



POLICY BRIEF
**PROPERLY ADDRESSING
INFORMALITY IN THE ARAB
WORLD: NATURE, SEVERITY,
AND POSSIBLE SOLUTIONS**



Task Force 6
**ECONOMY, EMPLOYMENT, AND EDUCATION IN
THE DIGITAL AGE**

Authors

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موجز السياسة معالجة مسألة عدم الرسمية في العالم العربي بالشكل المناسب الطبيعة والحدّة والحلول الممكنة

فريق العمل السادس
الاقتصاد والتوظيف والتعليم في العصر الرقمي



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ABSTRACT

Informality has been a persistent feature of Arab economies. In recent years, the shift to informality has been on the rise, featuring evolutions that make its negative impact even harsher on the society and the economy.

We approach informality from the worker's perspective, starting with the necessary preconditions for specific policy recommendations. The proposal emphasizes the importance of combining the right incentives and sensible checks and balances.

The incentives typically work on two parallel tracks: slowing down the pace of informality and tackling the stock through a set of well-integrated policies.

ظلّت عدم الرسمية سمة أكيدة في الاقتصادات العربية. وفي الأعوام الأخيرة، طفق التحول إلى عدم الرسمية يزداد، وهذا شكّل تطورات لها أثر سلبي، بل أشد، في المجتمع والاقتصاد.

نحن نصل إلى عدم الرسمية من منظور العامل، بادئين بالشروط الضرورية لتقديم توصيات سياسة محددة. يركز هذا المقترح على أهمية الجمع بين الحوافز المناسبة والفحوصات الحساسة والتوازنات.

الحوافز ما هي إلا العمل على مسارين متوازيين: تبطئة وتيرة عدم الرسمية، ومعالجة المخزون من خلال مجموعة من السياسات جيدة التكامل.



CHALLENGE

Informality has been a persistent feature of Arab economies since the late 1980s (Medina and Schneider 2018). A typical country in the region employs about 60 percent of its workers and produces about 30 percent of the GDP informally (ILO 2018a; Medina and Schneider 2018). Informality is on the rise and many Arab countries are shifting from regular to irregular informal work (Assaad and Krafft 2013).

While this analysis focuses on Arab countries, the challenge of informality and the solutions recommended are relevant to the entire world.¹ It is also of particular importance for Group of Twenty (G20) countries as it is closely associated with unemployment and the future of decent work. Both these issues are on top of the agenda for the T20s in 2015, 2016, and 2018.

In the 2019 G20 Summit, informality was explicitly mentioned, as Ministers of Labor and Employment of G20 countries clearly stated that youth employment in the informal sector was increasing in all countries. The way in which informality has been addressed in previous G20 Summits, however, has neglected the multidimensional and complex characteristics of informality (G20 2018; T20 2018). This policy brief attempts to bridge this gap by providing a set of comprehensive, well-integrated, practical, and evidence-based policies that address the core aspects of informality.

Informality has devastating effects at the macro and micro levels, which manifest as follows:

1. Tax evasion owing to informal practices accounts for 50 percent, 70 percent, and 50 percent of the total tax revenues in Palestine, Lebanon, and Tunisia, respectively (Jaber and al-Riyahi 2014). This implies a large number of free riders (Loayza 1996; Johnson, Kauffman, and Shleifer 1997).

2. Informality is strongly associated with lower productivity and reduced economic output. The potential of the growth of informal enterprises is stymied by the lack of access to capital, land, training, technology, and limited market access nationally and internationally (World Bank 2014a, 2019a).⁴

3. Informality is largely associated with weak human capital, vulnerability, inequality, and poverty as seen in Figures 1 and 2. Even though the direction of causality between informality and poverty is still unresolved, there is strong evidence that causality goes in both directions.^{5, 6, 7}

CHALLENGE

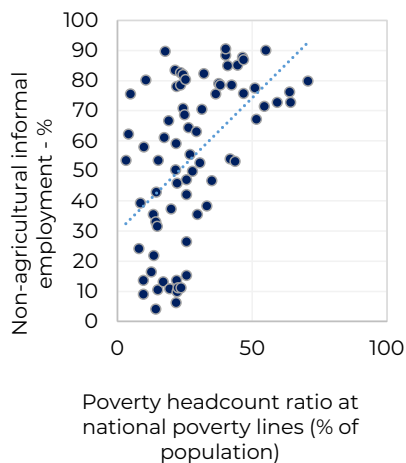


Figure 1: Significant positive correlation between informality and poverty

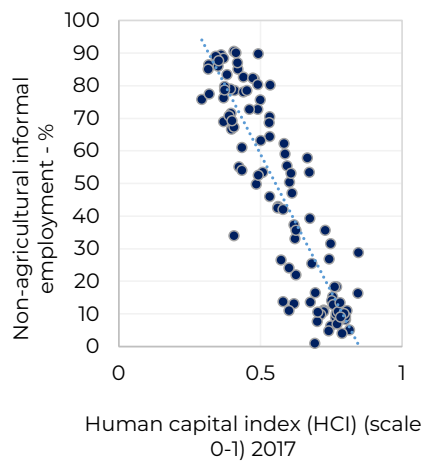


Figure 2: Significant negative correlation between informality and human capital

Source: Authors' calculations based on WB, WDI (2018), and ILO (2018a, 2018b).

4. Informality is closely associated with political and social instability. The association among poverty, irregularity, and informality makes societies prone to all kinds of social ills (Arab NGO Network for Development 2016).

5. The lack of decent employment is the main reason for illegal international migration (Villarreal and Blanchard 2013). The problem becomes more serious when the workers stay informal at their destination) Bosh and Farré 2013).⁸

6. Finally, it has been proven that informal workers are severely affected by COVID-19 (ECES 2020). The ECES has also indicated that COVID-19 has a multiplier negative effect on the economy and society as a whole, because of its effect on informal workers.



PROPOSAL

We propose two broad categories of solutions to change informality from a liability to an asset. Our comprehensive analysis aims to enable policymakers to identify the pros and cons of adopting these solutions and seeing the full picture, ranging from preconditions to specific policy recommendations.

1. Preconditions for successfully addressing informality range from data availability and improving conditions for formal enterprises to adopting a correct approach to informality.

1.1 Ensuring the availability of updated and precise data on informality on both employment and enterprises is essential to understand the dynamics and manifestations of informality at the national level on a yearly basis and to adapt policies accordingly.

1.2 Improving conditions for formal enterprises is the shortest route to cutting the increase in the flow of informality. This can be done by:

- i. Achieving good governance and improving business climate. The ILO (2014) emphasized that informality is mainly an issue of governance because of the ineffective, misguided, or badly-implemented macroeconomic and social policies. Figures 3 and 4 show that informality decreases as governments achieve higher scores in governance indicators, namely government effectiveness and corruption control.

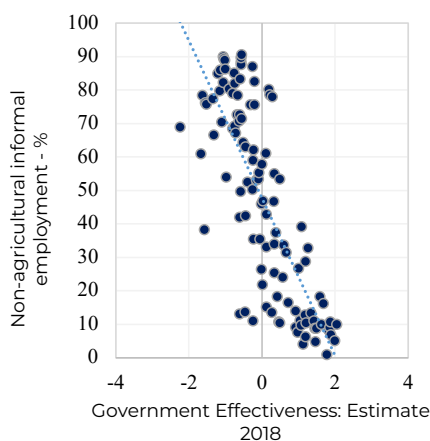


Figure 3: Significant negative correlation between informality and government effectiveness

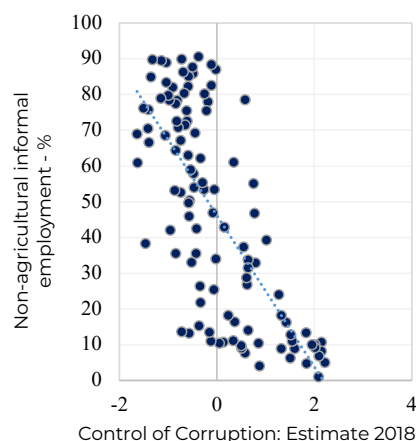


Figure 4: Significant negative correlation between informality and control of corruption

Source: Authors' calculations based on WB, WDI (2018), and ILO (2018a, 2018b).

ii. Implementing sound digitization.

The World Bank (2018) showed that digitization is indispensable for efforts toward formalization to succeed.⁹ Proper digitization also allows for sufficient transaction traceability through a single fiscal identification number for public and private transactions (ILO 2019).¹⁰

1.3 Adopting an accurate approach to informality

i. Adopting a comprehensive reform approach that encompasses complete solutions.

Informality declined the most in countries that adopted a comprehensive strategy with well-integrated policies that cover all aspects of informality (Oviedo, Thomas, and Kamer 2009; Loayza 2018).¹¹ Partial reforms and isolated policies will not only result in limited impact but can even worsen the situation (Fernández et al. 2017).¹²

ii. Changing the mindset.

Informal workers should not be perceived as criminals or as belonging to a low social class. Instead, governments must build their image as resilient entrepreneurs who keep the economy functioning even during times of crises (African Development Bank 2016).

iii. Adopting an employment-oriented approach as well, rather than an enterprise-based approach alone.

In most countries, particularly Arab countries, formalization efforts focus exclusively on informal enterprises, ignoring the fact that a sizable portion of informal employment also exists in formal enterprises as clearly identified in Figure 5.¹³ An employment approach captures and addresses informal enterprises and employment within the formal sector (World Bank 2014c).

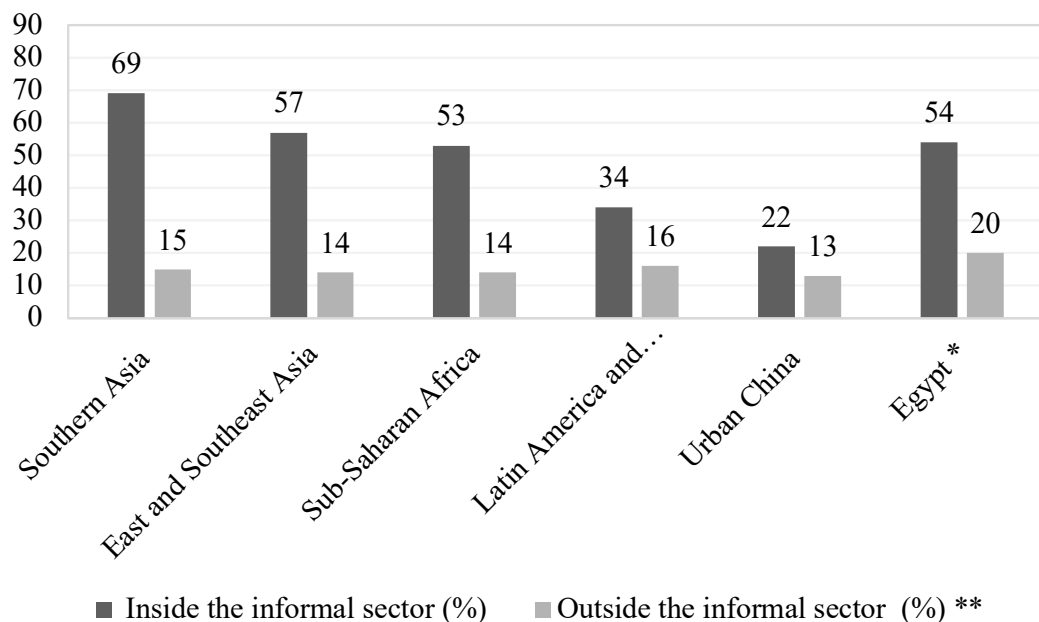


Figure 3: Informal employment inside and outside the informal sector as a percentage of non-agricultural employment (2004–2010)

Source: Authors' calculations based on the World Bank (2014d) and Vanek et al. (2014).

* Percentage of all employment in the formal sector.

** In formal enterprises

iv. Building trust between the people and the government.

The absence of trust in the government makes individuals and firms follow informal rules rather than government regulations (Williams 2018). This leads to a difference between state and citizen morality (Windebank and Horodnic 2017). Governments should build trust through smart communication, by improving perceptions of fair tax collection and usage, and by reinforcing citizen engagement in the process of decision-making (Bakry 2015).¹⁴

2. Specific policy recommendations

The World Bank (2011) emphasized that for any formalization efforts to be sustainable, the productivity of both workers and enterprises should be boosted. Decent employment is a fundamental human right as recognized under Article 23 of the Universal Declaration of Human Rights (ILO 2013).

We propose comprehensive policies that address informality from an employment perspective. This is critical for capturing and addressing both informal enterprises and employment within the formal sector (World Bank 2014c).

We propose a set of comprehensive policies to stop the flow and tackle the existing stock of informal work in Arab countries. We also present and address the most common governmental fears that accompany each policy solution. These solutions are elaborated in the following sections.

2.1. Slowing down the inflow of informal workers

i. Creating enough private formal jobs to utilize the demographic dividend better.

Arab economies have failed to generate enough private formal jobs for the population in the working age group. Therefore, any obstacles that cap private sector potential as captured by the Doing Business Report should be totally abolished (World Bank 2019b).

ii. Promoting social mobility.

Meeting the expectations of the Arab youth in climbing the social ladder is critical to preventing them from pursuing their aspirations through informal work. International experience has showed that improved education in combination with redistributive justice and inclusive growth constitute the main channels through which governments can promote social mobility and reduce informality (Kerstenetzky and Machado 2018).¹⁵

iii. Adjusting differences in employment benefits between the government and the private sector.

The vast majority of the Arab youth aspire to work in the government sector because of its stability and benefits. In Egypt, Jordan, the Occupied Palestinian Territory (OPT), Lebanon, and Tunisia, 49.6 percent of the unemployed youth on average prefer to wait until they work in the government (Dimova, Elder, and Stephen 2016).¹⁶

While the rich can afford the cost of staying unemployed, most of the youth cannot. To survive, they tend to accept informal jobs during the transitional period (World Bank 2014b; ILO 2012). Therefore, bridging the gap in terms of benefits and access between government and private employment in Arab countries is expected to reduce informal employment (World Bank 2014b).¹⁷

The experience of G20 countries in this area has been very illuminating. According to the ILO (2018b), most G20 countries introduced significant amendments to their labor laws to protect all forms of employment, to restrict abusive behavior by employers who provide short-term contracts instead of permanent employment, and to guarantee a minimum income level for short-term employees. Specific examples of such measures are as follows:

- Extending legal coverage to temporary employment. The corresponding measures included limiting the number of successive fixed-term contracts authorized by law or establishing a limit on their maximum cumulative period.
- Implementing the principle of equal treatment for workers in non-standard employment is one of the most efficient ways of ensuring an adequate level of protection for informal workers. This is enshrined in the EU Directives on part-time, fixed-term, and temporary agency work and is implemented through legislation adopted by EU member States.
- Additional measures may include setting a minimum number of hours for part-time workers to ensure that they receive a minimum amount of remuneration, or establishing minimum entitlements for on-call workers, should the employment contract fail to regulate these issues.

iv. Easing labor regulations and ensuring the freedom of association.

Instead of allowing labor unions, most Arab countries tend to protect the rights of workers through rigid regulations. The rigidity of firing regulations prevents businesses from the flexible reallocation of labor during economic downturns, thus causing a significant loss of efficiency (OECD 2010; Oviedo, Thomas, and Kamer 2009). Finding themselves unable to fire, private firms have a natural incentive to employ workers informally (World Bank 2014b).

Institutional reform in that area can help reduce informal employment. Labor unions and associations will enable workers to negotiate, gain visibility, and have their rights recognized without the need for excessive state interference (European Union 2018; ILO 2014).¹⁸

International experience has showed that many developing countries around the world have allowed informal, domestic, self-employed and agricultural workers, and workers without contracts to organize themselves such as Uganda, Mauritius, and Senegal. They allowed all kinds of workers to exercise union rights. This has also been a common practice in all G20 countries (ILO 2018b). Allowing for collective bargaining has led to improvements in working conditions and, in some cases, the regularization of these workers (India) or the establishment of time-limits after which temporary contracts are converted into permanent ones (Canada and South Africa).

v. Eliminating premature entrance into the labor market.

Premature entrance into the labor market primarily takes place because of poverty in the family. Providing decent jobs and promoting social mobility will boost the wages of working adults, increase family income, and incentivize them to invest in their children instead of sending them out for informal employment (Tzannatos, Diwan, and Ahad 2016; Kerstenetzky and Machado 2018).

2.2. Tackling the existing stock of informal employment

i. Remedying the vulnerabilities of informal workers through social insurance and unemployment benefits.

Most of the Arab population is very vulnerable to shocks of illness, job loss, and disability because they lack access to social security and basic employment benefits (ILO 2019b).¹⁹ They often resort to informal work as a safety net in the short run until they find a regular job in the formal sector (Oviedo, Thomas, and Kamer 2009).*

Supporting workers during cyclical economic downturns can remedy these vulnerabilities and prevent them from seeking employment in the informal sector (ILO 2015; ILO 2019). This can be achieved through a strong safety net

* This specific feature has disappeared during COVID-19 as the informal sector is no longer able to accommodate temporary unemployment (moving from job to another) because it is facing its own problems because of the pandemic.

that combines both social and health insurance along with unemployment benefits for all types of employment, including self-employed and agricultural workers (World Bank 2019a, 2019b).²⁰ The need for this safety net is even stronger now, given the spread of COVID-19.

An adequate safety net also has the advantage of assisting the labor inspection administration in detecting non-complying enterprises (Kanbur 2017; World Bank 2011).²¹

It is important to note that such a safety net must be accompanied by an adequate system for vocational training that increases worker productivity. The heavy burden of social insurance on enterprises (41 percent of the basic wage in Egypt and 26 percent in Tunisia) discourages the commitment to formally hire workers unless they show high productivity (Assaad, Krafft, and Salemi 2019).

Meanwhile, workers themselves often prefer informal hiring because they perceive their share of social and health insurance to be high, given how far it is due for recuperation (pension) and given how poor public services are in general (Oviedo, Thomas, and Kamer 2009).

As for the experience of G20 countries, to address the gaps in legal coverage and level of social security benefits of workers in temporary and part-time employment, many of them lowered or eliminated thresholds regarding minimum working hours and/or earnings or duration of employment to qualify for benefits, which is of particular relevance for women. For instance, in Japan, mandatory coverage of part-time employees was finally extended in 2017, by reducing the monthly salary threshold for registration and by lowering the required number of hours worked on a weekly basis from 30 to 20 (ILO 2018b).

Typical areas of concern for governments in this field are insufficient financial resources to meet all needs, unemployment benefits may disincentivize workers from working hard, and the probability of not targeting the right person. These concerns can be mitigated easily by building comprehensive and precise databases, restricting unemployment benefits to a limited period of time, and accessing funds through tax revenues, which will automatically increase with higher productivity.

i. Boosting skills and upgrading vocational training.²²

The poorly educated, whether male or female, are seemingly stuck in informality because of poor qualification. In Egypt, Tunisia, and Jordan, individuals with less than secondary education have no chance of obtaining formal jobs (Assaad and Krafft 2016; World Bank 2012).²³

Therefore, Arab governments must reform their vocational education and training systems, link their outcomes to labor market needs, strike a balance between their supply and demand, and rebuild the image of vocational graduates to guarantee them the same social recognition as that of university graduates.

2.3. Checks and balances

Checks and balances are achieved through effective enforcement. This requires governments to upgrade their capacities to ensure compliance, especially in non-GCC countries. A sufficient number of well-trained inspectors should be hired and offered the right incentives based on their work.

Effective enforcement also requires building a centralized database that links social security, labor, and tax administration. With notebooks, inspectors can consult the database in real time through the Internet to verify working conditions and check whether the enterprise and its employees are registered and pay their taxes and social security contributions (Chacaltana, Leung, and Lee 2018). Non-GCC countries can draw on the experience of GCCs, especially the United Arab Emirates, which applied a similar system.

3. The role of the G20

The ILO emphasized that transitioning from informality to formality needs international coordination and the G20 is the right format for such cooperation. As the group accounts for about 90 percent of the world's gross domestic product and 80 percent of trade, they have the coverage, the financial means, and the necessary tools to coordinate global actions against informality, particularly among Arab countries.

Many G20 countries such as Germany, South Korea, and the United Kingdom are already among the most formal economies in the world. Other countries such as Argentina, Mexico, and Brazil have implemented sound formalization policies that have significantly reduced informality over the past few decades. These countries should

transfer their technical experience such as those mentioned in subsections 2.1 and 2.2 to Arab countries and help them replicate their successful policies especially in the areas of business creation and taxation, as well as the expansion of the coverage of social and health insurance to cater to all types of workers.

Since there is a strong correlation between informality and poverty, informality should be a core element in the G20's plans to eradicate global poverty not only for social reasons but also for economic reasons. The G20 should link access to finance at preferential terms with countries that have clear programs to deal with informality.

Final Remarks

1. The main objective behind addressing informality is to make the economy more efficient and to benefit from all the available resources. This lies at the core of the strategy for a more resilient, inclusive, and sustainable economy, which is required to survive COVID-19 and its repercussions, and to be able to face any future crises.
2. Although the devastating impacts of informality have been recognized, few countries have developed a comprehensive and integrated approach to curb the spread of informality. Policy responses worldwide still tend to be uncoordinated, ad hoc, or limited to certain categories of workers (ILO 2014). Achieving policy coherence is expensive and challenging. However, the costs of partially addressing informality can be even higher (Galal 2004).²⁹
3. Microenterprises associated with activities in households in rural and remote areas such as handicrafts and similar activities, can and should remain informal. As they primarily fight poverty with limited contributions toward development efforts, the opportunity costs of directing resources to the formalization of these micro activities are very high. They are best dealt with through specialized marketing companies that collect their products and market them on their behalf.

Disclaimer

This policy brief was developed and written by the authors and has undergone a peer review process. The views and opinions expressed in this policy brief are those of the authors and do not necessarily reflect the official policy or position of the authors' organizations or the T20 Secretariat.



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END NOTES

- (1) According to the ILO 2018a, more than 56 percent of the G20's employed population are in informal employment. The share of informal employment in total employment ranges from less than 20 percent of total employment in developed G20 economies to more than 85 percent in India and Indonesia. The ILO statistics have also confirmed that the general characteristics of informal workers in G20 countries do not significantly differ from those of their counterparts in the Arab region and the rest of the world.
- (2) According to De Soto (1989), the engagement of entrepreneurs in informal activities can be seen as a form of popular protest and political movement to generate their own rational competitive market economy.
- (3) World development indicators have showed that the working age population (15 to 64 years) reached 63 percent in 2017, indicating an increase over the original 51 percent in the early 1970s. At the same time, the cited evidence proved that Arab economies have persistently failed to absorb this growing workforce because their industrial policies have long been biased against labor-intensive production in addition to a freeze on public employment since the late 1980s.
- (4) In Egypt, for example, only 20 percent of the identified microenterprises in 2006 survived in 2012. Those that survived did not grow.
- (5) Loayza (2018) found that the productivity of informal workers ranges between 25 and 75 percent of the overall labor productivity in most countries world over.
- (6) Wage differentials vary from 10 percent in Syria to over 50 percent in Morocco.
- (7) ILO (2018b) reached a similar conclusion on G20 countries. For those with available data, there is a positive relationship between poverty and informality. The poor face higher rates of informal employment and poverty rates are higher among workers in informal employment when compared to workers in formal employment, either because they earn lower incomes or because, despite decent labor incomes, they share their income with a high number of economic dependents within the household.
- (8) In Spain, 70 percent of the overall increase in unreported employment between 2000 and 2009 was attributed to migration.

- (9) Countries with the lowest informality have the highest Internet penetration rates, the biggest number of secure servers per million population, and the highest utilization of banking accounts.
- (10) In Chile, for example, every person aged over 14 years with a Chilean identity card is entitled to have an account in the State Bank with a debit card bearing the number of the identity card. This has been crucial in improving transaction traceability not only for tax purposes but also for minimizing all kinds of legal violations.
- (11) For example, a considerable body of literature proved that flat tax rates are only effective in reducing informality if they are combined with other reforms, most importantly, better social services.
- (12) Fernández et al. (2017) proved that addressing informality for tax purposes alone can lead to unemployment, poverty, and inequality with all associated social evils.
- (13) Informal employment in the formal sector accounts for about 15 percent and 16 percent of non-agricultural employment in Southern Asia, and Latin America and the Caribbean, respectively. As for the Arab region, there are not enough statistics available except for Egypt, where informal workers constitute about 20 percent of all employment in the formal sector.
- (14) In the case of Arab countries, particularly Egypt, Bakry (2015) argued that designing policies in isolation from informal workers led to disastrous unintended consequences for both informal workers and society in general.
- (15) Those three elements enabled Brazil to expand its middle class and reduce informality by 16 percent between 2002 and 2014.
- (16) The share ranges from a high of 81.6 percent in Egypt to a low of 21.0 percent in the OPT.

- (17) According to ILO (2018b), most G20 countries introduced significant amendments to their labor laws in order to protect all forms of employment. Most notably, extending legal coverage to temporary employment helps prevent abusive recourse to this form of employment. The corresponding measures include limiting the number of successive fixed-term contracts authorized by law (Brazil, China, Indonesia, Saudi Arabia, and most EU member States) or establishing a limit on their maximum cumulative duration (Indonesia Russian Federation, Saudi Arabia in the case of casual work). With regard to measures for improving the level of legal protection, implementing the principle of equal treatment for workers in non-standard employment is one of the most efficient ways of ensuring an adequate level of protection for these workers. This principle is enshrined in the EU Directives on part-time, fixed-term, and temporary agency work and is implemented through legislation adopted by EU member States. Similar rules apply for temporary workers in the Republic of Korea and South Africa. The principle of equal treatment is also legally recognized in India and Mexico for temporary agency workers, and in Argentina, Brazil, and Turkey for part-time workers. Additional measures may include setting a minimum number of hours for part-time workers, ensuring that they receive a minimum amount of remuneration (France), and establishing minimum entitlements for on-call workers should the employment contract fail to regulate these issues (Germany and Turkey).
- (18) Many developing countries around the world have allowed informal, domestic, self-employed, and agricultural workers, as well as workers without contracts to organize themselves such as Uganda, Mauritius, and Senegal. They allowed all kinds of workers to exercise union rights. This has also been a common practice among all G20 countries. Allowing for collective bargaining led to an improvement in the working conditions, and in some cases, the regularization of these workers (India) or the establishment of time-limits after which temporary contracts are converted into permanent ones (Canada and South Africa).
- (19) Over 54 percent of the Arab population lack social security coverage. Nearly a quarter of the workers in the Arab region are very vulnerable, especially in non-GCC countries. Over 33 percent (or 8.3 million) workers in non-GCC countries were estimated to be living in extreme and moderate poverty in 2018.

- (20) To address gaps in legal coverage and level of social security benefits for workers in temporary and part-time employment, many G20 countries lowered or eliminated thresholds such as minimum working hours and/or earnings or duration of employment to qualify for benefits, which is of particular relevance for women. For instance, in Japan, mandatory coverage of part-time employees was finally extended in 2017 by reducing the monthly salary threshold for registration and by lowering the required number of hours worked on a weekly basis from 30 to 20 (ILO 2018b).
- (21) Ensuring social security benefits even if the employer did not pay any contributions can incentivize workers to inform the authorities when they are laid off, even from undeclared work. Thus, it will be easier for the labor inspection administration to detect non-compliance.
- (22) Even though it is classified as stock, it will also affect the flow.
- (23) As for G20 countries, ILO (2018b) concluded that nearly 45 percent of the population in informal employment in the G20 has either no or only primary level education. The lack of education among workers in informal employment is critical in lower-middle income G20 countries, with the highest level of educational attainment for nearly three quarters of the workers in informal employment being primary education.
- (24) In Mexico, the Fast-track Business Creation system raised the number of registered firms by 4 to 8 percent in the first year.
- (25) It may be much easier to replicate a model of another Arab country with similar culture and context than a model from a totally different context. Non-GCC countries should draw on the experience of GCC countries such as the UAE, Kuwait, Oman, Qatar, and Saudi Arabia. Saudi Arabia made starting a business easier by consolidating procedures to obtain a commercial license and by streamlining online company registration with a minimal fee.
- (26) In Chile, the government procured 59 percent of its purchases from SMEs in 2017 (ILO 2019a). In Brazil, the Ministry of Education is obliged to get 30 percent of school meals from family-based local farms. In 2012, more than 185,000 farming families supplied products through tenders (European Union 2018).

- (27) A success story in this context is an initiative titled “Your Job Near Your Home” in Egypt, where large garment firms bought all the production of small factories for a specified period of time provided that they formalized and complied with typical quality standards (ISI 2016).
- (28) A flat tax system replaced all kinds of tax payments with a single monthly fee placed on the overall revenue. Argentina increased the number of registered taxpayers by 215 percent between 1998 and 2009, whereas the SIMPLES program in Brazil increased operation licenses by 12 percent and tax registration grew by 7 percent. In Egypt, this system also enhanced compliance between 2007 and 2010.
- (29) In the case of Egypt, for example, strengthening enforcement without undertaking real reforms to provide a viable path to formality will leave the overall economy worse off, with a net annual loss of one percent of GDP and a significantly increasing rate of loss over time.



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