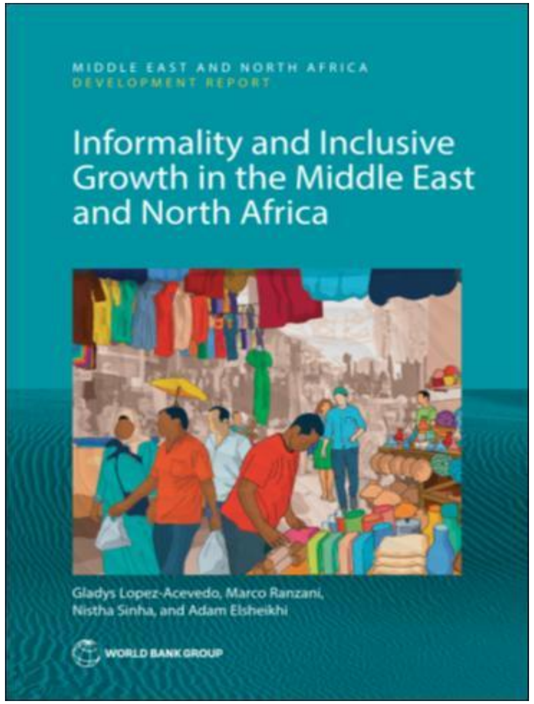
Informality and Inclusive Growth in MENA



WORLD BANK GROUP
Poverty & Equity

In MENA, a piecemeal approach to addressing development challenges…

- **Social security systems** introduced to provide on-the-job and life-long benefits to **civil servants**.
- A marginally incremental approach led to addition of *ad-hoc* contributory regimes for employees of SOEs and formal private sector firms and recently some self-employed.
- Non-contributory social insurance operates as a cash transfer accompanied in some countries by health insurance.
- **Special tax regimes** created to bring own-account workers and micro/small firms into the tax system.
- **Market reforms** undertaken but not as effective in re-balancing role of SOEs, thereby constraining the growth of a vibrant private sector.
- **Recent shocks** have once more highlighted the limits of this approach as well as its negative effects

..has led to a suboptimal equilibrium

Limited coverage of population against contingencies

Reduced risk pooling and little redistribution

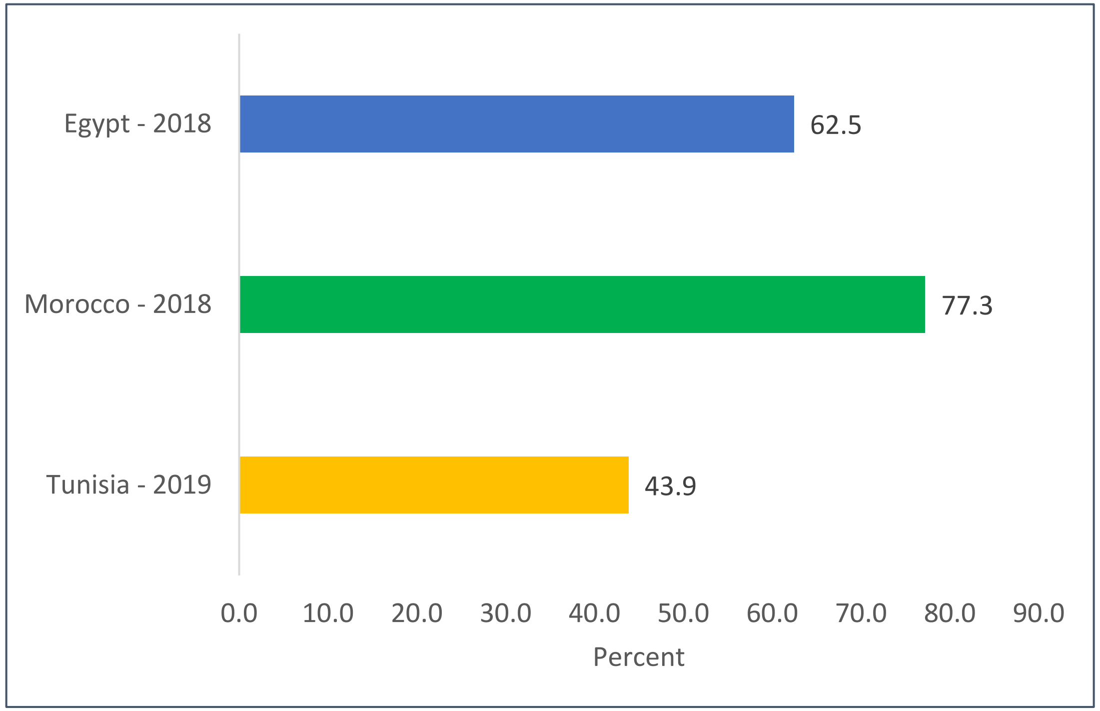
Subpar tax revenues collection

Limited resources to deliver high quality public goods and services

Low productivity and subpar economic growth

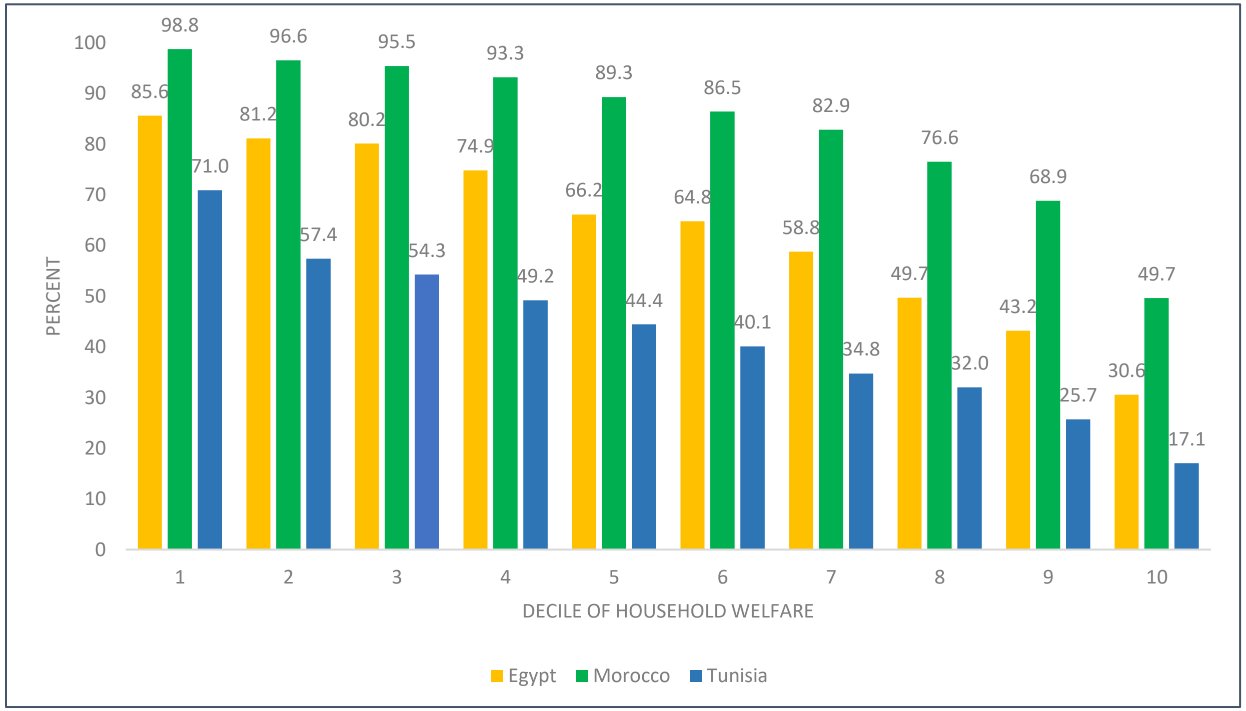
And this suboptimal equilibrium shows up as informal employment - a large share of MENA's workers are without risk protection, regardless of whether poor or not

Informal employment rates by country, circa 2018



Source: Authors' own elaboration based on data from labor force surveys.

Informal employment rates by decile of household welfare



Note: In the case of Morocco and Tunisia, household welfare is captured by household per capita expenditures, whereas in the case of Egypt wealth deciles are based on a factor analysis approach using household ownership and durable assets and housing conditions.

Source: Based on data from the Tunisia Household Budget Survey (HBS) 2015, INS; Morocco Household Budget Survey (HBS), 2013, HCP; Egypt Labour Market Panel Survey (ELMPS), 2018.

Piecemeal reforms are unsuccessful in providing social security coverage to workers because many factors drive firm and worker behavior – there is no one single factor (so no “magic bullet”)

Like any social and economic outcome, informality is shaped by the **laws and institutions** of a country that set the rules of the game faced by economic agents when making decisions to

- start a business,
- produce,
- invest,
- take risks (innovate, lend, borrow); or
- decide whether to work for themselves or for somebody else.

The “magic” is in coordination across three realms

That is, coordinating laws, regulations, institutions, and policies in the following areas:

1) Entrepreneur-worker relations

1. Contributory social insurance programs
2. Non-contributory social insurance programs
3. Hiring and firing regulations
4. Minimum wage and collective agreements
5. Enforcement institutions

2) Tax and transfer system

1. Laws on personal income tax
2. Laws on corporate income tax
3. Laws on consumption tax
4. Transfers to households
5. Institutions in charge of enforcing taxes and delivering transfers

3) Market conditions

1. Functioning of institutions enforcing credit and commercial contracts
2. Firm registration procedures and costs
3. Laws regulating domestic competition and SOEs

Firms’ and workers’ decisions are <u>determined jointly by laws, regulations, institutions, and policies across the three </u>areas and this in turn drives the size of informal employment in the economy, the distribution of income (poverty and inequality), the level of productivity, and the pace of economic growth.

From piecemeal to coordinated - Policy principles for reforms to tackle informality

1. Coordinate reforms

Policy makers should bear in mind that incentives offered to firms and workers to operate informally when introducing a new or changing an existing policy

→ **Establishing cross-ministerial implementation groups to ensure a holistic and coordinated approach to policy changes.**

2. Cover population exposed to the same risk by the same program

Providing coverage to all individuals exposed to the same risk (old age, health) with the same program can lead to **more risk pooling**, more efficacy and diversification of risk, and same quality of service provided.

3. Vary source of financing with the type of risk covered

Risks of different nature are best covered through different sources of financing.

- Risks common to all the population should be funded from general taxes;
- Risks common to all workers should be funded from workers' earnings;
- Risks specific to workers in firms should be funded from firms' contributions based on workers wages.

From piecemeal to coordinated - Policy principles for reforms to tackle informality

4. Social protection for the poor via non-contributory program should be targeted based on family's income (not workers' formality status)

This is to **reduce the risk of informality and poverty traps** and to support the vulnerable in labor market adjustment periods, considering proposed changes to health and retirement schemes.

5. The tax structure should strengthen incentives for formal employment, and together with social protection be progressive

A large number of **tax regimes** offered to different types of firms by size reduces the tax revenue and may also allow low productivity firms to survive. **Tax schedules** should have sufficient progressivity to fund redistribution without discouraging productivity growth and raising enough funds to finance high quality public services.

6. Ensure market conditions are conducive to firm entry, growth and exit

Simplify registration processes. Enforcement of commercial and credit contracts should increase by strengthening the quality of the judicial process. Policies should address product market competition, price controls and presence and role of SOEs.

Realm I
Entrepreneur-worker relations

Main Findings

- The current design of the social protection systems in the MENA region offers **limited coverage and redistribution**, particularly in relation to health and old age.

- Combined with factors such as minimum wage laws, complex dismissal procedures, and weak enforcement of labor regulations, this **encourages informality and hinders productivity growth**.

Contributory social insurance provides little value for money…

The system provides **strong incentives** to be formal among **high-earners** and few incentives among low-earners

Contributory pension systems do not provide adequate protection against the longevity risk to private sector workers with short formal careers, who are more likely to be low-earners

Contributory health insurance does not deliver good coverage to workers in the private sector, as a result households face considerable out of pocket expenditures, disproportionately affecting low earners

The case of pension systems

	Morocco	Tunisia	Egypt
Contribution rate	13.46%	12.5% (RSNA)	25%
Cap on gross monthly wage	YES (DM 6,000)	NO	YES (EGP 3,448 and MIN=EGP 750)
Min age	60	60	60
Min years of contributions (#YC)	10.4 (~50% ref wage) 24.2 (~70% of ref wage)	10 years (~2/3 of min wage)	10 years (~80% ref wage)
Reference salary	Average salary last 8 years	Average salary received last 10 years, capped at 6 times MW	Average base salary last 2 years
Entitlement if #YC<Min	Lump-sum = worker's contributions	Lump-sum = worker's contributions	Lump-sum = worker's contributions + a portion of employer contributions

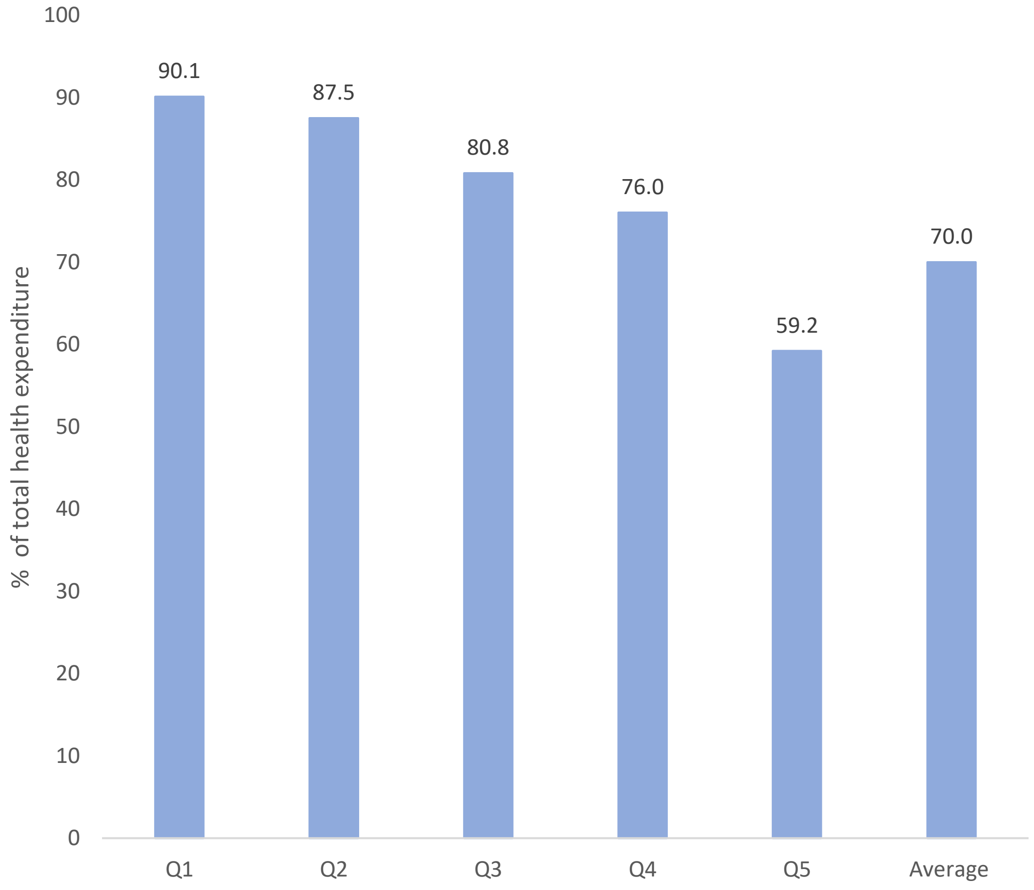
- The presence of **vesting periods** introduces a tax on workers with short formal careers, given their low contribution densities, and a redistribution from low- to high-wage workers

- Pension systems are **more than actuarially fair** for workers who are eligible, further reinforcing redistribution from low- to high-wage workers

The case of health insurance

- **Contributions** paid for health insurance are in general **too low** to provide good coverage (around 5-7%).
- CHI provides free access to **public health care**, which presents a cost in terms of **long waiting lines** and does **not** provide **all** types of **treatments**.
- CHI refunds the **negotiated tariff** in case workers opt for **private** providers, which is though **below** the **market price**.
- This leads to **high out of pocket expenditure**, particularly at the bottom of the welfare distribution.
- Low-wage formal workers are unlikely to be able to afford private clinics and hospitals and might be limited in their choice of public health facilities, where the quality of services is low and waiting times long.
- **Risk pooling is limited** and there is some **redistribution** from high- to low-wage workers

Incidence of Out-of-Pocket health expenditures by quintile of per capita household expenditures in Morocco, 2013/14



Source: Based on data from the Household Consumption and Expenditures Survey 2013, HCP in Oudmane et al., (2019) "The impact of out-of-pocket health expenditure on household impoverishment: Evidence from Morocco".

Noncontributory social insurance provides little coverage against contingencies

- However, **little resources** are devoted to social assistance:
    - In **Tunisia** (2019), **7.1%** of GDP goes to contributory social insurance compared with **0.76%** of GDP allocated to non-contributory schemes.
    - In **Morocco** (2019), over **7%** of GDP is spent on contributory schemes (pensions and AMO) relative to **0.15%** of GDP on RAMED.
- Non-contributory social insurance provides **partial coverage** (i.e., health insurance).
- Non-contributory social insurance might act as a **subsidy to informal employment.**

Distribution of Workers According to Poverty and Formality Status, Tunisia, 2015

Category	Public sector workers	Formal private workers	Informal private workers	Total
Nonpoor, nonvulnerable				
Number	717,247	1,157,014	887,663	2,761,924
Percent	93.1	91.5	70.6	83.9
Nonpoor, vulnerable				
Number	8,492	8,254	152,936	169,682
Percent	1.1	0.7	12.1	5.2
Poor				
Number	44,452	98,157	216,861	359,471
Percent	5.8	7.7	17.2	10.9
Total				
Number	770,192	1,263,425	1,257,460	3,291,077
Percent	100.0	100.0	100.0	100.0

Source: Based on data from the 2015 Household Budget Survey, National Institute of Statistics.
Note: The statistics refer to the employed population age 18 and older. Poverty is defined at the household level based on per capita expenditures and the official poverty lines. Households are classified as vulnerable if they report they have access to subsidized health care (they have a free medical assistance 2 card).

Realm II
Tax System

Main Findings

- **Special tax regimes** for some firms, loopholes, and exemptions **favor some businesses** at the expense of others in MENA, impeding firm expansion, productivity growth, and formal job creation, especially when tax enforcement is weak.

Personal Income Tax

- PIT is levied on personal income of individuals and on profits of individual enterprises (IE) and self-employed professionals (Egypt and Morocco).
- **PIT rates rise steeply at the bottom of the tax schedule**: from 0 to 26% for example in the case of Morocco.

Annual income bracket (TD)	Marginal tax rate (%)
0 to 5,000	0.0
5,001–20,000	26.0
20,001–30,000	28.0
30,001–50,000	32.0
50,001 and above	35.0

- IEs and self-employed professionals can pay PIT under more favorable tax regimes relative to regular PIT rates, depending on firm's characteristics and performance (such as industrial sector, amount of sales).

The case of special regimes

- Special regimes offer **significant tax savings** to firms or self-employed so long as specific requirements are met (e.g., unincorporated business, below sales threshold, single shareholder)

- They are implemented with **good intentions** and are designed to:
    1. Support micro and small firms and own-account workers
    2. Encourage compliance and broaden tax base
    3. Increase tax revenues

- However, they lead to **subpar TFP, growth, and formal job creation** for a number of reasons:
    1. They do not generate incentives for firms to expand in size
    2. They help *small firms with low productivity survive*, distorting the natural process of firms' selection
    3. Coupled with VAT exemption, they limit the extent to which firms can interact with other firms (typically larger) under the CIT regime, thus *also reducing technical and technological transfer*
    4. *They limit capital diversification* (typically a single shareholder) and thus the possibility to have more access to credit or at better conditions

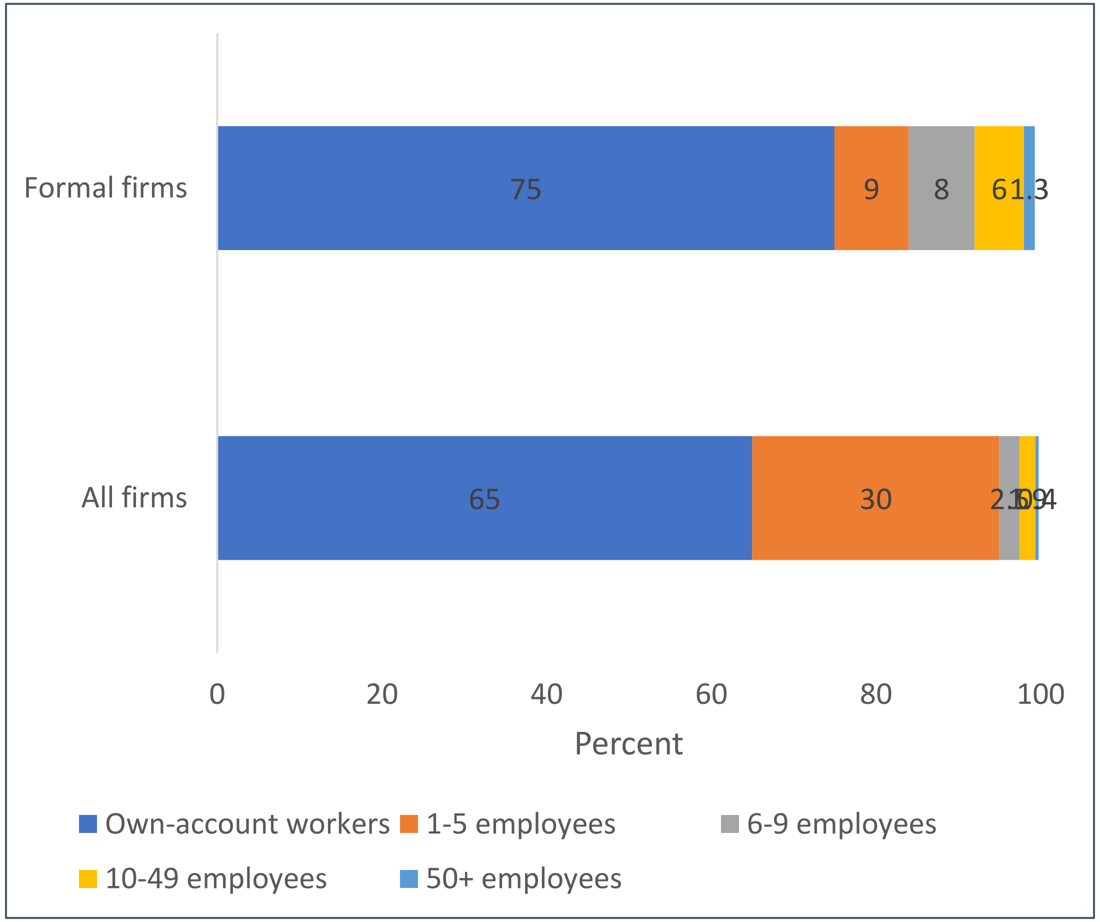
An overview of PIT, CIT, and special tax regimes

Tax regime		EGYPT 2018		MOROCCO 2018		TUNISIA 2019	
		Bracket (EGP)	Rate	Bracket (DAM)	Rate	Bracket (TND)	Rate
PIT	**Tax rates**	0-6,500 6,501-30,000 30,001-45,000 45,001-200,000 200,001 and above	0% 10% 15% 20% 22.5%	0-2,500 2,501-4,167 4,168-5,000 5,001-6,667 6,668-15,000 15,001 and above	0% 10% 20% 30% 34% 38%	0-5,000 5,001-20,000 12,001-30,000 30,001-50,000 50,001 and above	0% 26% 28% 32% 35%
PIT for firms	**Under what conditions?**	PIT schedule available to firms operating under sole proprietorship or simple partnerships 0-5,000 5,001-20,000 20,001-40,000 > 40,000	0% 10% 15% 20%			PIT schedule available to individual unincorporated enterprises with annual sales above 100,000	0% 26% 28% 32% 35%
Special tax regime for firms	**Under what conditions?**			Available to self-employed either: 1) Earning professional income within three profession groups: (i) commercial, industrial and craft professions; (ii) real estate professions; and (iii) liberal professions 2) Under auto-entrepreneur status if revenue below 500,000 for commercial, industrial, and artisanal activities, and 200,000 for services.	1) Tax rate determined by which regime economic unit falls under - i) real net income regime, ii) simplified net income regime, iii) fixed benefit regime, and profession category; 2) i) 1% for commercial, industrial and craft professions, ii) 2% for services	Available to individual unincorporated enterprises with annual sales 1) <10,000, 2) 10,000-100,000	1) 200 (100) per year in (rural) communal areas 2) 3% of annual sales
	VAT exemption			1) No 2) Yes		Yes	
CIT	**Tax rates**	General CIT	22.5%	0-300,000 300,001-1,000,000 1,000,001 and above	10% 20% 31%	1) Standard rate 2) Financial, insurance, oil production and telecoms activities	1) 25% 2) 35%
VAT	**Tax rates**	General VAT	14%	General rate	20%	General rate	18%
	Method	Credit invoice		Credit invoice		Credit invoice	

Special tax regimes allow many micro and small firms to survive, but contribute little to tax revenues

- Firms' distribution is heavily skewed towards micro and small firms, which often operate at very low productivity.
  - In Tunisia, about 74% of firms employ up to 5 employees, and the vast majority are own-account workers
- Many individual enterprises (IE) operate under special regimes, contributing little to tax revenues
  - In Tunisia, out of 550k IEs, 73% (400,000) were under the special regime
  - IEs under the special regime represent 11.8% of tax revenues from IEs compared to 88.2% for those under standard regime
  - on average, paying TND 100 (TBD 2,365 per IE) per enterprise per year

Distribution of firms by size in Tunisia, 2019



Source: Based on data from the National Business Register, Survey of Economic Activity of Micro Enterprises, and Labor Force Survey.

Examples of policy changes

Improve value for money of contributory social insurance

Improve value for money of contributory social insurance to incentivize participation of workers, in particular of:

→ Health insurance

→ Retirement pension

Start a gradual unbundling of risk and insurance

→ Health insurance could be financed via general tax revenues

→ Retirement pensions could be financed with an additional charge proportional to wage/income bundled together with PIT and set aside in a dedicated fund

And unbundle risk and insurance

Risk of different nature are best covered through different sources of financing

1. Risk **common to all citizens** should be **funded from general taxes** (health and old-age poverty)
   → Universal health insurance
   → Universal flat pension benefit to avoid old-age poverty

2. Risks **common to all workers** should be **funded from workers' earnings** (smoothing consumption between work and retirement, contributory pension)
   → Contributory system: all workers contribute (employees and self-employed) and participate in the same system, the obligation to pay is shifted from firms to workers, possibly combined with the payment of PIT

3. Risks **specific to workers in firms** (employees) should be **funded from firms' contributions** based on workers' wages (job loss risk and accidents at work, unemployment insurance)

Noncontributory social insurance

The **proposed changes** to social insurance would provide **protection against fundamental risks to all**, including the poor and vulnerable.	**All the poor** should receive **income transfers**
	Eligibility should be **conditional on household income** not on workers employment formality status
	The amount of the **transfer** should **balance** the need to support current **consumption** and the need to minimize an **implicit tax on formality among poor workers** who would lose the transfer if they moved above the threshold

What about the tax system?

The design of tax systems need to be more conducive to formality, productivity, and firm growth

1. **Make PIT more progressive**
2. **Removal** of **special tax regimes**
3. **Removal** of **VAT exemptions** for firms filing taxes under special tax regimes

- There is **space to increase tax revenues**, also considering the net increase in tax burden would be lower since part of the additional tax revenues would replace wage-based contributions for health programs
  - The tax-to-GDP ratio in pilot countries is below OECD countries and most revenues come from indirect taxation

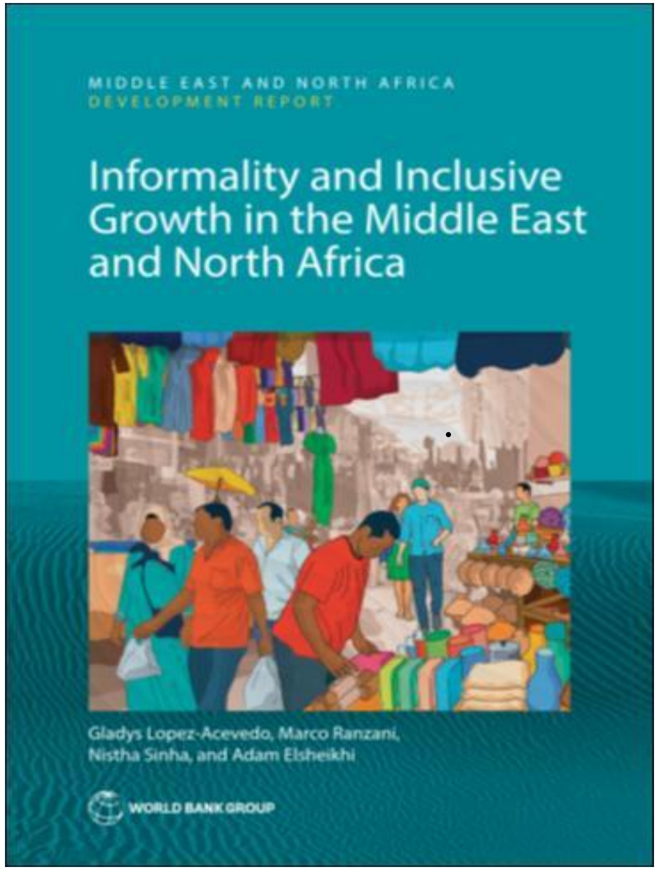
- **Improve tax enforcement** is required as many micro firms and informal workers (with wages similar to formal workers) evade taxes. This will require:
  - Providing more resources to tax authorities
  - Better data integration and use of digital technology
  - More collaboration across entities

An Illustrative Roadmap

Each country will need a way-forward tailored to specific context and political economy

- Step 1: **Extend health coverage to the whole population**
- Step 2: **Pension systems**
  - Workers are solely responsible to pay contributions in combination with their PIT obligations (firms are not responsible for this)
  - Remove vesting periods and make system actuarially fair
  - Provide a low flat non-contributory pension benefit to all citizens above a given age to reduce old-age poverty
- Step 3: **Expand the tax base and increase tax revenues to fund universal health insurance and improve quality of public services**
  - Introduce new taxes and/or raise taxes on certain activities (property, environmental unfriendly industries, etc.)
  - Gradually remove universal consumption subsidies
  - Gradually remove special tax regimes and associated VAT exemptions
  - Improve quality of public services delivered, particularly health care
- Step 4: **Make job stability regulations more flexible and minimum wages less binding as a revamped unemployment insurance will support workers transitioning to a new job (and they will always be protected against health risk)**
- Step 5: **Introduce market conditions reform that can foster dynamism of private sector**
  - Simplify and reduce cost of firm's registration
  - Strengthen enforcement of commercial/credit contracts
  - Increase product market competition: gradually remove restrictive entry regulations and price controls, lower barriers to FDI and high import tariffs
  - SOE

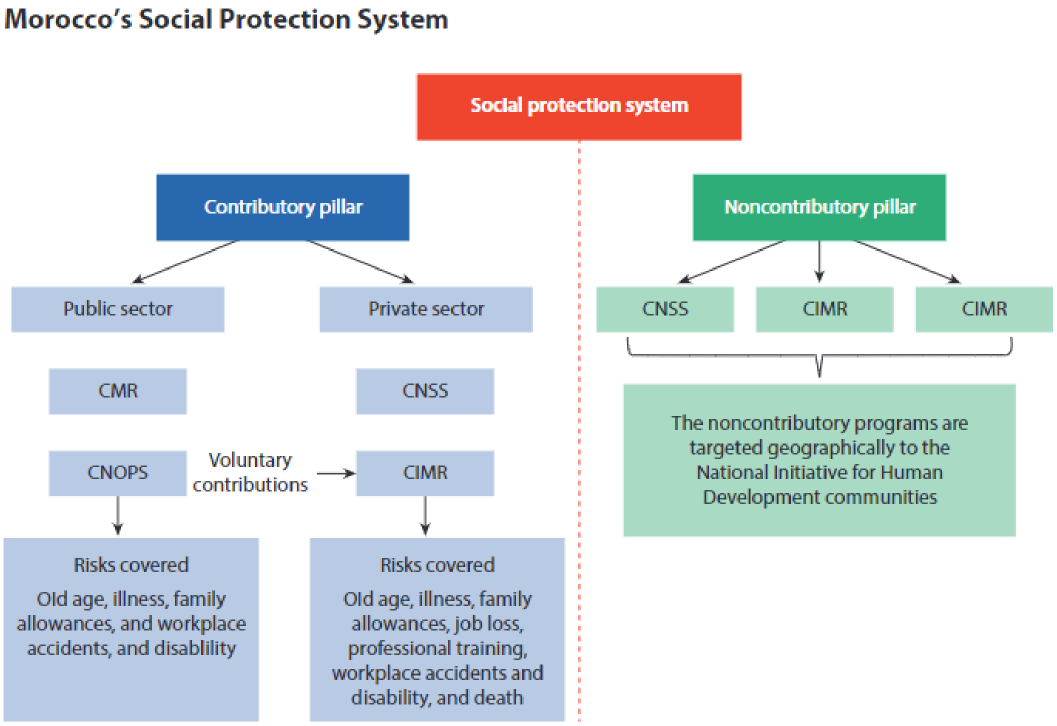
Do not forget to download the book and check out the blog



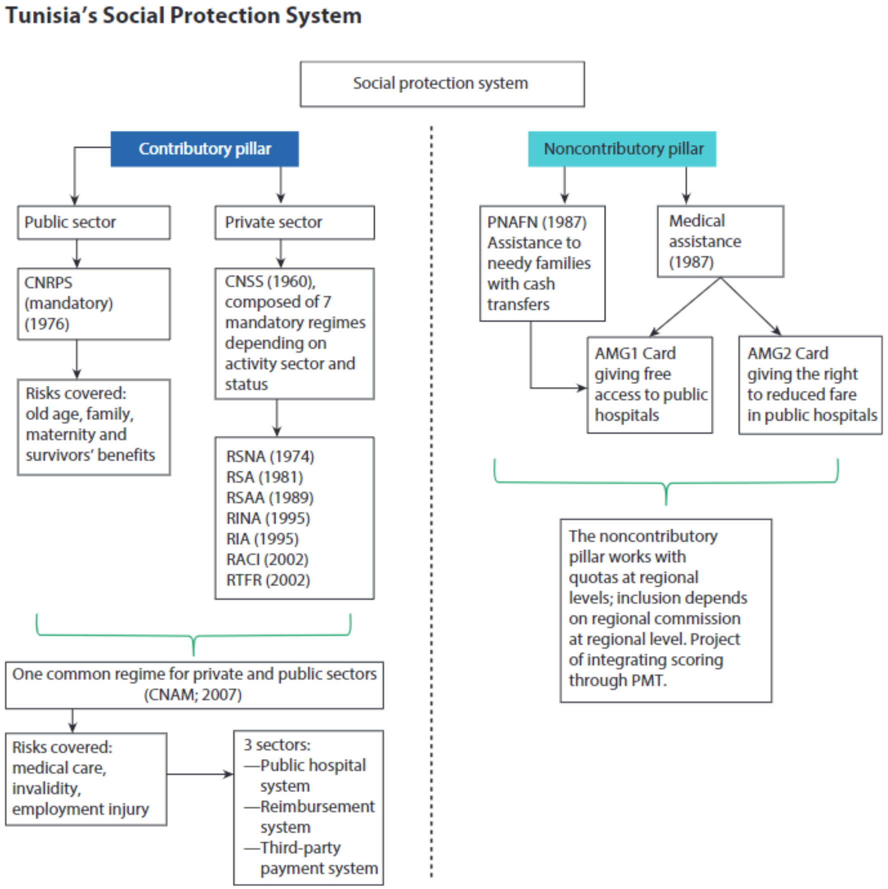
Click on the images!

Thank you

Examples of fragmented social protection systems



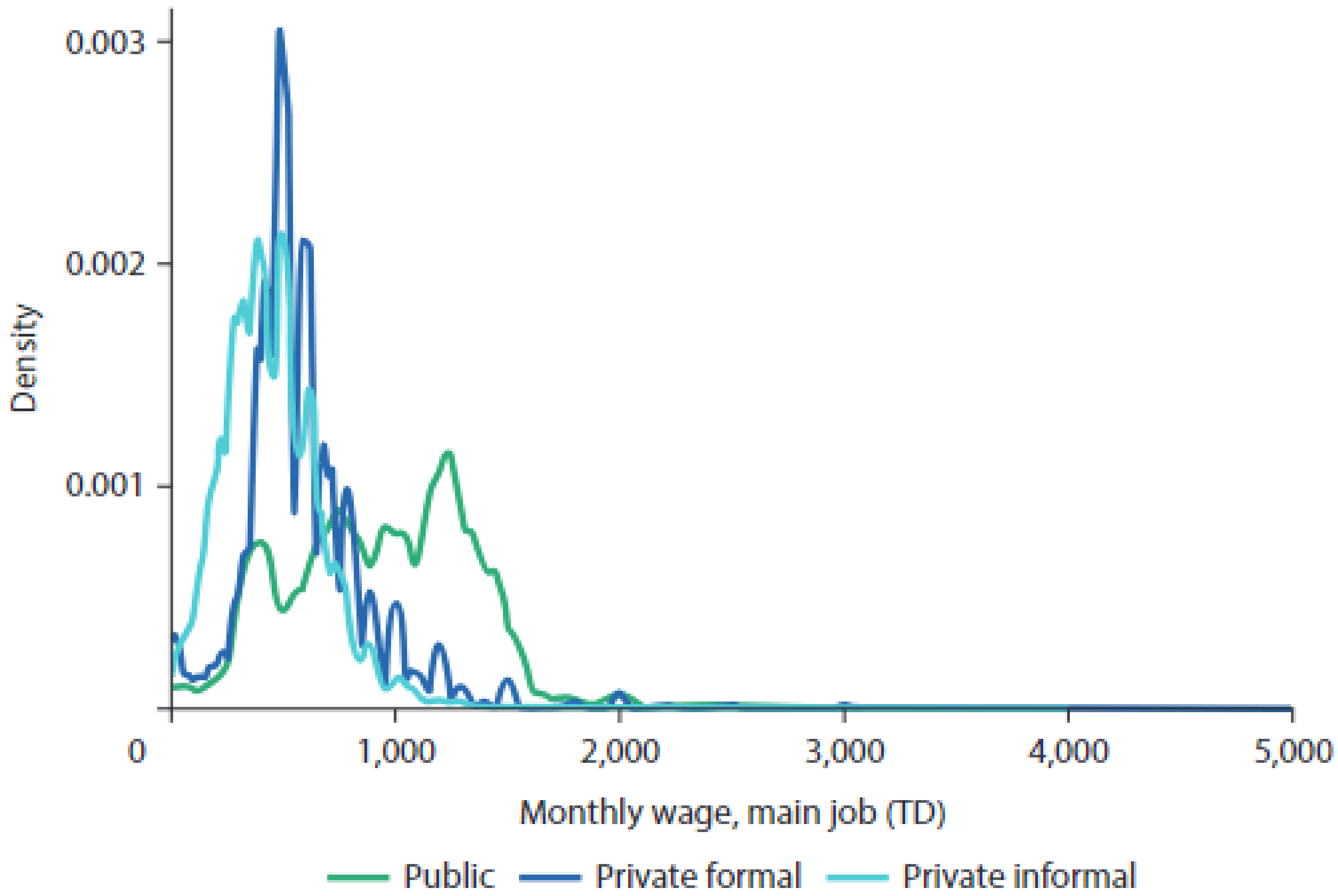
Source: Original figure for this publication.
Note: The noncontributory pillar includes a multitude of other programs not reported here. CIMR = Moroccan Interprofessional Pension Fund; CMR = Moroccan Pension Fund; CNOPS = National Fund of Social Welfare Organizations; CNSS = National Social Security Fund.



Cost of contributory social insurance to firms and workers in the private sector

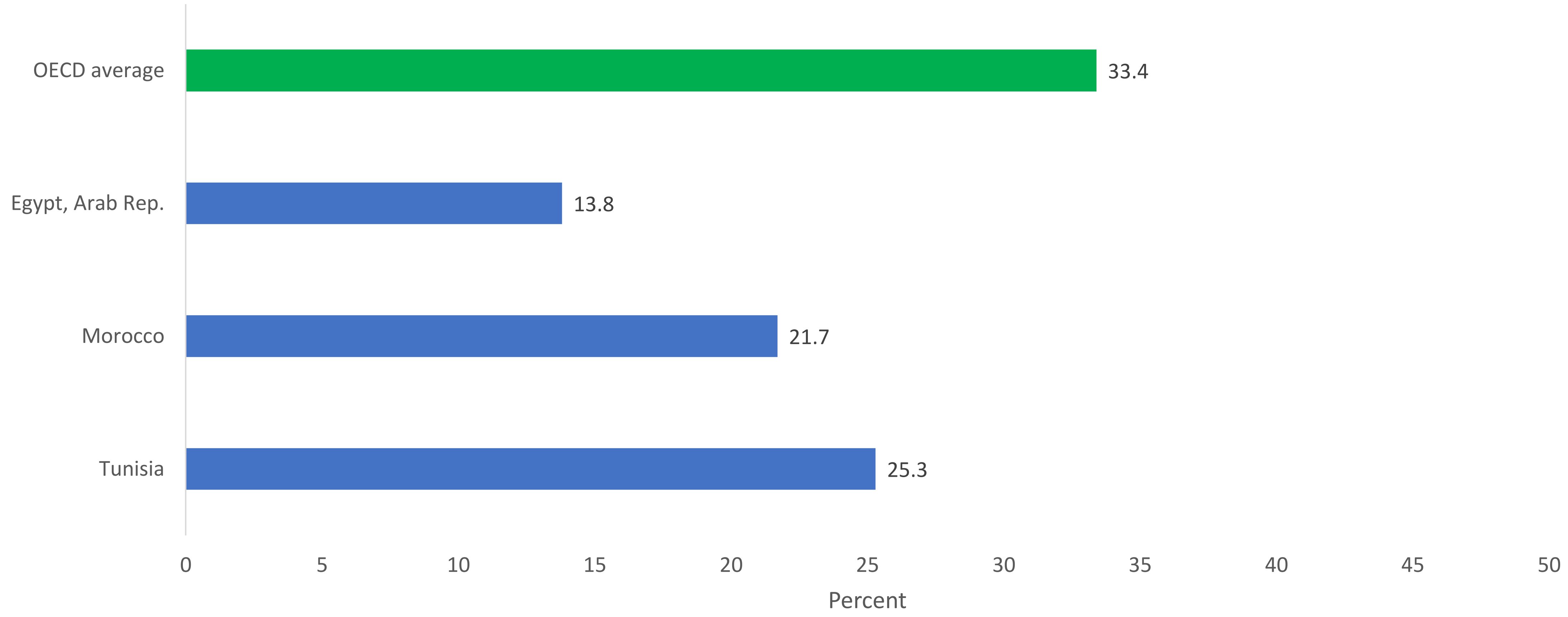
	Tunisia	Morocco	Egypt
Retirement pension	12.50	13.46	25.00
Health insurance	6.75	6.37	
Family allowance	3.10	6.40	
Workplace accident and occupational disease	1.00	2.74*	3.00
Sickness and maternity benefits	0.85	1.00	5.00
Job loss		0.57	2.00
Lump sum death benefit	0.65		
End of service bonus			5.00
Employee social protection	0.40		
State special fund	0.50		
Vocational training tax	2.00	1.60	
Housing fund	1.00		
Total	**28.75**	**29.40**	**40.00**

Monthly wage distributions by sector, Tunisia 2019



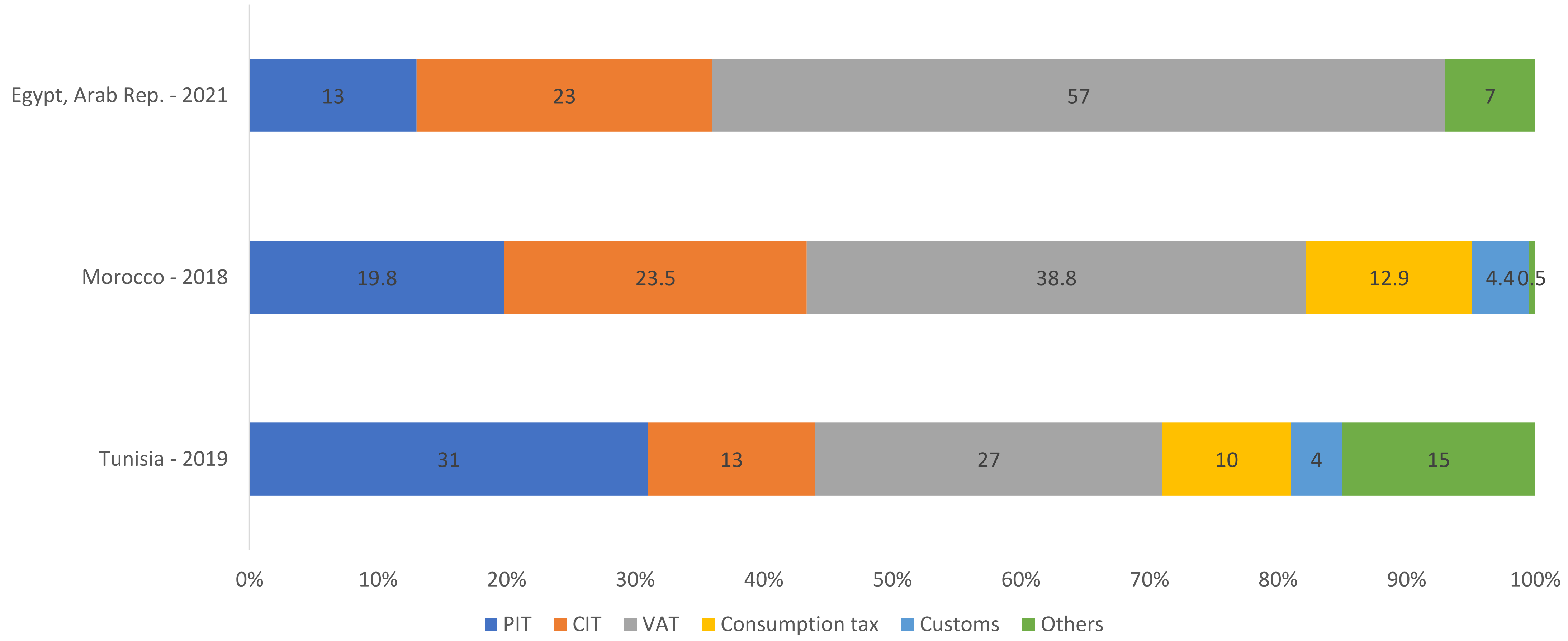
Source: Based on data from the Labor Force Survey.

Tax revenues as a share of GDP, 2019



Sources: Based on data from the International Monetary Fund; OECD.
Note: GDP = gross domestic product; OECD = Organisation for Economic Co-operation and Development.

Composition of tax revenues, 2019



Egypt: the VAT group (at 57%) includes other indirect taxes.