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A study of Egyptian and Palestine trans-formal firms – A neglected category operating in the borderland between formality and informality

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Abstract

This article[*] outlines a new approach to firm behaviour different from both 'dichotomist' and 'continuum' formal/informal models. The approach adopts a new heuristic based on the notion of a borderland as space of interaction between dimensions of formality, and creates an umbrella category of trans-formal firms, which are neither purely formal nor informal. Three formality dimensions are adopted: (i) registration of the firm, (ii) existence of a bank account in the name of the firm, and the (iii) presence of an official balance sheet. After elucidating the new approach theoretically, the paper assesses the analytical capacity of the approach with quantitative and qualitative information representing 16 Egyptian and 16 Palestinian firms. The majority of the considered firms are found to be trans-formal moving in a space of decision-making representing our new, broadened notion of borderland showing that policies aiming at formalization processes misrepresent the realities of significant numbers of firms.

Keywords

Institutional economics of the firm, informal economy, borderland economy, (trans-formal) firms, Palestine, Egypt.

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1. Introduction

The 104th International Labour Conference-ILC, held in Geneva in June 2015, ended with an historical record of consensus resulting in the approval of the Recommendation 204, which led to a renewed emphasis on the formalization of economic activities, i.e. "the transition of workers and economic units from the informal to the formal economy" (International Labour Organization 2015). The document conceptualises firms according to a dichotomy between formal and informal, which had been criticized within the International Labour Organization (ILO) itself in the report "Women and Men in the Informal Economy" (International Labour Organization and WIEGO 2013, International Labour Organization 2002). The 2002 report had provided a new definition of informal economy that suggested interaction between the informal and formal economy outlining a model, where economic activities move from the informal to the formal in a 'continuum space', rather than acting independently in two separate spheres.

The paper at hand offers a critical examination of the dichotomous model as presented in the 2015 ILO report and builds upon the concepts in the 2002 report. We first theoretically develop the concept of a borderland economy as a *space of ambiguity* suggesting that firms interacting in the borderland are neither formal nor informal but 'trans-formal'. Second, we analyse the situation of firms in Egypt and Palestine empirically starting from three formality dimensions to test our new heuristic showing that most of the firms explored in our analysis exhibit 'trans-formal' characteristics.

The increasing size of the so-called 'informal' economy all over the world is generally recognized (Tanzi 1999). Schneider and Enste (2000) have empirically assessed the significance of economic activities labelled as 'informal' in a number of economies. They estimate that on average as much as 42% of the gross national product (GNP) of African countries is generated by informal activities. For example, the contribution of the informal sector in Zimbabwe is as high as 59%. For Latin American countries the informal contributions to GNP are similarly high as for Africa, namely 41%. Even in OECD countries informal contributions to GNP play a role, yet they are down to 14%. Other studies have similarly estimated that a significant share of the economic activities take place in the informal economy (International Labour Organization and WIEGO 2013, Charmes 2012, Hussmanns 2004, Chen et al. 2002, OECD 2002). These studies indicate the ubiquity of the concept of informality as well as its quantitative relevance. Yet, there is considerable divergence in estimation methods and data. Tanzi (1999) suggests that a precise estimation of the informal economy is necessary for designing and implementing effective economic policies, though such an approach does not question the concept of informality itself. We argue that claims of such a large informal sector should encourage researchers to question the homogeneity of the firms in the informal economy, and thus deconstruct the concepts of informality and formality.

The formal-informal conceptual *dichotomy* has been used to design and implement policies based on formalization across the globe (Sindzingre 2006). Formalization is considered desirable because it is associated with economic growth, particularly with increased employment and higher labour productivity (International Labour Organization 2015, Andrews et al. 2011, Fajnzylber et al. 2011). But formalization is also valued in terms of development ethics, as informality is associated with avoiding regulations and evading taxation and therefore socially irresponsible (Schneider et al. 2011, Nichter and Goldmark 2009, Porta and Shleifer 2008, OECD 2007, USAID 2005, De Soto 2003). Formalization is advised as well since it is linked to improved labour conditions and better social protection, which are considered to be lower in the informal economy (International Labour Organization 2015, Tijdens et al. 2015, Gatti et al. 2014).

In terms of agency, firms labelled as informal are frequently seen as suffering from agency 'deficit' and in need of assistance. Such firms are considered incapable of escaping a 'low level equilibrium trap' without external encouragement and help. Though the key to unlock the trap door is a subject of much debate over the forms and quantities of help needed and the role of firm development and entrepreneurship for economic growth (African Development Bank 2011, Schneider et al. 2011, Hansen and Schaumburg-Muller 2010, OECD 2007, USAID 2005). This contrasts with the view of formal firms where rational, well-informed, autonomous decision-making is assumed, albeit constrained by market forces and competition.

Contrary to the dichotomist view, this paper aims to overcome the formal-informal separation by introducing a new economic heuristic based on the notion of a substantial borderland economy and large numbers of trans-formal firms. We define the borderland economy as the space of interaction between formal and informal economy; the concept of trans-formal firms refers to an umbrella category representing the set of firms, which are neither formal nor informal.

We are not the first ones to question the dichotomist approach to informality. Other authors (Guha-Khasnobis et al. 2007, Sindzingre 2006, Chen 2005) have already introduced the idea of interlinked informal and formal economy as valid alternatives to the policies aiming at the systematic formalization of the informal agencies. Recent empirical evidence also emphasises that informal and formal firms are interlinked (Bohme and Thiele 2014). Explicitly, Bellanca (2008) suggested that significant amounts of economic activities operate in a border space between formal and informal, known as the borderland. Bellanca stresses that most of the policies focus on the borderline separating formal and informal economy and efforts to raise or lower the line, instead of focusing on borderland firms in the space between formal and informal economy. In other words, dichotomized formalization policies focus on crossing a well-defined line. The borderland concept identifies a new category of firms, which are not purely formal or purely informal: the trans-formal firms.

To date, few authors have focused on the heterogeneity between informal firms: Davis (2006) suggests the existence of an informal 'petty bourgeoisie' next to a wider 'informal proletariat'. Similarly Portes and Haller (2010) identified three types of informal activities: survival, dependent, and growth oriented, while Berner et al. (2012) distinguish survival from growth-oriented activities. Finally, Grimm et al. (2012), in the context of a survey on informal firms in seven capital cities of West African countries, found three types of firms: top performers, constrained gazelles, and survivalist. Like these authors we focus on the heterogeneity within the group of firms labelled as informal. We further conceptualize earlier work suggesting that the informal sector is far from being only a disadvantaged residual of segmented markets (Maloney 2004).

We introduce a new interpretative model with a tri-dimensional empirical classification assessing a) the legal status of a firm, b) whether it has an official balance sheet, and, c) a bank account. The analytical validity of the new approach and of its assumptions is tested with data stemming from a mixed-methods survey among 32 firms, 16 Egyptian and 16 Palestinian.

The remainder of the paper is organized as follows. In section 2 we start by giving a brief history of the academic debate on informal economy. This is followed by our conceptualization of the borderland economy with trans-formal firms in section 3. In section 4 we empirically assess our concept of borderland economy by classifying 32 firms from Egypt and Palestine. This is followed by section 5, which explores the economic potential of the firms in our sample. Section 6 concludes with a discussion of the institutional and policy implications of the borderland economy.

2. A brief history of the academic debate

The first stage of the debate about the informal economy was characterized by the dichotomist view: Despite a subtle variety of positions and approaches, the common tendency was to adopt a differentiation between formal and informal economic sectors and actors.

The historical concept of formal versus informal firms relies on a *dualist* approach differentiating a 'modern' formal sector from a 'traditional' informal sector. This dualist approach is rooted in the anthropological model of Boeke (1953)[1] and the economic model of Lewis (Lewis 1954)[2] and argues that the informal sector is a set of inefficient activities likely to disappear over time through a process of modernization (Hart 1973, International Labour Organisation 1972). More recently dualist authors define informal economy as characterized physically by low levels of capital accumulation, low levels of human capital, low productivity and product quality, and lack of labour protection (Porta and Shleifer 2008, USAID 2005).

Different from the dualist approach, authors representing the *structuralist* school argue that the informal sector is a structure embedded within the capitalist system (Portes and Haller 2010, Basile and Cecchi 2001, Rakowski 1994, Portes 1994, Portes and Schauffler 1993, Portes et al. 1989, Portes and Sassen-Koob 1987). The informal economy is likely to persist

[1] Dutch anthropologist Boeke developed a dual model of the economy constituted by a market economy and a lay part (Boeke 1953).

[2] Lewis (1954) conceptualized in his influential two-sector model of development one sector that has modern capitalist firms and maximizes profit and a traditional sector that is comprised of peasant households where the rules for sharing output are different from the modern sector.

over time since it produces for and exchanges with the formal sector (Portes and Haller 2010, Volpi 2003, Portes 1994, Rakowski 1994). The informal sector is defined as a set of activities characterized by the absence of a clear separation between capital and labor, the lack of formal contractual relations between employers and employees and non-binding, vague payment arrangements (Volpi 2003, Portes et al. 1989, Portes and Sassen-Koob 1987). In a more radical version of structuralism, Davis (2006) defines informal economy as a 'living museum of human exploitation' representing a pool of cheap workforce for the formal economy.

Contrasting with dualist and structuralist views, the *legalist* approach portrays informal economy from the legal perspective arguing that the evolution of the informal economy is a consequence of excessive registration costs. Countries with an inflated bureaucratic apparatus and lengthy administrative processes exhibit lower rates of formality (De Soto 2003, Friedman et al. 2000, Schneider and Enste 2000). According to the legalist view the links between formal and informal economy are sporadic and the informal firms unfairly compete with the more efficient and more productive formal firms since they do not pay taxes.

Different from the legalist models, the *voluntarist* approach suggests that many firms deliberately decide to stay informal due to the higher benefits compared to operating informally (Maloney 2004). Hence, informal economy is an unregulated economic space rather than a disadvantaged residual of the informal economy (Maloney 2004). In other words, the voluntarist approach suggests that informal economy does not only have a negative connotation. Nonetheless, it defines informal economy as unregulated space opposite to formal economy as regulated space.

Challenging the first 'family' of three dichotomised approaches to informal economy, other authors introduced the 'continuum model' (International Labour Organization and WIEGO 2013, Bellanca 2008, Guha-Khasnobis et al. 2007, Sindzingre 2006, Chen et al. 2002). In the continuum model the dichotomist logic is partially left behind and the economic system is presented as a continuum of economic activities having different degrees of formality (Bellanca 2008). The notion of the continuum relies on the new definition of informal economy adopted by ILO in 2002 (International Labour Organization 2002). The report defines informal economy as both (i) the set of employment activities within the informal sector and (ii) informal, casualised employment within the *formal* sector giving a continuum of working experiences (International Labour Organization 2002).

The new definitions, therefore, suggest the existence of a dimension of overlap between what is labelled 'formal' and 'informal' economy. The economic system is perceived as a 'continuum' space, where the economic activities are characterized by different degrees of formalization and frequencies of interactions (Chen 2005). Despite the innovative component of the continuum models, the formal-informal interactions are reduced to a matter of *employment relations*, which is understandable in the context of the ILO mandate (International Labour Organization and WIEGO 2013, International Labour Organization

2002). More importantly, the approach tends to subscribe to the dichotomist contraposition between formal and informal *firms* in other dimensions and thus keeps the dichotomy.

On the contrary, the borderland approach highlights the need to recognize the existence and economic ambit of significant numbers of heterogeneous firms instead of focusing on the borderlines that separate formal and informal.

3. Theorizing the borderland economy with trans-formal firms

In our attempt to recognize the economic ambit of many small and medium enterprises we identify a borderland economy in which trans-formal firms operate. The introduction of the concept of trans-formal firms represents a further necessary step to overcome the dichotomist logic. In this borderland space, trans-formal firms take decisions about their degree of formality and their engagement with both fully formal and fully informal economic actors. The resulting picture is an economic system characterized by the existence of three interrelated spheres, which are informal economy, formal economy, and borderland economy (Figure 1). The three spheres represent different types of firms with distinctive decision-making contexts which widens the institutional theory of the firm to include a socio-economic model with its own peculiar dynamics.

The borderland implies the existence of three spaces of decision-making between formal, informal and trans-formal firms, as well as the existence of differing firm dynamics within each of the three spaces. Concerning the impetus of the firms as agents, we subscribe to Polanyi and Pearson (1977), who argued that the dominant motivation of decision-makers in every economic system is to satisfy the material needs represented by a sustainable livelihood. Thus, the decisions taken by the economic actors in the borderland are in first place needs based (dominant in informal sector activities), but also reflect the cultural, economic and political conditions of their specific context (marginal for formal sector firms). The borderland emerges partially as a response to institutional regulatory barriers and opportunities. Consequently, the economic activities in the borderland are not only need-based and context-adapted but also reflect demands that may be frustrated by following formal regulatory requirements. The firms acting in the borderland are prolific, expand if opportunities are given and are thus far beyond survivalist activities. The economic activities and exchanges in the borderland result in the creation of an institutional environment that sustains the firms working in it. The borderland develops as a space for interactions between trans-formal firms.

This space of interaction is institutionally embedded. The concept of embeddedness highlights that firm activities and decisions are rooted in the prevalent socio-cultural system. In this regard, Portes and Haller (2010) stress that the informal economy is not only driven by market forces, but also social institutions different from official state institutions. Importantly, informal firms and are integrated in a network of relations. The institutions, in which the borderland economy is embedded, are not static. Firms' decisions depend on cultural values as well as economic assets and both may change over the time (Basile 2013). Firms moving in the borderland opt for a specific trans-formal nature based on their perception of strengths and vulnerabilities at a given time. Therefore, they are not bound to a rigid position in the borderland space and may become more formal or informal depending on contextual changes.

As operational definition for classifying firms as formal, trans-formal or informal we propose the following three formality criteria, which can easily be expanded, namely (i) registration of the enterprise, (ii) existence of a bank account in the name of the enterprise, and the (iii) presence of an official balance sheet. The different combinations of the three criteria allow us to identify three categories of firms: formal firms, informal firms, and trans-formal firms. The formal firms are those firms satisfying all the three adopted criteria; the informal firms are those who do not satisfy any of the three criteria. What characterizes the borderland economy and the trans-formal firms acting in it? Firms in the borderland choose different degrees of formality. The trans-formal firms are those firms, which satisfy only one or two of the adopted criteria; for instance a firm is registered but does not have any official balance sheet or bank account. Hence, trans-formal firms in the borderland economy are those firms, which are not purely formal or purely informal.

We decided to adopt the three indicators assuming the operative perspective of banks, microcredit institutions and international cooperation projects. Registration of an enterprise makes it visible to public authorities and allows for tax collection, a formal bank account facilitates financial transactions with social 'strangers', and balance sheets can transparently display the formal indebtedness and economic vulnerability of a firm to ownership take-over. In practice, the three indicators are often required as eligibility criteria for loans and in support programs (STEM-VCR 2014).

4. Empirical classification of firms

Our dataset consists of 32 firms, 16 Egyptian and 16 Palestinian firms interviewed between December 2013 and April 2014. Snowball sampling was applied since the aim was to identify firms that cannot necessarily be found in official registries but are well enough established to be known by the local business partners. Following Granovetter (1985), who suggests that sustained institutions depend on ongoing social relations, our sampling builds on networks of personal relations. In the sampling procedure we deliberately excluded street artisans, food vendors and taxi drivers. In line with the theoretical framework, we dropped these informal micro-entrepreneurs because the research focus is on mature firms that have employees and relate to wider markets but do not have all the characteristics of formality. While we clearly cannot claim representativeness of all trans-formal firms, the sampling allowed us to collect information about the decision-making of trans-local candidate firms and the borderland relationships they build and sustain.

To verify whether indeed our sample represents trans-formal firms we start by looking into the size distribution of the enterprises in our sample. There is considerable consensus that the statistical size distribution of firms is approximately log normal (Cabral and Mata 2003).[3] For the sample at hand, the distribution of the firms as measured by the number of employees is similar to a log normal distribution skewed to the right (Figure 2, Left Panel). There is no evidence of bi-modality that would support the formal-informal dichotomy based on the number of employees. In other words, drawing a borderline separating formal and informal firms is not supported by the size distribution. Hence, we suggest the existence of a borderland space represented by the core part of the distribution.

As Cabral and Mata (2003) further show the pattern of survivors is very similar across firms no matter the initial number of employees. Predicting survivors cannot be made on the basis of the initial size of the firm. Therefore, we also present the age distribution of the studied firms since the focus of our study is on enterprises that have survived the infancy stage and achieved 'maturity' (Figure 2, Right Panel). As shown by the age distribution, most firms have persisted over time; Egyptian firms are on average 27.5 years old and Palestinian firms 5.1 years. Only 6 firms are less than 2 years old.

The size distribution and the maturity of the firms highlight that we are not studying survivalist, purely informal activities. We next apply the three formality criteria for classifying the firms. We defined formal firms as those firms that are registered, have a bank account in the name of the enterprise and an official balance sheets that can be shared with the public authorities. Conversely, informal firms are those not fulfilling any of the formality criteria. We define trans-formal firms as those firms having traits of both formality and informality; hence, those firms satisfying only one or two criteria adopted in the definition.

According to the legalist notion of formality, informal enterprises are those firms that are not registered. Following this definition, out of 32 enterprises 23 are formal and 9 are informal (Table 1, Panel A). Thus, the majority of the firms namely 72% are formal based on the registration criterion. However, adopting the new definition based on the combination of three criteria leads to a completely different picture: 20 firms --representing most of the considered firms-- are trans-formal operating in the borderland economy; 6 enterprises are formal and 6 are informal firms. Table 1 further shows the classification by country. Notably, according to our definition of formality no single firm in Egypt is considered formal whereas in Palestine the number of formal and trans-formal firms is nearly identical.

The sample shows that it is possible for a firm to be registered but simultaneously not to have any bank account or official balance sheet (Table 1, Panel B). We argue that conceiving registered firms as formal may be paradoxical, especially if they do not have any bank account in the name of the enterprise to use for transactions and payments; in fact they might be likely to conduct informal activities despite their formal registration.

[3] The study analyses the distribution of employment data from Portuguese manufacturing firms' in 1984 and 1991 taking into consideration the rate of closures among newly established firms. The distribution of firm size in 1984 is similar to a log normal distribution skewed to the right and becoming more normal in 1991 when the firms have matured.

The two countries considered present different distributions along the three formality criteria. Therefore, we further looked into the components of our formality indicator. Table 1, Panel B contains data concerning the number of enterprises satisfying each criterion. Overall, 23 firms are registered (10 in Egypt and 13 in Palestine) while 9 are not registered (6 in Egypt and 3 in Palestine). A bank account is held by 15 enterprises (7 in Egypt and 8 in Palestine) while 17 firms do not have any bank account (respectively 9 in Egypt and 8 in Palestine). Finally, only 9 enterprises provided an official balance sheet; all 9 are Palestinian firms. Yet, the majority of the firms namely 23 do not have official balance sheets (all 16 Egyptian and 7 Palestinian firms). In Egypt, no single firm provides an official balance sheet, which may be linked to the collapse of the previous political regime and the ensuing uncertainties. In the interviews the Egyptian firm owners indicated that they were careful in providing too much information to the authorities since they were not yet sure whether the new political system was stable. Because of fear of the grabbing hand of the state the enterprises did not want to provide figures of the annual economic turnover. In Palestine, on the other hand, due to the importance of official development assistance and the presence of a large number of microcredit programs many enterprises have been encouraged to provide official balance sheets in order to be eligible for economic programs.

The absence of a bank account in the name of the firm, which is the case for more than half of the firms in our sample, makes it difficult to obtain loans from banks pushing the entrepreneurs to move through informal institutions such as credits from relatives and friends, credits on supplies, or rotating credit systems. Moreover, many firms declared that they did not have access to credit for financing the start-up of the firm’s activity; some of the entrepreneurs stated that they obtained credit from relatives and friends, while other firms prefer to buy supplies on credit. One entrepreneur in Palestine set up a rotating credit system with other young entrepreneurs to access credit, suggesting the importance of networking.

Registered firms not providing official balance sheets are also likely to move through informal paths even if they are considered formal according to the legalist notion of formality. Paradoxically, registered firms may conduct part of their activities outside the formal legal framework. Some registered enterprises in our sample have more than one balance sheet: one for the family, one for the employees, one for the joint partners and one for the creditors. Conversely, unregistered firms that maintain official balance sheets are very likely to conduct transparent management of the business. In this regard, most entrepreneurs from our sample declared that they entrust accounting tasks to an employee and some even entrust it to an external expert. Thus, it is rather the presence of an official balance sheet than formal registration that allows us to assess whether the economic and employment relations tend to be formal or informal in the sample at hand.

The three indicators together question the mono-dimensional notion of informality as synonymous with absence of registration. In order to further disentangle the formality criteria,

Table 2 summarizes data concerning the number of firms per grouping of formality criteria[4]. We observe firms in 6 of the 8 possible categories. The combination of the different formality indicators reinforces the existence of trans-formal firms as new category. The majority of the trans-formal firms are registered but do not have a bank account or an official balance sheet (25 percent). The second largest group of trans-formal firms are registered with bank accounts but without a balance sheet (19 percent). But we also find firms that only have a bank account. Registration comes out as important criterian as most of the Palestinian firms are registered. However, unregistered firms with a bank account still make up for 9 percent of the sample. According to our metric the majority of the firms is trans-formal and moves in the borderland.

For our argument to jointly consider three formality criteria to be valid it is relevant to look into the correlation of the three criteria (Table 3). While the criteria are positively correlated the correlations are moderate since they are all below 0.5. Moreover, only one of the three correlations is statistically significant. Registered firms have a likelihood of 39 percent to also have an official balance sheet. There is no correlation between registration and a bank account. The findings suggest that the three criteria provide complementary information about the lines of formality along which the firms operate.

Since our classification is based on a small sample concerns about its statistical representativeness are valid. Farazi (2014) conducted a survey among more than 2,500 firms in 13 countries of Sub-Sahara Africa and Latin America confirming the qualitative findings of our empirical analysis. He shows that both formal and informal firms might not have a bank account. In particular, only 54 percent of the registered firms have a bank account while unregistered firms also have a significant likelihood of having a bank account. Like in our sample, a substantial part of the studied enterprises did not fit the category of pure formal or pure informal.

5. Economic performance of the trans-formal firms vis-à-vis unambiguously formal and informal firms

A new classification by itself is of limited value if it is not linked to the economic performance of the firms. Thus, following the classification, we compared the economic performance along several dimensions.

Most of the literature describes informal firms as conducting small-scale activities, very often household or subsistence activities, characterized by low levels of capital and hiring of unspecialized workforce (La Porta 2012, Gulyani and Talukdar 2010, USAID 2005). Contrary to this literature, we found that most of the studied trans-formal firms in Egypt and Palestine

[4] We use the term formality criteria or formality traits different from those authors adopting the term formality degrees. We argue that the latter term implicitly suggests the idea of collocating economic activities along an evolutionist line from the pure informal to the pure formal. Contrary to this approach, we adopted the term formality criteria referring to the criteria that shape the economic activities defining them as formal, informal or trans-formal.

do not match the stereotypical characteristics applied to informal firms. Figure 3 shows four different business characteristics and activities by enterprise type.

All three types of enterprises, formal, trans-formal and informal firms, mainly serve the local market as the top left panel of Figure 3 shows. The exclusive reliance on the local market is largest for formal firms. Interestingly, all three types of firms are engaged in export activities. Both informal and formal firms declare direct export activities and trans-formal firms also report indirect export activities as subcontractors for exporting firms. Contrary to formal firms informal firms also indicate the national market as important. The view that trans-formal firms are less exposed to competitive market forces is thus questionable based on our sample of firms. In fact the trans-formal firms in the borderland have the most diversified business ambit suggesting that they are dynamic actors in the market.

The top right panel of Figure 3 shows that customer needs dominate the choice of new products across all types of firms, but mostly so for informal firms. Surprisingly, it is the formal firms that indicate that almost 40 percent of their product decisions are based on the availability of raw materials. The creativity of the owner mainly affects product decisions for formal and trans-formal firms but was not mentioned by informal firms. It is only trans-formal firms that also indicate that they get some of their ideas from the internet. Again, trans-formal firms do not appear to be any less creative than formal firms.

The bottom left panel of Figure 3 displays whether the firms have invested in new machinery and equipment over the last two years. There, some differences between informal and trans-formal versus formal firms emerge. The latter are considerably more likely to have invested in new machinery and equipment. Trans-formal firms are least likely to have recently invested in equipment and machinery and launched new products, suggesting a relatively conservative investment strategy. Trans-formality may involve being relatively risk averse related to being culturally both more secure and more conservative. Yet, these self-evaluations by the owner might be biased. Therefore, we also inquired about the annual turnover to assess the economic viability of the enterprises; a question, which was not readily answered by the firms since they are worried to be reported to the tax authorities. Only 22 firms reported annual turnover. Interestingly the average turnover for formal firms is € 8,966, and it is lower than the average for both informal and trans-formal firms, which declared € 16,500 and € 15,583, respectively. Variability is also highest among the informal and trans-formal firms. Since a priori we do not see any reason why informal and trans-formal firms should overstate their annual turnover, in fact we were rather expecting them to underreport, these figures give further support for acknowledging trans-formal firms as important economic players and for including them in the official economic system.

Thus, the open question is why trans-formal firms are not well integrated in the formal, national institutional and financial systems. To capture the inclusion of the firms along the institutional and political dimension we chose another four criteria: (i) the involvement in associations or trade unions; (ii) the participation in development and international cooperation projects; (iii) involvement in activities proposed by the (local) government supporting the enterprise, such as trainings and formation; and (iv) access to microcredit. They are presented in Figure 4. Even from a glance at the figure it can be seen that most of the trans-formal firms do not have institutional visibility. Despite their maturity in terms of age and the integration into the local market, politically and financially they have a low profile. The top left panel of Figure 4 shows that most of the trans-formal firms do not join associations or trade unions whereas almost all formal firms are represented in associations and unions. The informal firms are completely left out from these groups. Similarly, it is mainly the formal firms that are involved in development projects and international cooperation (Figure 4, top right panel). The trans-formal firms by and large do not benefit from international cooperation projects neither do the informal firms. Business development activities promoted by the government and other local authorities also reach mainly out to formal firms although some 25 percent of the trans-formal firms in our dataset report having benefitted from such activities (Figure 4, bottom left panel). Again, informal firms are completely left out. Complementing qualitative evidence suggests that trans-formal firms remain in the borderland since they are socially embedded and peer group social relationships are used as alternatives to formal institutions in order for trans-formal firms to survive and conduct their business.

The picture is reversed when considering access to micro credit (Figure 4, bottom right panel). It is the informal firms that are targeted by the microfinance institutions and 50 percent of the informal firms in our sample make use of this form of credit, compared to 40 percent of the trans-formal firms. The lower level of access to microcredit by trans-formal firms can be explained by the fact that microcredit systems are not attractive for these firms or they may even be excluded from such schemes. At the same time, trans-formal firms are not able to satisfy the eligibility criteria of many banks and often do not have sufficient collateral. Formal firms hardly rely on microcredit.

In short, the sample of firms from Egypt and Palestine supports the usefulness of a concept of trans-formal firms in a borderland. The lack of inclusion in development activities with the low access to credit explains the persistence of trans-formal firms in the borderland over time and the relatively low levels of new investments and product innovation. The borderland can be seen as comfort zone, where individual relations and informal institutions guarantee business continuance while providing the needed flexibility to adjust to moderately changing production conditions and market needs.

6. Conclusion: Institutional and policy implications of the borderland economy

The dominant formal-informal dichotomy has affected both the academic debate and policymaking. On the one hand, the wide literature on informal economy often accepts the contraposition between formal and informal firms describing "informal economy" and "informal firms" as lacking human capital, having low profitability rates, and competing unfairly with the more productive large, formal firms. (El Mahdi 2002, El-Fattah 2012, El-Said et al. 2014, Harati 2013).

Policymakers accepted this situation resulting in the implementation of policies based on the formal/informal dichotomy. But this dichotomy does not recognise the heterogeneity of characteristics within the so-called informal economy (Sindzingre 2006). Many policies aim at systematically formalizing the informal economy through the reform of the fiscal environment. However, very often the impact of the interventions paradoxically results in firms becoming more wary of formality (Chen 2005). Policies that focus on raising or lowering the borderline between formal and informal economy, and on the formalization through institutional reform and revision of the fiscal framework might be ineffective when they consider firms as passive actors that can simply be moved from one category into another by fiat.

In Egypt and Palestine, for policy purposes, the economy was dichotomized between large established firms on the one hand and small and micro enterprises on the other hand. Egyptian policies over the last twenty years focused mainly on supporting big firms excluding de facto other firms from the development and growth strategies and leading to a system of crony capitalism that favoured large and established enterprises (Ghanem 2013). In Palestine, policies similarly favoured big established firms giving little attention to small and medium enterprises (STEM-VCR 2014). Moreover, the Israeli[5] occupation further limits the survival and growth of smaller enterprises. More recently, the formalization of informal firms has been identified as desirable to unlock the growth potential of small and medium enterprises in the region (MAS 2013). Many authors describe Palestinian smaller firms as lacking technical skills and long-term entrepreneurship capacities (Malki et al. 2004, MAS 2013). However, they recognize the crucial role of informal food production and informal investment in smoothing the effect of the adverse political situation. In both economies, viewing firms through the lens of the formal/informal dichotomy has been unhelpful in understanding the specific characteristics of trans-formal firms in the borderland.

The overwhelming presence and perseverance of trans-formal firms in countries like Egypt and Palestine suggests that they are already tied into the existing institutional environment and need to be considered when economic policies are designed. Successful economic policies need to recognize trans-formal firms as decision-makers, right-holders, and stakeholders. To date trans-formal firms in the borderland survive by constructing institutional relationships that counteract (market) forces, which could threaten their survival. Trans-formal firms survive by building durable, institutional relationships with customers, suppliers, firms in the same line of business, creditors, and individual state officials. Two Palestinian enterprises in our the sample, which were classified as trans-formal, declared that it is impossible for their firms to access loans through formal paths but they have obtained a

[5] The Palestinian Ministry of National Economy and the Applied Research Institute of Jerusalem (2011) estimate that the costs of the Israeli occupation for the Palestinian economy was US$ 6.897 billion in 2010.

loan from the Chamber of Commerce because of personal relations. Such shadow networks that are intertwined with official structures give room for considerable inefficiencies.

Understanding the institutional environment and existing shadow networks is crucial to understanding why firms remain and survive in the borderland. Creating deliberative processes that allow for transparent engagement with trans-formal firms in the borderland is a challenge as many of the assumptions about informality profoundly misrecognize the realities of trans-formal firms in the borderland. There is an inherent need for differentiated policies able to address the different priorities of informal and trans-formal agencies (Grimm et al. 2012, Grimm et al. 2011). Implementing growth policies based on survival activities for micro-enterprises is prone to be ineffective or even counterproductive (Berner et al. 2012). Conversely, implementing poverty alleviation policies, as well as micro-credit lines addressed to trans-formal firms may be unattractive or lead to ineffective outcomes. Policies and interventions need to address the specific potential characterizing the borderland and its actors. In this regard, policies and practices recognising the borderland and trans-formal firms are a first important policy step. An inclusive development process holds the promise of being more effective in generating both local infrastructure development and community cohesion as the owners of trans-formal firms can make use of their contextual knowledge and provide both economic and political local leadership and create a forum for local initiatives for the development of sustainable firms (Lindell 2010, Guha-Khasnobis et al. 2007, Chen 2005).

Recognizing the capacity of trans-formal firms and giving them political visibility may have the potential to spur economic growth considerably and represents a valid alternative against formalization efforts. There is an inherent need to recognize the borderland so that the study of processes and dynamics in the borderland can be promoted free from dichotomist perspectives. The strengths and weaknesses of the agents navigating in the borderland together with the structures and institutions regulating their interactions need to explored further to find new, (unorthodox) ways of inclusion and ultimately inclusive growth.

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Tables and Figures

Table 1: Firm classification per legalist notion and per new definition of formality

Panel A	*Legalist* notion of formality			*New* definition of formality		
	Egypt	Palestine	Total	Egypt	Palestine	Total
Informal	6	3	9	3	3	6
Formal	10	13	23	0	6	6
Trans-formal	-	-	-	13	7	20

Panel B	Enterprises per formality criterion		
	Egypt	Palestine	Total
Registration	10	13	23
Bank Account	7	8	15
Official Balance Sheet	0	9	9

Source: Authors' elaboration.

Table 2: Enterprises per groups of 'formality criteria'

	Group	Criteria	Egypt # of firms	Egypt %	Palestine # of firms	Palestine %	Total # of firms	Total %
1	Formal	Registered, bank account, official balance sheet;	0	0.00	6	37.50	6	18.75
2	Informal	Unregistered, no bank account, no official balance sheet;	3	18.75	3	18.75	6	18.75
3	Trans-formal	Registered, bank account, no official balance sheet;	4	25.00	2	12.50	6	18.75
4	Trans-formal	Registered, no bank account, no official balance sheet;	6	37.50	2	12.50	8	25.00
5	Trans-formal	Registered, no bank account, official balance sheet;	0	0.00	3	18.75	3	9.38
6	Trans-formal	Unregistered, bank account, no official balance sheet.	3	18.75	0	0.00	3	9.38
7	Trans-formal	Unregistered, no bank account, official balance sheet;	0	0.00	0	0.00	0	0.00
8	Trans-formal	Unregistered, bank account official balance sheet;	0	0.00	0	0.00	0	0.00

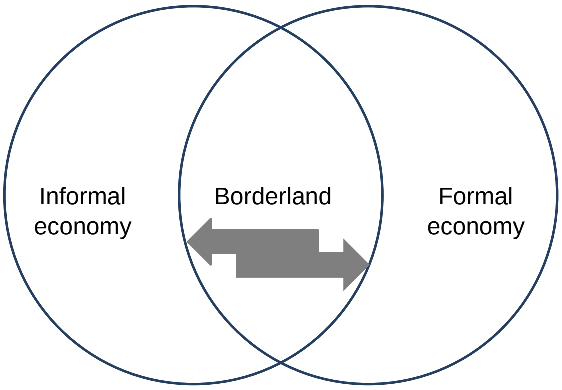
Source: Authors' elaboration.

Table 3: Cross-correlation between registration, bank account, and official balance sheet

	Registration	Bank account	Official balance sheet
Registration	1		
Bank account	0.19	1	
	(0.35)		
Official balance sheet	0.39	0.22	1
	(0.03)	(0.17)	

Source: Authors' elaboration. *p*-values in parentheses.

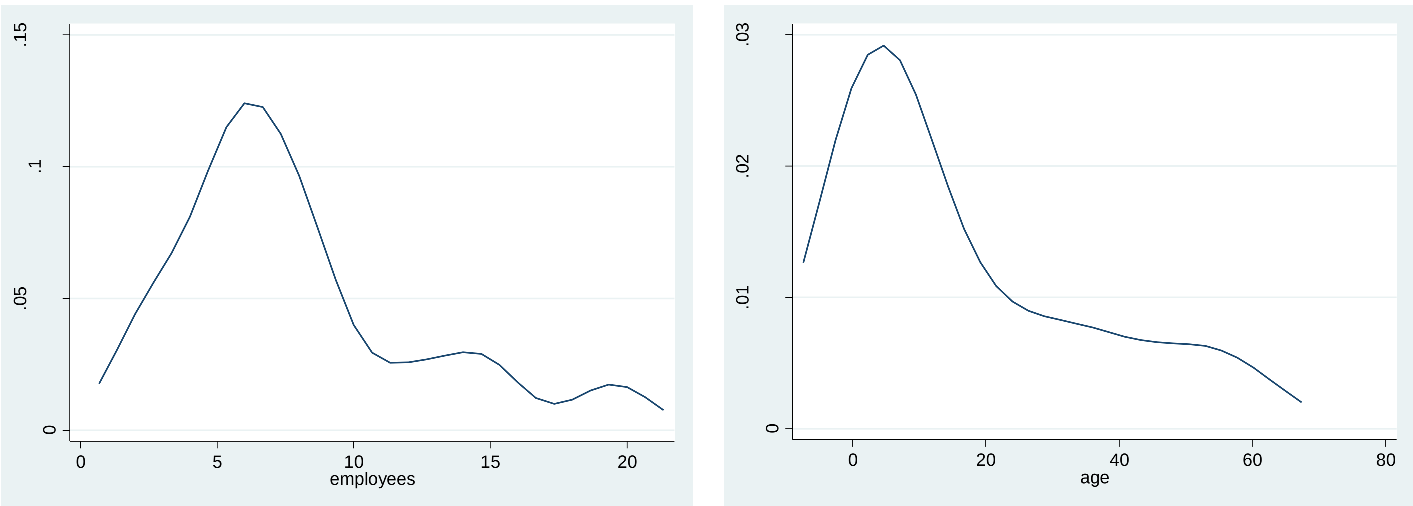
Figure 1: Stylised borderland economy in a continuum model



Note: Trans-formal firms operate in the borderland moving in the set of possibilities between the two boundaries of overlap between unambiguously informal and unambiguously formal

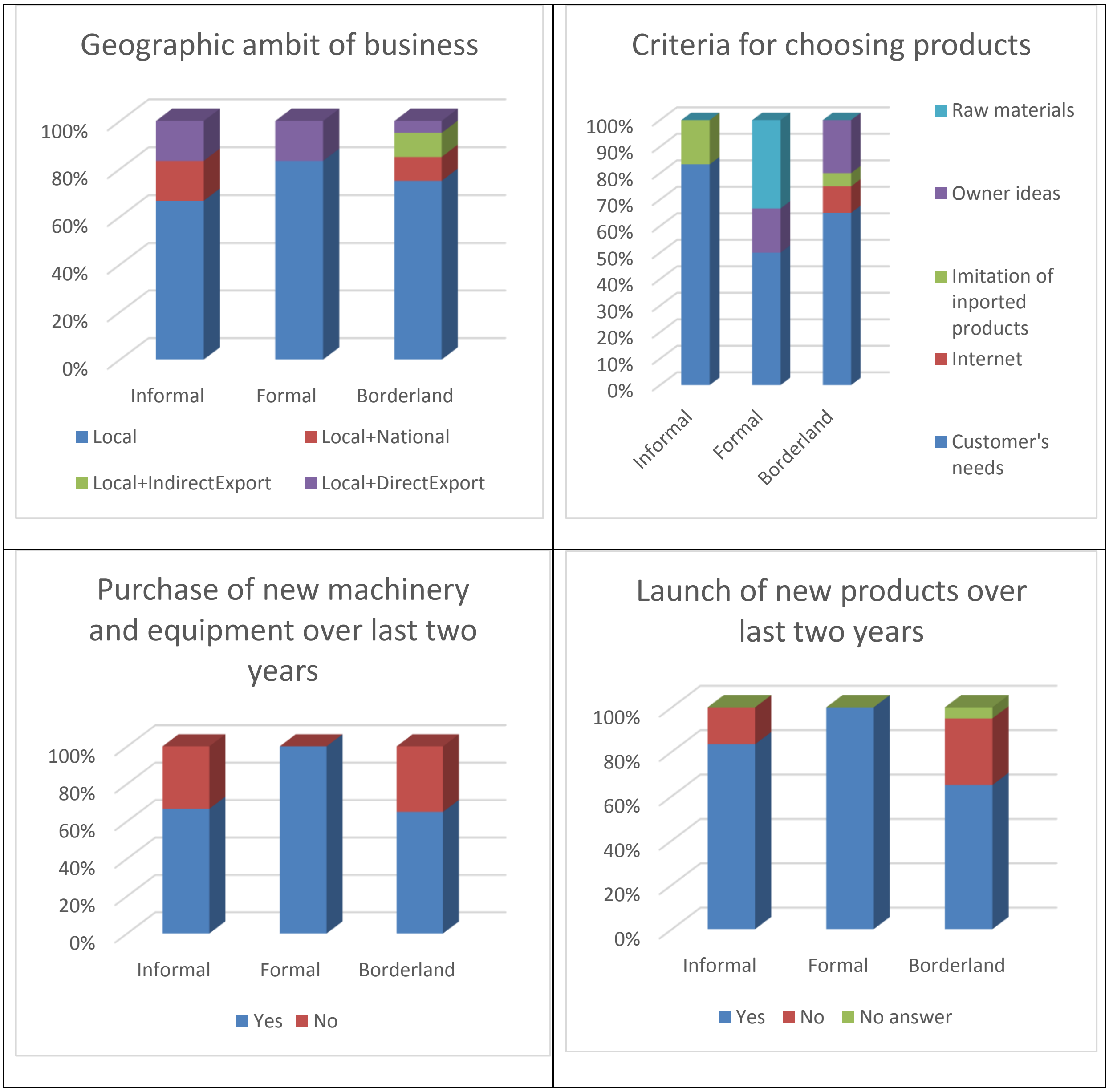
Source: Authors' construct.

Figure 2: Size and age distribution of the sampled firms



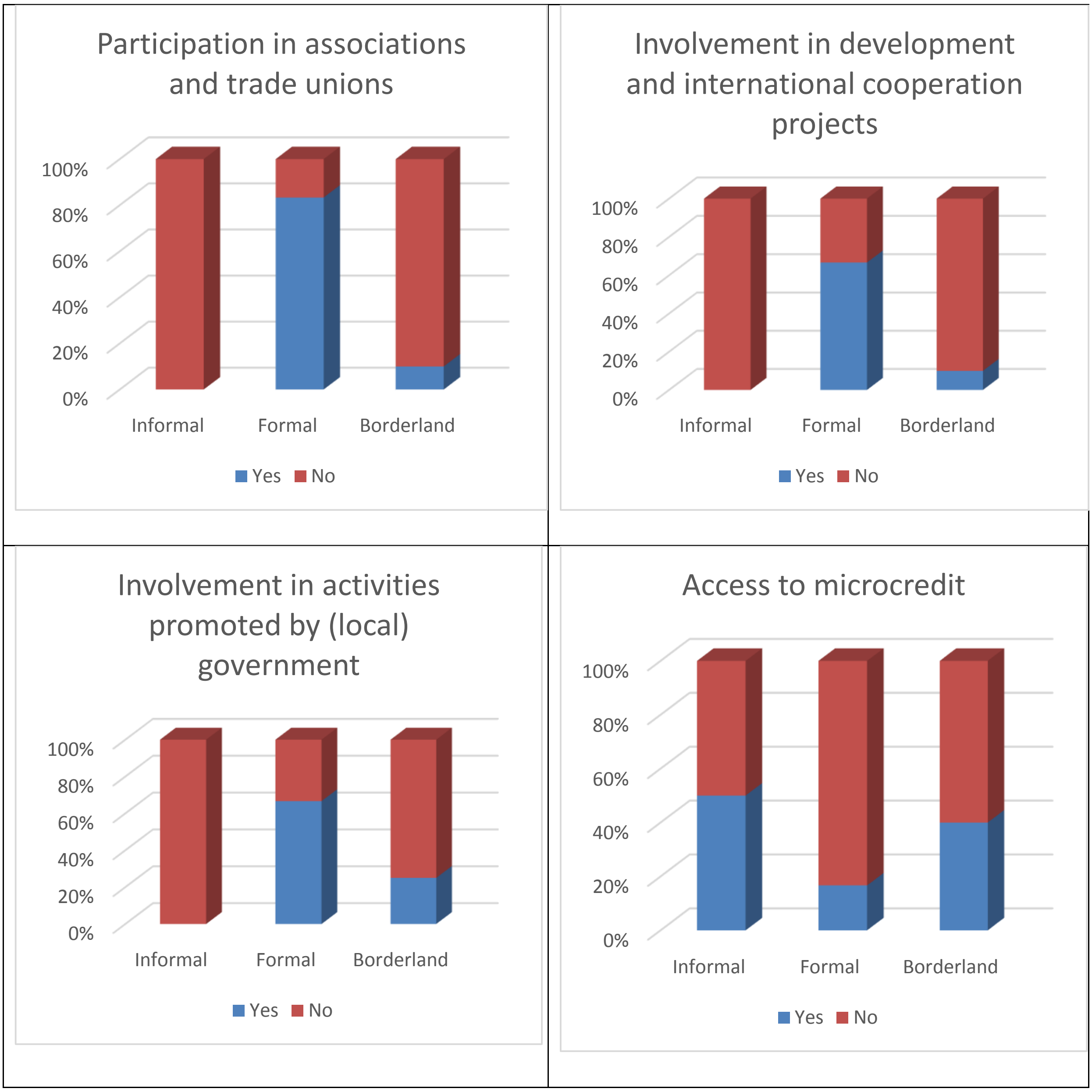
Source: Authors' elaboration.

Figure 3: Business characteristics and activities by enterprise type



Source: Authors' elaboration.

Figure 4: Participation and access to financial services by enterprise type



Source: Authors' elaboration.