lengthy approval process. One participant observed: “To obtain our license, we initially received a visit from a five-member committee to inspect our food products. The committee did not approve one of our products, the biscuits, on the grounds the product did not meet food safety standards. This was followed by a visit from a committee, with an entirely new composition, which determined that our bottled water did not meet safety standards. The saga continued, and the years pass by without us obtaining the license. The bureaucratic hurdles are difficult to comprehend. It is possible that the committee members were seeking bribes. At any rate, it has been four years since the first visit, and we still did not receive our license. We are losing hope.”
- Many participant questioned the rationale behind issuing temporary licenses, the current practice. They complained about a recently issued decree which reduces the validity of the temporary license from three to one year. In their view, the decree adds more burden on enterprises as it sets an unreasonable limitation period on the validity of a license. This burden is particularly significant considering the many hurdles enterprises face in renewing a license or obtaining a permanent license.
- Many observed the lack of assessments that captures community needs at the governorate level. In their view, such assessments can serve as a good gauge to systemize and prioritize licensing in a manner that meets the needs of communities.

- The diffusion of responsibility for licensing between government's entities adds to the woes of small entrepreneurs. To obtain a license, a small entrepreneur must go through multiple channels including the Social Fund for Development, and other relevant authorities such as civil protection, health, social insurance, and taxation, and finally the City Council. One participant described the process as “the grand misery—a process infested with corruption and bureaucratic obstacles.”
- Redundant licensing requirements are viewed as a significant burden on businesses. Not only is the same one document requested by multiple entities, but also the same entity requests the document more than once. The time wasted on meeting redundant licensing requirement cannot be overstated.
- Many of the licensing departments are inconveniently located in distant areas, far from where enterprises are concentrated. For example, entrepreneurs located in Port Said Governorate need to commute to Ismailia Governorate to access the local branch of the Investment Authority.
- Some participants voiced concerns regarding the handling of licenses in the event the business owner dies. Complexities related to the sorting out of issues related to license transfer usually result in the beneficiaries operating informally.
- Discussion revealed a lingering sense of trepidation about licensing among informal entrepreneurs. Formalization is viewed as “invitation to trouble” as it involves engaging with local officials. One participant provided an example to demonstrate the rationale for such trepidation, noting: “A factory owner we know has all his papers in order. His factory has been in operation for the past twenty years. A month ago, he was bombarded with a myriad of new requirements, a ruse by government to collect money. He was asked to obtain a new set of documents: a permit to connect his factory to the public sewer system, the approval of the General Directorate of Civil Protection, an environmental registration certification, and an industrial safety certificate.”

ON PROVISION OF UTILITY, SERVICES AND OTHER OPERATION REQUIREMENTS

- The predominant theme expressed by the participants was that the provision of basic utilities and services to their facilities remain too cumbersome.
- Business owners suffer from the high cost of electricity. In particular, many called on the Electricity Company to be more attuned to the nature and needs of micro enterprises. Participants recommended that the company review their estimation procedures, and make a distinction between between micro and large enterprises when calculating their estimations. A factory owner in Kafr El Sheikh Governorate said: “My factory, which was licensed 25 years ago, is in an industrial zone in Kafr El Sheikh Governorate. Although it is a small 200-square-meters factory that operates one shift using two machines, the representative of the Electricity Company presented me with a bill of EGP 16,000. I still have to pay wages-the weekly wage of one worker is EGP 500.”
- Participants also noted that other supporting services critical to industrial operation are distantly located away from villages and marakez⁴ where small enterprises are usually located. The geographic bias in the availability and accessibility of support services was viewed as a reflection of the priority given to the interests of large investors. For example, the Federation of Egyptian Industry which is supposed to serve industries in the city of Fuwaah in Kafr El Sheikh Governorate is in the city of Gamasa in Dakahlia Governorate, which is 200 kilometers away. One participant commented: “Why this injustice?”
- A predominant concern among participants was the unjustified escalation in rents, particularly for premises rented from the local units. It was noted that rents have more than doubled over the past two years.
- Penalties are another major concern for entrepreneurs. Often, the reasoning behind imposed penalties, whether it is for littering or for failing to meet lighting standards, is not understood. The law needs to adequately address penalties in a clear manner. It was noted that for settling penalties, formal enterprises end up paying double the amount that informal enterprise pay, since the latter settles the situation by bribing the local official.

⁴ *Marakez (singular: Markaz) is a tier in Egypt's five-tier local administration system.*

- Participants lamented about the lack of reasonably priced local inputs which negatively affects their operations. Moreover, they noted that government does not meet its commitment to set aside a percentage of its procurement budget for SME products.

ON LAND USE ALLOCATION

- Corruption was the main recurring theme throughout the discussion on land use allocation. Examples of corrupt practices in land allocation cited by participants included allocating the best parcels of land to investors with close links to local administration officials, and unjustly allocating multiple parcels of land to one individual and his family members.
- Inefficient allocation of land is another concern. Participants noted that in some instances land is allocated with no consideration to the criteria of use. The industrial zone in the city of Gamasa in Dakahlia Governorate is a case in point. The zone is very distant from the area with the highest concentration of industrial enterprises in the city Fuwaah in Kafr El Sheikh Governorate. One business owners noted: “The industrial zone is 200 kilometers away from my factory. Even if land was offered for free, I am not still interested, as it is of no use to me. The operating expenses will be exorbitant. The daily wage of any worker will jump from EGP 70 to EGP 150, without even taking into consideration the cost of transportation and lodging.”

ON MARKET EXIT

- Absence of a good bankruptcy legal system that facilitates market exit in case of business distress was noted as one major factor deterring informal enterprises from formalization. Enterprises worry that lack of an enabling bankruptcy law would adversely affect their chances for market re-entry.

3. TAXATION

Informal entrepreneurs view the issue of taxation with persistent trepidation. The complexity of the taxation system, along with the risk of imprisonment that formal investors face for failing to pay their taxes feeds into this fear and acts as a barrier to formalization.

Law No. 8/ 1997 regulating investment guarantees and incentives, was designed to encourage domestic and foreign investment. Among the incentives offered to investors were tax and custom incentives. In fact, Article 3 of the law stipulates that “The provisions of this law shall not affect any tax privileges or exemptions or other better guarantees or incentives provided under other legislations or agreements.”

The Income Tax Law enacted in 2005, Law 91/2005 eroded many of these incentives. The underpinning philosophy of the law focuses on safeguarding the interests of the state against investors who might manipulate tax holidays. In some instances, investors manipulate the system by closing out their business at the end of the tax exemption period, to later reopen the same business, with a different name but the same owners.

While the Income Tax Law limited income tax holidays, it also lowered the taxes on corporate profits, not to exceed a 20% cap. In 2015, the income tax rate applicable to the annual taxable corporate profit was reduced from 25% to 22.5%. However, Law No. 8/ 1997 maintained other incentives for large investors such as obtaining industry inputs at a lower cost, and other incentives related to land use allocation and exemption from sales taxes.

Compared to large investors, small investors operate under less favorable conditions, thereby leaving them with no option but to operate informally. One participant summed it up as follows: “When it comes to taxation, we are hit with unrealistic guesstimates. While there is an appeal process, it is still time and energy consuming. It is no secret that the informal enterprise, which is neither registered nor licensed, and does not pay social insurance or taxes, end up winning and generating profit. Even if the informal business owner brings down the price of his product, he is still able to generate profit as he has no significant obligations.”

Amendments introduced to the property tax is a new tax concern to enterprises. The changes aggravated the tax challenges facing formal enterprises, and at the same time generated additional fear of formalization among informal enterprises. Many participants expressed their frustration noting: “We used to pay EGP 600 in property tax, now we are asked to pay an amount ranging

from EGP 6,000 to EGP 23,000.”, “We are facing major problems with the property tax. While 70% of the residents of Fawaah do not pay property tax, the tax authorities are really cornering us, and requesting that we pay significant amounts. They are focusing only on us, small business, and at the same time, they are ignoring others- home owners and large investors.”, and “We are asked to pay EGP 15,000 a year in property tax.”

Some participants pointed to an additional tax challenge that comes into play in the event an industrial investor decides to expand his business, by adding a commercial component to it. In this instance, the business owner is requested to hold two tax cards: one for the industrial component of the business and another for the commercial.

4. ACCESS TO FINANCE

Access to financial services was widely viewed as a key driver for formalization as it allows investors the opportunity to expand. Yet, the extent of its influence on the decision to formalize remains uncertain particularly in view of the high interest rates and the high recurrent costs of operating a formal enterprise.

The Social Fund for Development is viewed as far removed from the realities and needs of SMEs. According to the participants, its requirements are very complex and contribute to the problem. For example, to receive a loan, the entrepreneur must have a license, which, in and of itself, consumes a significant portion of the loan to obtain.

The high cost of borrowing, exceeding 20% for SMEs, remains to be an obstacle to business expansion. According to one business owner: “Interest rates exceed the profit rate.”

The SME Initiative of the Central Bank of Egypt⁵ elicited varied reactions from participants. Some participants were not fully convinced of the initiative, viewing it as merely a rescheduling borrowers’ debts. Others considered the requirements to be too complicated. It was concluded that the initiative did not reach its intended beneficiaries.

⁵ *The initiative makes available EGP 200 billion for loans to SME, over five years, with a declining balance interest rate.*

Participants expressed their frustration over the implementation mechanisms and the cumbersome loan guarantee requirements of the Central Bank's SME Initiative. For accessing a simplified loan the business must: 1) already be established, 2) has annual sales of EGP 1 million, and 3) possess a certificate of commercial registration, a tax card and a license. While, theoretically speaking, this type of loan program is designed to benefit small enterprises, there was serious doubts as to whether it does really benefit these enterprises since most, if not all, of the supposedly targeted enterprises do not have any of the required documentation.

Another problem noted with the SME Initiative's loan program was the age-based criteria applied for approving loans. One business owner lamented: "They refused me a EGP 50,000 loan because I am 69 years old. They overlooked the fact that I have already invested EGP 1million to build my business."

In sum, the above opinions and thoughts offered during the focus group discussions clearly revealed the extent of challenges and concerns facing informal enterprises and impeding their transition for formalization. Summed up in the words of one participants: "The benefits of operating informally far exceeds the benefits of formalization." Indeed, the costs of operating as an informal enterprise is significantly lower than those for operating formal enterprise-hence the dilemma of formalization.

A final word: while the role of the informal sector in generating employment, and providing a buffer to prevent families from falling into the poverty trap is well recognized, yet this should not justify informality. Besides the substantial government revenue losses, primarily in taxes and licensing and other fees associated with formality, the social costs imposed by the informal sector's lack of consideration to safety, health and environmental measures sector cannot be overlooked.

ANNEX

B. CHALLENGES AND SUGGESTED POLICY INTERVENTIONS: PERSPECTIVES OF THE GOVERNMENT ENTITIES

This section presents the views of the concerned government entities regarding the challenges facing SMEs, and the practical measures that can mitigate these challenges. In other words, it provides a solution-focused framework for formalization, designed to maximize the benefits to the state budget, while at the same time minimize any negative effects on the employment generation capacity of the informal sector. The proposed measures are ranked and presented in order of “ease of implementation”, starting with “the easier to implement” interventions. The other category of interventions includes measures proposed by SMEs, however, government entities found unacceptable, on account of their unfeasibility in the short-run.

Following is a summary of the major views, ideas, and recommendations of the consulted government entities:

1. LICENSING

- A new law to regulate licensing is in its final stages. Currently the draft law is being reviewed by the State Council. Upon conclusion of the review, the draft law shall be presented to the House of Representatives for enactment. It is expected that with the passage of the new law, licensing problems will finally be put to rest.
- A new approach to licensing based on safety considerations has been introduced. Low-risk industries would be licensed via notification, while high-risk industries would be subject to a rigorous approval process to obtain a license.
- Faster licensing is critical. Granting the Industrial Development Authority the exclusive authority to issue licenses should result in shortening the licensing process from 635 days to one week.

- A business will no longer be issued an initial temporary license. Rather, permanent licenses will be issued straightaway. Relevant information on issued licenses will be posted on a website which will be updated to reflect any changes in the status of any license. For example, if, for committing a violation, a business license is temporarily suspended, the information will be updated on the website so as to be readily accessible to concerned officials, such as tax or customs officer, as necessary.
- The government is currently reviewing all non-written requirements imposed on investors. Government entities have been asked to make an inventory of all these requirements and forward them to the Industrial Development Authority. The Prime Minister will form a committee led by the Industrial Development Authority to vet these requirements and eliminate requirements that serve no particular purpose relevant to the licensing request. For example, it is expected that the requirement that business owners submit a feasibility study when requesting a license will be eliminated, as it is relevant to finance matters and not licensing.
- The government is in the process of reviewing licensing costs. Consideration is given to basing license fees on the nature and scope of the activities to be licensed, and the safety risk assessment noted earlier.
- The industrial license will be issued in tandem with the approval of the industrial registration.
- Procedures for issuing licenses for expanded business activities will be streamlined.
- Cumbersome bureaucratic procedures and corruption will be addressed by awarding the Industrial Development Authority jurisdiction over industrial land use allocation. For other land parcels, already under the jurisdiction of governorates, business owner will be required to obtain the approval of the governorate in which their business is located, after obtaining the preliminary approval from the Industrial Development Authority.
- Already operating informal enterprises will have the opportunity to obtain a license in 24 hours. Moving the premises of informal enterprises to industrial areas will be encouraged by facilitating their access to land that fall under the jurisdiction of the Industrial Development Authority.

- Develop clear, streamlined and comprehensive licensing requirements rosters for the different business activities. The rosters are to be accessed electronically.
- Promote and make more efficient the one-stop-shops serving entrepreneurs.
- Develop detailed and comprehensive maps of investment and business opportunities for governorates and marakez, nationwide.
- Put in place simplified rules and procedures for license transfer, license inheritance and the entry and exit of business partners.
- Eliminate the requirement that business owners submit the license request to the security apparatus for review, as mandated by districts and the Social Fund for Development.

2. ACCESS TO FINANCE

- Priority is given to developing a standardized definition for SMEs to be adopted across government entities. This will improve the consistency and efficiency of designing and delivering SMEs finance schemes.
- It is critical to reform the credit guarantee schemes to further support SMEs access to finance. Reform should focus on simplifying and harmonizing procedures, with the Central Bank overseeing these schemes.
- Expedite the enactment of the bankruptcy law to facilitate easy and time-bound market exit for loss-making businesses.

3. TAXATION

- Amending the property tax law is not possible at present. However, government representatives acknowledged the broader implications of imposing this tax for informal enterprises wishing to formalize.
- Government entities do not agree with the SMEs recommendation regarding tax exemptions.
- Consideration should be given to developing a simplified tax system for small enterprises to facilitate VAT reporting/record-keeping.
- Consideration should be given to introducing a simplified, one to two-page tax return forms, that SME owners can fill out with some assistance from tax officials, without the need to seek the assistance of a certified accountant.
- Consideration should be given to amending the law on tenders and bids to enforce compliance with the public procurement requirements related to SME set-asides.

4. BANKRUPTCY LAW

- Expedite the enactment of the bankruptcy law to facilitate easy, and time-bound market exit for loss-making businesses. It was noted that compared to informal enterprises which, enjoy easy market entry and exit at any time, formal enterprises can find themselves trapped in a process of financial distress with no easy way out.

5. UTILITIES

- Strengthen the complaints and grievance handling mechanisms related to high electric costs.
- Control the unjustified escalation in prices of land in industrial zones.
- Conduct a performance assessment of the Industrial Development Authority, with an eye toward transforming its role to that of a “quintessential” agency for managing industrial areas. All responsibilities related to licensing and reviewing utility installation requests should be relegated to the department of industrial zones.

6. TRAINING

- Provide focused training to SME employees. Training programs should be designed by business owners in collaboration with training professionals. Upon completed the training, trained employees should commit to the employer for some minimum periods to be specified in the employment contract.

7. EMPLOYMENT AND SOCIAL INSURANCE

- Representatives of the National Authority for Social Insurance dismissed complaints voiced by business owners regarding the social insurance inspection visits carried out by its officers. They stressed that the social insurance system is not complicated, noting that the only requirement to enroll employees is presenting a commercial registration certificate or any business verification document. They also pointed out that the process allows for a one-month adjustment period for resolving issues.
- The representatives rejected, on grounds of unfeasibility, the recommendation of business owners to raise the social insurance premiums. From their perspective, such raises will add financial burden on businesses!
- Complaints related to temporary workers' insurance requirement, mandated in bidding documents along with the recommendation that businesses be exempted from providing temporary workers with insurance coverage were disregarded for social considerations. It was suggested that to avoid dual social insurance payments (in the instance the business uses already insured workers for carrying out awarded contract), businesses should submit a request for exemption to the National Authority for Social Insurance prior to starting work on contracts, rather than later, which is usually the practice.
- Representatives of the National Authority for Social Insurance viewed the request that the state assumes the burden of the employer's share in social insurance, during the first year after registration, as both unreasonable and unfeasible. In addition, the recommendation that the employer's portion of the social insurance payment be held constant at a fixed rate was also discarded. They noted that social insurance funds, particularly the ones pertaining to private sector employees, are already suffering from significant deficits.

NOTES

THE FEDERATION OF ECONOMIC DEVELOPMENT ASSOCIATIONS - FEDA

9 Hassan El Marmoun Street, 8th Area, Nasr City, Cairo

Telephone: 0224706163

info@fedamisr.net