UCLA
UCLA Law & Economics Series

Title
Personal Income Taxes in the Middle East and North Africa: Prospects and Possibilities

Permalink
https://escholarship.org/uc/item/50c322th

Journal
Canadian Tax Journal/Revue fiscale canadienne, 70 (supp.)

Authors
Zolt, Eric M
Mansour, Mario

Publication Date
2022

eScholarship.org Powered by the California Digital Library
University of California

CANADIAN TAX JOURNAL / REVUE FISCALE CANADIENNE (2022) 70 (SUPP.), 291-334
https://doi.org/10.32721/ctj.2022.70.supp.mansour

Personal Income Taxes in the Middle East and North Africa: Prospects and Possibilities

Mario Mansour and Eric M. Zolt*

PRECIS

À l'exception de quelques pays d'Afrique du Nord, l'impôt sur le revenu des particuliers (IRP) joue un rôle minime, voire inexistant, au Moyen-Orient et en Afrique du Nord (MOAN), puisqu'il représente souvent moins de 2 pour cent du produit intérieur brut (PIB) en termes de revenus. Cet article examine comment les IRP ont évolué au cours des dernières décennies et à quoi ils pourraient ressembler dans les 20 prochaines années. Dans l'ensemble de la région, les taux marginaux supérieurs d'imposition sur les revenus du travail et d'entreprise des particuliers ont beaucoup diminué. Cette tendance reflète les réductions observées dans les économies avancées et en développement. L'imposition des revenus passifs du capital a très peu changé, et la contribution aux recettes provenant de cette source reste faible dans toute la région, puisqu'elle représente en moyenne moins de 1 pour cent du PIB et se concentre dans les États non fragiles importateurs de pétrole. Les cotisations de sécurité sociale (CSS) ont gagné en importance dans presque tous les pays de la région MOAN, et certains pays ont instauré des cotisations sociales et des prélèvements supplémentaires sur les salaires. La réduction des taux marginaux d'imposition conjuguée à l'imposition allégée des revenus du capital et des activités commerciales et à l'augmentation des CSS a donné lieu à des systèmes d'impôt sur le revenu qui découragent le travail et incitent à l'informalité, et qui contribuent peu aux recettes publiques et à la redistribution des revenus. Compte tenu des différences de structures économiques et politiques, de démographie et de points de départ, les réformes de l'IRP et des CSS ne suivront pas le même chemin dans toute la région. Les pays dotés de systèmes d'IRP et de CSS relativement matures, où les recettes se sont améliorées au cours des deux dernières décennies, devront de plus en plus équilibrer

* Mario Mansour is division chief, Fiscal Affairs Department, International Monetary Fund (IMF) (e-mail: MMansour@imf.org); Eric M. Zolt is Michael H. Schill Distinguished Professor of Law Emeritus, UCLA School of Law, and Extraordinary Professor, African Tax Institute, University of Pretoria (e-mail: zolt@law.ucla.edu). The views expressed in this paper are the authors' and do not necessarily represent those of the IMF, its executive board, or its management. The authors would like to thank Julieta Raquel Ladronis and Fernanda Morales for their excellent research assistance.

Electronic copy available at: https://ssrn.com/abstract=4402261

les objectifs de recettes et d'équité avec les objectifs d'efficacité (en particulier, les incitations sur le marché du travail et l'informalité). Les pays qui n'ont pas un IRP devront évaluer si un système de taxe sur la consommation et de cotisations sociales qui imite un impôt uniforme sur les revenus du travail est suffisant pour diversifier les recettes en dehors du pétrole, et s'il convient d'adopter des IRP pour remédier à l'inégalité croissante des revenus et des richesses. Enfin, les États fragiles, qui font face à une plus grande volatilité politique et qui ont des institutions budgétaires plus faibles que les États non fragiles, devront se concentrer sur la simplicité de la conception et de la perception de l'impôt pour être en mesure de tirer des recettes des IRP.

ABSTRACT

With the exception of a few North African countries, personal income taxes (PITs) play little or no role in the Middle East and North Africa (MENA), often yielding less than 2 percent of gross domestic product (GDP) in revenue. This paper examines how PITs have evolved in recent decades, and what they might look like in the next 20 years. Throughout the region, top marginal tax rates on labour and business income of individuals have declined substantially, a trend that mirrors reductions in advanced and developing economies. Taxation of passive capital income has changed very little, and the revenue contribution from this source remains low throughout the region, averaging less than 1 percent of GDP and concentrated in oil-importing non-fragile states. Social security contributions (SSCs) have increased in importance in nearly all MENA countries, and some countries have introduced additional payroll taxes and levies. The combination of reduced marginal tax rates, light taxation of income from capital and business activities, and increases in SSCs has resulted in income tax systems that create disincentives to work and incentives for informality, and contribute little to government revenue and income redistribution. Given differences in economic and political structures, demographics, and starting points, the path to PIT and SSC reforms will vary across the region. Countries with relatively mature PIT/SSC systems, where revenue performance has improved in the past two decades, will increasingly need to balance revenue and equity objectives against efficiency objectives (in particular, labour market incentives and informality). Countries without a PIT will have to weigh whether a consumption tax/SSC system that mimics a flat tax on labour income is sufficient to diversify revenue away from oil, and whether to adopt PITs to address rising income and wealth inequality. Finally, fragile states, which face more political volatility and have weaker fiscal institutions than non-fragile states, will have to focus on simplicity of tax design and collection to be able to raise revenue from PITs.

KEYWORDS: AFRICA ■ DEVELOPING COUNTRIES ■ MIDDLE EAST ■ PAYROLL TAXES ■ PERSONAL INCOME TAXES ■ TAX REFORM

CONTENTS

Note to Readers 293
Introduction 294
Policy Design Considerations for MENA Countries 297
Types of PIT Systems 297
Tax Regimes by Type of Income 297
Tax Regimes by Type of Taxpayer 299

Electronic copy available at: https://ssrn.com/abstract=4402261

Factors Influencing the Success of PITs 300
Political Economy Considerations 304
Assessment of Personal Income Taxes in MENA Countries 308
Overview and Evolution Since 2000 308
Rate Structure 310
Income from Wages and Salaries 312
Business and Professional Income of the Self-Employed 313
Passive Income from Capital 313
Payroll and Social Security Contributions 315
The Revenue Contribution of PITs 315
Determinants of the Revenue Performance of the PIT 318
Are PITs in the MENA Region Progressive? 320
Statutory Progressivity 321
Effective Progressivity 325
Where Next for PITs in MENA Countries? 326
Competing PIT Objectives 326
Possible Approaches for Different Countries 329
Oil-Exporting Countries with No PIT 329
Oil-Exporting Countries with PITs 331
Oil-Importing Countries 332
Conclusions 332
Appendix 334

NOTE TO READERS

Richard Bird, Mario Mansour, and I began this paper several months before Richard's passing. This is exactly the type of project that Richard enjoyed: messy, complex, and not susceptible to model or formulaic answers.

Throughout the paper, you will recognize Richard's voice, as well as several themes common to Richard's scholarship. Richard called for a "bottom's-up" approach to tax reform. He emphasized the need to know why a country's tax system works the way it does before making recommendations about how it should work. For Richard, every country was different—and each had its own history, economic and political environment, and administrative constraints. Not surprisingly, Richard recognized that the best tax reforms were all country-specific.

Early in his career, Richard saw the challenges of cross-country comparisons, noting the folly of using a collection of other countries' imperfect tax regimes as a guide for tax reforms. He repeatedly emphasized the importance of tax administrative constraints in designing tax policy. Even as an economist, Richard recognized that tax policy is determined more by politics than by economic theory.

Few individuals have had a greater impact on how we think about tax and developing countries than Richard Bird. We are confident that Richard's influence on scholarship and policy advice will continue for decades to come.

In completing this paper, we have tried to stay true to Richard's vision. It has been bittersweet working on this project without Richard. We miss his advice, criticisms,

Electronic copy available at: https://ssrn.com/abstract=4402261

wisdom, and, most of all, his sense of humour. But working on the project has also been a constant reminder of how lucky we were to have Richard as a mentor, colleague, co-conspirator, and friend. Please attribute anything novel or interesting in the article to Richard. Mario and I bear joint responsibility for any errors or omissions.

Eric M. Zolt

INTRODUCTION

Personal income taxes play little or no role in most countries in the Middle East and North Africa (MENA),[1] yielding on average about 2 percent of gross domestic product (GDP) in revenue. Like all countries, MENA countries must reassess the extent to which their tax systems can cope with restoring some degree of normalcy in a post-pandemic world and providing an adequate base for future growth and development. Although no simple answer can possibly be right for such a diverse set of countries, the question is particularly salient with respect to the personal income tax (PIT). Like other taxes, the PIT is important for revenue purposes. A well-designed PIT may also play a key role in redistributing income and may be potentially important to strengthen the political base for sound government. Taxpayers are more willing to pay taxes if they believe that governments spend tax revenues on programs that benefit people like them or programs they value, that others are paying their fair share of tax, and that they have some role in making tax and spending decisions.[2] While it is often both politically and administratively easier to raise needed revenues through indirect taxes like value-added taxes (VATs) and excise taxes, in countries with high levels of income and wealth inequality, a well-designed PIT can play an important role in raising revenue, reducing inequality, and developing a more inclusive society.

This paper seeks to assess the role of PIT systems in MENA countries. We take a long-term view of PITs by examining what they looked like at the turn of the century and how they have changed since, and what they might look like in the next 20 years. The key question is easy to state: Should MENA countries adopt a PIT regime, or, for those that already have a PIT, should they substantially strengthen it, and how? The answer is a lot more challenging. It may depend on the time horizon of policy makers, the objectives they intend to achieve with PITs, and a host of economic, demographic, institutional, and political factors.

Several reasons exist to review the role of the PIT in MENA countries. First, probably because of the small role the PIT plays in most of these countries, little analysis

1 MENA can be, and has been, defined in many ways. Table A1 in the appendix to this paper lists the countries and subgroups considered here, which follow the IMF's regional classification. The two subgroups are oil-exporting and oil-importing countries. We also note those countries that are fragile and conflict states.

2 Deborah A. Bräutigam, Odd-Helge Fjeldstad, and Mick Moore, eds., *Taxation and State-Building in Developing Countries: Capacity and Consent* (Cambridge, UK: Cambridge University Press, 2008).

Electronic copy available at: https://ssrn.com/abstract=4402261

exists that examines them in detail.[3] Over the last 20 or so years, policy makers have not paid too much attention to the taxation of individual incomes, although in nearly all countries social security contributions (SSCs) have increased, and some countries have introduced payroll taxes in addition to PITs. More recently, the primary focus of fundamental tax changes in the region has been the introduction of VATs and excise taxes in Gulf Cooperation Council (GCC) countries.[4]

Second, all countries in the region face pressure to maintain or increase spending on social programs. The economic and social impact of the pandemic will increase both the level of government spending and the challenges in raising tax revenue. Resource-rich MENA countries need to diversify their revenue base to replace declining oil revenues, manage the fiscal implications of oil price volatility, and introduce climate mitigation policies to counter the impact of CO_2 emissions. While these countries have faced revenue volatility in the past, this time is different. Many of these countries have "notched in" higher living standards, generous subsidies for food and fuel, and other social spending programs—all of which require additional non-resource revenue to sustain them.

Third, like other regions, there is greater attention in MENA countries to levels of income and wealth inequality and the role that taxation may play in reducing inequality. MENA countries likely have the highest level of both income and wealth inequality in the world.[5] The PIT is the tax instrument that has the greatest potential for reducing income inequality, but it has limited impact on reducing wealth inequality. The few PIT reforms in the region in recent years took the form of reductions in top marginal tax rates without meaningful expansion of the tax base. This likely reduced the progressivity of the PIT, at a time when issues related to equity and inclusiveness play a more prominent role in policy debates.[6]

3 Recent studies covering some aspects of PITs include Mario Mansour, *Tax Policy in MENA Countries: Looking Back and Forward*, IMF Working Paper WP/15/98 (Washington, DC: International Monetary Fund, 2015); Andrew Jewell, Mario Mansour, Pritha Mitra, and Carlo Sdralevich, *Fair Taxation in the Middle East and North Africa* (Washington, DC: International Monetary Fund, 2015); International Monetary Fund, "Diversifying Government Revenue in the GCC: Next Steps," paper prepared for the Annual Meetings of Ministers of Finance and Central Bank Governors, Riyadh, Saudi Arabia, October 26, 2016, on a proposal for a business profit tax for Gulf Cooperation Council (GCC) countries; and Geneviève Verdier et al., *Revenue Mobilization for a Resilient and Inclusive Recovery in the Middle East and Central Asia* (Washington, DC: International Monetary Fund, 2022). None of these studies extends the analysis of personal income taxes to social security contributions, an increasing channel through which MENA governments have been raising taxes on labour income.

4 The GCC is a regional intergovernmental union consisting of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The GCC is also a customs union.

5 Facundo Alvaredo, Lydia Assouad, and Thomas Piketty, "Measuring Inequality in the Middle East 1990-2016: The World's Most Unequal Region?" (2019) 65:4 *Review of Income and Wealth* 685-711.

6 Jewell et al., supra note 3; and Catriona Purfield et al., *Opportunity for All: Promoting Growth and Inclusiveness in the Middle East and North Africa* (Washington, DC: International Monetary Fund, 2018).

Electronic copy available at: https://ssrn.com/abstract=4402261

Fourth, several developments improve the likelihood that countries could successfully adopt a PIT or strengthen existing ones. Most MENA countries have VATs that increased tax administration capacity and effectiveness over the past three decades (and more recently in GCC members), which may be transferable to PIT regimes. Changes in technology and digitalization, business practices, and payment methods have the potential to improve the information available to tax authorities, a key element for a successful PIT regime. Across regions, greater cooperation among tax authorities will increase transparency and provide access to information about taxpayers' activities and financial holdings outside their country of (tax) residence.

Fifth, over the last 70 or so years, policy advisers, academics, and others have focused on the evolving role of the PIT, as well as on how nominally global, comprehensive, progressive PITs fail to tax certain sources of income and different types of taxpayers. More recently, the focus has been on the role that taxation (particularly the PIT) can play in making governments more accountable and transparent. The potential for PIT regimes to contribute to "state building" depends on some type of fiscal contract between taxpayers and the government, as well as a political environment that allows such bargaining. These developments may influence both the decision whether to have a PIT and design considerations for new and existing ones.

Finally, the diversity of MENA countries, in terms of natural resource endowment, fragility, and political systems, should provide lessons that could be useful for other regions and countries around the world.

This paper proceeds as follows. After this introduction, it examines different alternatives for adopting or reforming PITs, as well as the economic and political factors that may influence policy choices. The next section assesses how PIT systems have evolved in the MENA region since 2000, with particular attention paid to their revenue contribution, their progressivity (or lack thereof), and the role of SSCs, which have become more prominent in the region in the past two decades, including in GCC countries. Against this background, the paper then suggests possible reform strategies. The final section concludes. Throughout the paper, we divide MENA countries into two groups: oil-exporting countries[7] and oil-importing countries.[8] This division roughly corresponds, respectively, to countries with no PIT or a PIT that raises little revenue, and countries with a relatively robust PIT and the tax administration capacity to collect substantial revenue. We also consider fragile and conflict states (FCSs),[9] which have their own particularities, including political volatility and limited institutional capacity.

7 GCC countries (which do not have PITs) and Algeria, Iran, Iraq, Libya, and Yemen (all of which have a PIT).

8 Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, and Tunisia. Syria, Somalia, Sudan, and Afghanistan were excluded owing to the unavailability of data.

9 FCSs are oil-exporting countries Iraq, Libya, and Yemen, and oil-importing countries Djibouti and Lebanon. They are classified as fragile states according to the World Bank's Country Policy and Institutional Assessment (CPIA) index. All fragile states in the MENA region have an income tax, but their enforcement of the tax is relatively weak compared to non-fragile states.

Electronic copy available at: https://ssrn.com/abstract=4402261

POLICY DESIGN CONSIDERATIONS FOR MENA COUNTRIES

In this section, we consider different alternatives for countries seeking to adopt a PIT or to expand an existing one. We first examine tax regimes by type of income and type of taxpayer. We then review various factors that may influence tax capacity and spending levels, as well as those factors that are unique to the MENA region that may contribute to a successful adoption or expansion of PITs. The final part examines political considerations influencing the design and viability of PIT regimes.

Policy makers face many choices when designing a PIT regime. Revenue expectations, administrative challenges, and tradeoffs between the various objectives of the PIT shape and constrain these decisions. Tax choices are interrelated and influenced by non-tax policies. Countries make different choices on what collective government goods and services to provide and the types and level of taxes necessary to fund them. Many design choices also depend on country-specific circumstances.

Types of PIT Systems

The PIT regimes in different MENA countries generally follow a common approach for defining income subject to tax, providing adjustments for personal characteristics, and using PAYE (pay-as-you-earn) to collect most of the tax revenue. Despite these common features, PIT regimes vary greatly, primarily along three dimensions: (1) the types of income taxed; (2) the percentage of the population subject to tax; and (3) the portion of the population that bears the primary PIT burden. These differences result both from policy choices and from political will and administrative capacity for taxing certain types of income and groups of individuals.

Tax Regimes by Type of Income

One type of PIT regime seeks to tax all forms of income in a uniform manner. The so-called comprehensive, global PITs adopted by most developed countries are better classified as "semi-comprehensive" regimes. The PIT systems of all countries fall far short of taxing all income. These systems provide favourable treatment (including exemptions, rate reductions, and deferral of tax liability) for different types of income. For example, income related to personal residences, health insurance, and retirement benefits generally receive favourable tax treatment, and a substantial portion of income from capital is generally not taxed until the gain is realized, and then at favourable tax rates.

In the era following the Second World War, policy advisers viewed the PIT as the centrepiece of any modern tax system. They recommended that developing countries adopt a comprehensive, global, progressive personal income tax.[10] Advisers and

10 In many developing countries, the global progressive personal income tax long advocated by experts is in fact neither global, progressive, nor personal, and often is not even a tax on income. Richard M. Bird and Eric M. Zolt, "Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries" (2005) 52:6 *UCLA Law Review* 1627-95.

Electronic copy available at: https://ssrn.com/abstract=4402261

academics contended that comprehensive, global systems were more efficient than schedular systems because they taxed income from all sources in the same way, thus minimizing tax-induced distortions. They also thought that these systems were fairer on horizontal and vertical equity grounds. The progressive rate structure reflected the ability-to-pay principle, whereby those with a greater capacity to pay taxes should bear a greater portion of the tax burden by paying taxes at higher rates, and taxpayers with similar income but from different sources should face similar tax liabilities.

Two measures that highlight the comprehensiveness of the tax base of a PIT regime are the share of total personal income taxed (adjusting for tax-free thresholds) and the relative split between revenues from different types of income. Countries vary greatly on the relative amount of revenue derived from labour income and income from capital.

Some "semi-comprehensive" PIT regimes are effectively limited to a tax on wages. They focus almost exclusively on taxing income from labour in the formal sector (including public sector employees). Countries generally collect taxes on wages through withholding under PAYE regimes. While revenue collected under PAYE regimes represents a substantial percentage of PIT revenues in developed countries, the percentage is higher in developing countries because of the light taxation of capital income and weaker administrative capacity, especially in the taxation of business income of unincorporated entities.

A second type of PIT regime seeks to tax all income but provides for separate treatment of labour income and income from capital (recognizing that substantial challenges exist in separating these types of income, especially in owner-employee settings). These dual (or tripartite) tax regimes combine a tax on wages (at progressive tax rates) with a tax on capital (generally at a single rate and often collected through withholding). This type of PIT regime includes both explicit dual income tax regimes (such as those of the European Nordic countries) and more ad hoc regimes that combine a tax on labour income with a series of separate regimes for different types of income from capital (more typical of what MENA countries do). While dual income taxes were first adopted to address the challenges that high-tax Scandinavian countries faced from tax rate cuts in the United States and other countries in the 1980s, they have become an attractive alternative for many developing countries.[11]

Countries have two primary options for taxing the business income of non-corporate entities (sole proprietorships and partnerships). One approach, consistent with semi-comprehensive PIT regimes, taxes business income together with other types of income at progressive tax rates. Another approach, more typical of dual income tax regimes, taxes business income at a single flat rate, typically equal to the corporate income tax (CIT) rate. The latter approach is used in Mauritania and Djibouti and for non-GCC nationals in GCC countries. Taxing business income without regard to legal status eliminates the incentive for businesses to incorporate where

11 Richard M. Bird and Eric M. Zolt, "Dual Income Taxation: A Promising Path to Tax Reform for Developing Countries" (2011) 39:10 *World Development* 1691-1703.

Electronic copy available at: https://ssrn.com/abstract=4402261

CIT rates are lower than the top PIT rate. It is interesting that the policy rationales in Mauritania and Djibouti (where the choice was made in the context of an existing PIT) differ from that in the GCC (where the choice is largely dictated by the absence of a PIT).

Tax Regimes by Type of Taxpayer

Countries also vary greatly with respect to the portion of the population that is subject to PIT. At one end of the spectrum, countries can design a PIT as a class tax on the wealthy by imposing taxes primarily on high-income taxpayers. The early PIT regimes of many countries applied only to individuals at the very top of the income distribution. It is easy to design a PIT regime to exclude the non-wealthy by adopting a high exempt-income threshold—which would exclude from the taxpayer population nearly all wage earners.

But even in those countries with lower tax thresholds, the PIT could result in middle-income individuals paying a relatively smaller share of the PIT—though likely still high payroll and consumption taxes. While countries are generally successful in taxing the wage and salary income of high-income taxpayers, they face substantial challenges in taxing other types of income, primarily income from capital.

In some developed countries, high-income taxpayers pay a relatively large portion of the total PIT revenues; these taxpayers also receive a very large portion of total income. In the United States, for example, the top quintile (the 20 percent richest taxpayers) paid about 70 percent of federal PIT revenues, and the top percentile (the 1 percent richest) paid about 26 percent.[12] Similar PIT burdens are borne by high-income taxpayers in Latin America.[13]

At the other end of the spectrum, countries can design a PIT that applies to almost all individuals by adopting either no tax threshold or a very low tax threshold (as in Mauritania and Montenegro). The distribution of tax burdens across income levels

12 Congressional Budget Office, *The Distribution of Household Income, 2018* (Washington, DC: Congressional Budget Office, August 2021).

13 Karla Breceda, Jamele Rigolini, and Jaime Saavedra, *Latin America and the Social Contract: Patterns of Social Spending and Taxation*, Policy Research Working Paper WPS4604 (Washington, DC: World Bank, 2009). Historical factors contribute significantly to differences between PITs in developed and developing countries. Most developed countries adopted and expanded their PIT systems to raise revenue required to finance military operations during the First and Second World Wars. See Timothy Besley and Torsten Persson, "Why Do Developing Countries Tax So Little?" (2014) 28:4 *Journal of Economic Perspectives* 99-120. The need for additional revenue allowed these countries to make politically difficult decisions to increase dramatically the tax burdens on a large portion of the population, rather than just the wealthy—and made substantial investments in the needed tax infrastructures. It also allowed them to impose much higher rates on high-income taxpayers, especially as war casualties among the lower and middle classes reached very high levels. Kenneth Scheve and David Stasavage, *Taxing the Rich: A History of Fiscal Fairness in the United States and Europe* (Princeton, NJ: Princeton University Press, 2016).

Electronic copy available at: https://ssrn.com/abstract=4402261

in this type of mass tax depends greatly on the types of income subject to tax (and the rates) and the political and administrative capacity to tax different types of income.

In the middle of the spectrum are PIT regimes that reach a substantial portion of the population. A substantial tax threshold excludes the poor and lower middle class but theoretically taxes everyone else. Again, the effectiveness of this type of regime in reaching the income of individuals above the threshold depends greatly on the ability to tax certain sectors of the economy and certain types of income.

The percentage of the population that is required to file PIT returns or be subject to PIT liability varies greatly among countries. Some countries come close to universal coverage (such as Norway, Sweden, and Canada), while other countries subject a very small percentage of the population (less than 5 percent) to the PIT (such as India, China, and Pakistan). While substantial variation exists, in many developed countries more than 50 percent of the population is subject to PIT liability. The number of people filing PIT returns is higher in those countries that have income support programs (such as the earned income tax credit in the United States) built into their tax systems.

Factors Influencing the Success of PITs

This section examines several factors that may influence tax capacity and spending levels and that may contribute to the successful adoption or expansion of PITs. Beginning in the 1960s, researchers used cross-country comparisons to identify several factors that explain a significant share of the variance in taxes among countries. The challenge was to develop certain proxies that would effectively capture such factors. The Fiscal Affairs Department of the International Monetary Fund (IMF) took the lead in identifying those explanatory factors that were useful in determining differences in tax revenue between countries.[14] These studies focused on the supply-side factors that likely provide tax authorities with the necessary tax handles to facilitate tax collection.[15] They included per capita GDP, trade openness (imports plus exports

14 Joergen R. Lotz and Elliott R. Morss, "A Theory of Tax Level Determinants for Developing Countries" (1970) 18:3 *Economic Development and Cultural Change* 328-41; Roy W. Bahl, "A Regression Approach to Tax Effort and Tax Ratio Analysis" (1971) 18:3 *IMF Staff Papers* 570-612; Raja J. Chelliah, Hessel J. Baas, and Margaret R. Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1969-71" (1975) 22:1 *IMF Staff Papers* 187-205; and Alan A. Tait, Wilfrid L.M. Grätz, and Barry J. Eichengreen, "International Comparisons of Taxation for Selected Developing Countries, 1972-76" (1979) 26:1 *IMF Staff Papers* 123-56.

15 Later studies added explanatory variables on the demand side, including how levels of corruption, vice, and accountability impact tax revenues and compliance. See Richard M. Bird, Jorge Martinez-Vazquez, and Benno Torgler, "Societal Institutions and Tax Effort in Developing Countries" (2014) 15:1 *Annals of Economics and Finance* 301-51. Methodologies also evolved, with the use of stochastic frontier estimation models. See Ricardo Fenochietto and Carola Pessino, *Understanding Countries' Tax Effort*, IMF Working Paper WP/13/244 (Washington, DC: International Monetary Fund, 2013); Jean-François Brun, Gérard Chambas, and Mario Mansour, "Tax Effort of Developing Countries: An Alternative Measure," in Matthieu Boussichas and Patrick Guillaumont, eds., *Financing Sustainable Development:*

Electronic copy available at: https://ssrn.com/abstract=4402261

of goods as a percentage of GDP), the size of the agriculture sector, foreign aid, and revenue from natural resources. These factors support an intuition that tax authorities have an easier time collecting taxes in wealthy countries, with economies that generate a lot of activity with cross-border flows, and where agriculture (particularly subsistence agriculture) plays a relatively smaller role in total economic activity. For developing countries, foreign aid and natural resource revenues are generally negatively associated with tax revenue.[16]

While there is much to learn from this extensive body of work, it provides limited guidance to those concerned with improving tax policy in any particular country. While it is true that richer countries tend to have more options in designing tax systems, that they raise relatively more in taxes than poorer countries, and that they can generally do so without arousing strong domestic opposition, this provides little useful information for a developing country contemplating its fiscal future.

A different set of scholars have focused on factors that influence the size of government, including those that may limit the level of social spending. The level of social spending may be influenced by a combination of income levels, income distributions, relative sizes of different age groups, and political factors.[17] These factors are associated with larger spending programs that require government revenues to fund them. For many developing countries, the challenges of meeting sustainable development goals, especially in a post-pandemic world, call for significant increases in tax revenue to fund government programs.[18]

Table 1 presents our observations about key factors in the empirical literature that are highly correlated with tax and spending levels, and the direction of the correlation.[19] Challenges exist in isolating the effect of different factors on tax and spending policies partly because of the differences in the political and economic environments across countries. Studies have found a complex and often ambiguous relationship for different factors on fiscal outcomes, including trade openness,[20] levels of foreign

Addressing Vulnerabilities (Paris: Fondation pour les études et recherches sur le développement international and Economica, 2015), 205-16; and Jean-François Brun and Maïmouna Diakité, *Tax Potential and Tax Effort: An Empirical Estimation for Non-Resource Tax Revenue and VAT's Revenue*, Working paper no. 201610 (Clermont-Ferrand, France: CERDI, 2016).

16 Ernesto Crivelli and Sanjeev Gupta, "Resource Blessing, Revenue Curse? Domestic Revenue Effort in Resource-Rich Countries" (2014) 35 *European Journal of Political Economy* 88-101; and Brun et al., "Tax Effort of Developing Countries: An Alternative Measure," supra note 15.

17 Peter H. Lindert, "What Limits Social Spending?" (1996) 33:1 *Explorations in Economic History* 1-34; and David L. Lindauer and Ann D. Velenchik, "Government Spending in Developing Countries: Trends, Causes, and Consequences" (1992) 7:1 *World Bank Research Observer* 59-78.

18 Vitor Gaspar, David Amaglobeli, Mercedes Garcia-Escribano, Delphine Prady, and Mauricio Soto, *Fiscal Policy and Development: Human, Social, and Physical Investment for the SDGs*, IMF Staff Discussion Note SDN/19/03 (Washington, DC: International Monetary Fund, 2019).

19 These factors will be examined more formally later using regression analysis.

20 Julia Cagé and Lucie Gadenne, "Tax Revenues and the Fiscal Cost of Trade Liberalization, 1792-2006" (2018) 70 *Explorations in Economic History* 1-24.

Electronic copy available at: https://ssrn.com/abstract=4402261

TABLE 1 Factors Influencing Tax Capacity and Spending Levels

Factors	Effect on tax capacity	Effect on public spending
Economic factors		
Level of development	Mostly positive	Mostly positive
Trade openness	Mostly positive	Mostly positive
Share of agriculture in GDP	Negative	Negative
Share of informal economy	Negative	Negative
Demographics		
Population growth	Mostly positive	Positive
Age distribution (dependency levels)	Mostly negative	Positive
Level of inequality (of income or wealth)	Ambiguous	Mostly positive
Political factors		
Democracy index	Mostly positive	Mostly positive
Voting participation	Mostly positive	Mostly positive
Trust in government	Positive	Positive
Corruption	Negative	Negative
Non-tax revenue		
Natural resource revenue	Negative	Positive
Foreign aid	Ambiguous	Mostly positive
Effectiveness in taxing/spending		
Investment in tax administrative capacity	Positive	Positive
Investment in delivery of government services	Positive	Positive

GDP = gross domestic product.

aid,[21] and political factors.[22] Some factors (such as level of development and trust in government) have a mostly positive effect on both tax capacity and demand for public services. Other factors (such as share of agriculture and share of informal economy) have a mostly negative effect on both tax capacity and demand for public services. For some factors, the impact on tax capacity and demand for public services work in opposite directions (for example, the availability of natural resource revenues).

Several elements may contribute to the relative success or failure of a new or expanded PIT in MENA countries. First, in many countries, governments have access to a lot of information about potential taxpayers. This could result from the governments having the ability to track financial transactions or from information available

21 Dora Benedek, Ernesto Crivelli, Sanjeev Gupta, and Priscilla Muthoora, "Foreign Aid and Revenue: Still a Crowding-Out Effect?" (2014) 70:1 *FinanzArchiv* 67-96.

22 Barbara Dutzler, Simon Johnson, and Priscilla Muthoora, *The Political Economy of Inclusive Growth: A Review*, IMF Working Paper WP/21/84 (Washington, DC: International Monetary Fund, 2021).

Electronic copy available at: https://ssrn.com/abstract=4402261

from state pension and subsidy systems. Providing tax administrators with access to this information will make it easier for a country to adopt or expand a PIT regime.

Second, many MENA countries have a large public sector workforce. On the positive side, having a substantial percentage of employees working for the government makes tax administration relatively easy. On the negative side, a large public sector payroll increases the need for higher taxes and reduces funds available for other government spending programs. The revenue consequences of imposing or increasing taxes on government workers are unclear, because higher taxes will increase demands for higher public sector wages. To the extent that large public sector wage premiums exist in MENA countries, taxing government workers (and not workers throughout the economy) may have the advantageous effect of reducing the size of the premiums and increasing private sector employment.

Third, many MENA countries have experienced rapid population growth. Some MENA countries, notably GCC members, have experienced a large growth in the number of expatriates. Other MENA countries have had substantial internal displacements and migration. In most (non-oil-producing) countries, the growth of an increasingly youthful population has not been accompanied by any parallel expansion of either easily accessible tax bases or the revenue needed to finance the expenditures (for example, on education and health) that facilitate economic growth.

A fourth development is increasing levels of income and wealth inequality in many MENA countries. High levels of inequality make it both easier and harder for countries to adopt a progressive PIT. It is easier because growing inequality may increase popular and political support for progressive taxes. In addition, tax administrations can focus their resources on a relatively small group of taxpayers. But high levels of inequality also make it harder to adopt or expand a PIT. The economic elite have substantial political power to block PIT reforms. Further, the wealthy are in a better position to structure their business activities and financial holdings to minimize their tax liability by tax-avoidance and tax-evasion strategies.

The ability to use fiscal policy to reduce inequality varies greatly among and between developed and developing countries. For example, in 2000, Chu et al. found that before redistributive tax and spending policies, inequality was, on average, greater in developed countries than in developing countries.[23] In developed countries, taxes and spending programs significantly reduced levels of inequality (mainly thanks to spending programs). In contrast, neither taxes nor spending programs contributed to a meaningful reduction in inequality in developing countries. On the tax side, the PIT has done little to redistribute income or reduce inequality in developing countries.[24] This is not surprising given the small role the tax plays in many developing

23 Ke-young Chu, Hamid Davoodi, and Sanjeev Gupta, *Income Distribution and Tax and Government Social Spending Policies in Developing Countries*, IMF Working Paper WP/00/62 (Washington, DC: International Monetary Fund, 2000).

24 Bird and Zolt, supra note 10.

Electronic copy available at: https://ssrn.com/abstract=4402261

countries, both in terms of the amount of revenue raised (as a percentage of GDP) and the challenges of taxing income of the wealthy.

So, what has changed in the last 20 years? While there has been some progress in many developing countries in improving the progressivity of PIT regimes, developing countries (particularly in Latin America) have been more effective in targeting spending programs for those at the bottom of the income distribution.[25] On the PIT side, Benedek et al. note that the progressive capacity of the PIT (a measure of its capacity to contribute to income redistribution) remains low in developing countries relative to advanced economies, primarily because of its small contribution to taxes, rather than its statutory progressivity.[26]

A final factor is the issue of state capacity, particularly the ability of governments at all levels to develop and implement tax policy effectively, efficiently, and equitably. Countries with successful VAT regimes will have a greater chance of success in adopting or expanding a PIT. Many of the tasks in implementing and administering a VAT are transferable to PIT regimes, particularly those applied to professionals (doctors, lawyers, accountants, consultants, architects, engineers). MENA countries that have successfully digitalized their VAT regimes will find it easier to administer a PIT than countries that rely on manual processes and paper records. Countries that require e-invoicing for most commercial transactions will also have a substantial comparative advantage in administering a PIT than countries that do not require e-invoicing.[27] Developments in digitalization and the availability of a well-educated labour force in MENA make it more feasible than ever for most countries in the region to design and implement much better tax systems than most now have. This puts the spotlight on whether governments have the political will or at least the political support to make substantial reforms. A brief discussion of this factor follows.

Political Economy Considerations

Political factors play an important role in influencing the level of taxation in a country and the relative use of different tax instruments. Countries with different political institutions will likely make different decisions as to both the level and type of public expenditures and the taxes necessary to fund them. The political conditions that support improving tax capacity are constitutive institutions, inclusive politics,

25 Nora Lustig, Luis F. Lopez-Calva, and Eduardo Ortiz-Juarez, *Deconstructing the Decline in Inequality in Latin America*, Policy Research Working Paper WPS6552 (Washington, DC: World Bank, 2013).

26 Dora Benedek, Juan Carlos Benítez, and Charles Vellutini, *Progress of the Personal Income Tax in Emerging and Developing Countries*, IMF Working Paper WP/22/20 (Washington, DC: International Monetary Fund, 2022).

27 E-invoicing provides taxing authorities with real-time information that allows them to better administer a VAT, especially in identifying taxpayers with a greater likelihood of under- or non-compliance. The digitalization of data allows taxing authorities to use triangulation (comparing data from point-of-sale transactions with sales declared on tax returns) and segmentation (comparing data among similar taxpayers).

Electronic copy available at: https://ssrn.com/abstract=4402261

and creditable leadership.[28] One key insight is that political institutions matter for improving tax systems (especially for PIT regimes), and that taxpayers' views of the state's accountability, transparency, and competency affect their willingness to pay taxes. This is especially important for PIT regimes where taxpayers have greater opportunities to avoid or evade taxes and where political support for PITs is contingent on voters' trust in government.

A large literature examines the relationship between taxation and democracy.[29] A common starting point considers the social contract between the state and its citizens, particularly the fiscal component whereby individuals pay taxes in exchange for the protection of certain rights and the provision of services. Fiscal contract models grew out of feudal bargains whereby residents paid powerful kings and nobles for protection against outside invaders, and then contracts between kings and nobles to exchange tax revenue for the protection of property rights and some influence over government policy.

Despite the intuitive appeal of these models, it is hard to establish a causal relationship between taxation and democracy. While one can identify historical examples where taxation played a central role in fostering democratic institutions, it is uncertain how transferable these relationships are to other countries, such as MENA countries. Also not clear is the direction of the causal relations: does democracy lead to taxation, or does taxation lead to democracy? What is more likely is that the causation runs in both directions.

For oil-exporting MENA countries, a key question is the role of revenue from natural resources in shaping political institutions. The "resource curse" rests on the notion that governments that generate substantial revenue from non-tax sources do not need to engage in the messy business of collecting taxes from their residents.[30] As a result, they are less accountable to citizens, because citizens do not directly bear the costs of government. These types of governments also have less incentive to invest in spending programs to support other sectors of the economy and to invest in improving tax administration capacity. Governments that lack resource revenues must raise revenue directly from citizens, who then play a greater monitoring role in government activities, forcing governments to be more transparent and accountable.

28 Vitor Gaspar, Laura Jaramillo, and Philippe Wingender, *Tax Capacity and Growth: Is There a Tipping Point?* IMF Working Paper WP/16/234 (Washington, DC: International Monetary Fund, 2016).

29 Margaret Levi, *Of Rule and Revenue* (Oakland, CA: University of California Press, 1989); B. Guy Peters, *The Politics of Taxation: A Comparative Perspective* (Cambridge, MA: Blackwell, 1991); Sven Steinmo, *Taxation and Democracy: Swedish, British and American Approaches to Financing the Modern State* (New Haven, CT: Yale University Press, 1993); Stanley L. Winer and Walter Hettich, *The Political Economy of Taxation: Positive and Normative Analysis When Collective Choice Matters*, Working Paper no. 02-11 (Ottawa: Carleton University, 2003); and Richard M. Bird and Eric M. Zolt, "Fiscal Contracting in Latin America" (2015) 67 *World Development* 323-35.

30 Michael L. Ross, "Does Oil Hinder Democracy?" (2011) 53:3 *World Politics* 325-61; and Crivelli and Gupta, supra note 16.

Electronic copy available at: https://ssrn.com/abstract=4402261

What is not clear is whether countries blessed with natural resources would have become more democratic if such resources were not present. It is difficult to predict whether a Saudi Arabia without oil reserves would have a political system not that different from the current regime.[31] While resource revenues likely help autocratic regimes remain in power, the lack of resource revenues may not result in institutions that are more democratic.

Scholars focusing on the contribution of tax systems to state building use several of the themes set forth in the resource curse literature. Effective tax systems play a crucial role in creating effective governments. In a virtuous cycle model, tax increases lead to greater spending in programs for health, education, and infrastructure, which leads to greater economic growth, and then to even higher levels of tax revenues.

While adopting a new PIT or strengthening an existing PIT has the potential to contribute to more democratic institutions or more effective government, many factors influence whether the potential can be realized. Prichard sets forth several factors that may make constructive tax bargaining more likely in a particular country.[32] Some factors relate to levels of trust (both among diverse groups of taxpayers and between taxpayers and the government); other factors relate to taxpayers' enthusiasm for political engagement and their belief that a link exists between taxes and government spending that they value. A key condition for taxes contributing to state building requires taxpayers to have effective political organizations and the ability to bargain constructively with the government.

Social contracts between governments and their citizens come in different shapes and sizes. They are a combination of informal and formal arrangements between different social groups and governments that comprise the rights and obligations toward each other. The tax components of social contracts vary among countries. Bargains can be both implicit and explicit. For example, in recent years, the conservative governments of some Latin American countries have increased taxes on the rich to fund programs for the poor in order to maintain political control.[33] Other countries have made greater use of earmarked tax revenues to gain popular support for new or higher taxes.[34]

Following independence in the 1950s and 1960s, the social contracts in MENA countries shared much in common. Governments provided social and economic benefits (free health care and education, commodity subsidies, and public sector

31 Stephen Haber and Victor Menaldo, "Do Natural Resources Fuel Authoritarianism? A Reappraisal of the Resource Curse" (2011) 105:1 *American Political Science Review* 1-26.

32 Wilson Prichard, *Taxation and State Building: Towards a Governance Focused Tax Reform Agenda*, IDS Working Paper no. 341 (Brighton, UK: Institute of Development Studies, 2010).

33 Tasha Fairfield and Candelaria Garay, "Redistribution Under the Right in Latin America: Electoral Competition and Organized Actors in Policymaking" (2017) 50:14 *Comparative Political Studies* 1871-1906.

34 Rachel McCleary, "The International Community's Claim to Rights in Brazilian Amazonia" (1991) 39:4 *Political Studies* 691-707.

Electronic copy available at: https://ssrn.com/abstract=4402261

jobs for college graduates) in exchange for limited government accountability and restricted political participation.[35] The politically relevant groups that benefit from such contracts vary among MENA countries. They include the educated middle class (in Algeria, Egypt, Morocco, and Tunisia), all citizens in the GCC economies, and members of certain sects, tribes, or clans (in Jordan, Iraq, Libya, Syria, and Yemen).[36] Noticeably missing from the fiscal part of the social contract in many MENA countries is a meaningful tax component.

For several years after independence, MENA countries financed the costs of the social contracts through a combination of oil and gas revenues, foreign aid, and transfers from wealthy GCC countries. Declining oil and gas revenues, growing populations, and a decline in the quantity and quality of publicly provided goods and services strained the social contract in many countries. Several MENA countries scaled back public sector hiring and reduced or eliminated fuel and food subsidies.[37] The 2011 Arab uprisings reflected the frustrations of different societal groups with social and economic policies and the lack of any meaningful political participation.

While it is difficult to predict how and whether social contracts might evolve in MENA countries, it is likely that these countries will take different approaches. Some may adopt taxing and spending policies that reflect a new equilibrium, while other countries may seek to retain the old social contract with minor concessions. An important question for many MENA countries is how increases in size of the middle-income class might influence the demand for public goods and services as well as individuals' willingness to pay taxes. For those countries with PIT systems and meaningful political participation, a growing middle-income class will increase the proportion of the population that both votes and pays taxes. Preferences for size of government and types of government spending programs may change as the size of the middle class increases. In some MENA countries, this may result in a shift from general food and energy subsidies to more targeted spending programs, as well as higher-quality health-care and education programs.

All countries face substantial challenges in changing social contracts (including the fiscal component). But there are several reasons why the challenges may be even greater in many MENA countries. First, several MENA countries have a long history of providing public services and subsidies without charge to most or all of the population. It is much more difficult to impose taxes for public services that have already

35 Markus Loewe, Tina Zintl, and Annabelle Houdret, "The Social Contract as a Tool of Analysis: Introduction to the Special Issue on 'Framing the Evolution of New Social Contracts in Middle Eastern and North African Countries'" (2021) 145 *World Development* 1-16 (https://doi.org/10.1016/j.worlddev.2020.104982).

36 Ragui Assaad, "Making Sense of Arab Labor Markets: The Enduring Legacy of Dualism" (2014) 3:6 *IZA Journal of Labor & Development* 1-25.

37 Carlo Sdralevich, Randa Sab, Younes Zouhar, and Giorgia Albertin, *Subsidy Reform in the Middle East and North Africa: Recent Progress and Challenges Ahead* (Washington, DC: International Monetary Fund, 2014).

Electronic copy available at: https://ssrn.com/abstract=4402261

been available than to impose taxes for new public spending programs. It is even more challenging in those countries where the quality of public services and levels of subsidies are declining. Second, high levels of inequality mean that a new or expanded PIT would fall mainly on the wealthy. In all countries, it is challenging to convince the economic and political elite to pay higher taxes to fund government spending programs that they do not use. Finally, in many MENA countries, there is little appetite or foundation for tax bargaining between governments and citizens. Without some opportunity for such bargaining, it is challenging to use PITs to make governments more accountable and transparent.

ASSESSMENT OF PERSONAL INCOME TAXES IN MENA COUNTRIES

In this section we review the key structural elements of MENA PITs and assess their revenue contribution. We then study to what extent PITs are progressive and whether such progressivity has been enhanced since the early 2000s. We complete the analysis by assessing how SSCs contribute (or not) to the progressivity of PITs.

Table 2 provides selected macroeconomic and demographic indicators for the MENA region. This puts in perspective the analysis in this section and the next. Some observations are worth noting:

1. Since 2000, the MENA population increased by 47 percent, and that of the GCC doubled—primarily as a result of immigration.
2. Total revenues, as a percentage of GDP, declined by 0.9 percentage points; most of this decline is due to less oil revenue in oil-exporting countries.
3. Tax revenue in non-GCC oil-exporting countries (all FCSs) also declined, by 3.1 percentage points of GDP.

In summary, while the need for public spending may have increased as a result of population growth, tax revenues remained stable on average and declined in FCSs, and oil revenues declined. Meanwhile, per capita GDP (in US-dollar purchasing power parity [PPP]) remained constant.[38]

Overview and Evolution Since 2000

The tax laws in most MENA countries broadly define income subject to PIT. Progressive income tax rates generally apply to wage and business income of the self-employed. Countries take different approaches to taxing income from capital, with some countries taxing certain types of capital income at flat rates and other countries (less

38 The recent volatility in oil prices, and the corresponding additional oil rent that has accrued to oil exporters as a result of the impact of the war in Ukraine on oil and gas supply chains will affect this analysis. GCC countries stand to gain significantly from the war shock. From a long-term perspective, it would be wrong to assume that this changes the debate on income taxation in the MENA region—for the same reasons that the oil rent before the 2008 financial crisis changed the debate on VAT implementation in the GCC.

Electronic copy available at: https://ssrn.com/abstract=4402261

TABLE 2 Selected Economic and Demographic Indicators, MENA Countries

	Oil-importing countries	Oil-exporting countries			All MENA countries
		Total	GCC	Non-GCC	
2000					
Population (millions)	167.1	141.3	29.4	111.9	308.4
Share of oil GDP (%)	4.3	47.1	42.2	55.9	36.8
GDP per capita (US dollars, PPP)	5,178	37,930	61,525	9,617	24,140
Government revenues (% of GDP)					
Total revenues	23.0	34.4	35.3	33.0	29.3
Tax revenues	14.1	5.8	4.1	8.4	9.5
2020					
Population (millions)	235.1	219.6	58.7	160.9	454.7
Share of oil GDP (%)	1.9	36.2	41.0	23.0	28.2
GDP per capita (US dollars, PPP)	9,285	34,938	56,566	8,985	24,962
Government revenues (% of GDP)					
Total revenues	23.2	30.9	30.5	31.3	27.7
Tax revenues	14.1	4.5	3.8	5.3	8.6
Change 2020-2000 (%)					
Population	40.7	55.4	99.8	43.8	47.4
Share of oil GDP	−56.0	−23.1	−2.7	−58.8	−23.2
GDP per capita (US dollars, PPP)	79.3	−7.9	−8.1	−6.6	3.4
Government revenues					
Total revenues	1.1	−10.2	−13.5	−5.3	−5.7
Tax revenues	0.6	−21.9	−5.4	−36.4	−9.5

GCC = Gulf Cooperation Council; MENA = Middle East and North Africa; GDP = gross domestic product; PPP = purchasing power parity.

Note: Averages are simple means across countries.

Sources: International Monetary Fund, *World Economic Outlook* (Washington, DC: IMF, various years); World Bank, *World Development Indicators* (Washington, DC: World Bank); International Monetary Fund, *IMF Staff Country Reports* (Washington, DC: IMF); and authors' calculations.

commonly) taxing at progressive tax rates. For MENA countries with PIT regimes, most countries tax their residents on their worldwide income (including Algeria, Iran, Iraq, Morocco, Tunisia, and Yemen), but some countries tax their residents only on income earned in the country (including Jordan, Libya, and Syria). For those countries with worldwide tax regimes, it will be interesting to see whether greater availability of information exchanges will allow those countries to be more successful in taxing residents on income earned on assets held outside the country. Countries generally collect income taxes through withholding, which are creditable against the tax liability reported on tax returns for those taxpayers who are obligated to file.

Electronic copy available at: https://ssrn.com/abstract=4402261

Rate Structure

The rate structure of PITs varies across MENA countries (see table 3). Most countries have an income tranche taxed at 0 percent (except Mauritania); few provide instead a basic allowance (that is, a deduction from income before the application of tax rates), which varies according to the taxpayer's situation (marital status, number of children).[39] The lowest positive tax rates range from 2 percent in Djibouti and Lebanon to 26 percent in Tunisia,[40] and the top marginal tax rates range from 10 percent in Libya to 40 percent in Mauritania. As discussed in the previous section, these disparities in headline rates reflect country-specific factors, including the share of oil revenue in total revenue and social preferences as to the role that the PIT plays in raising revenue and reducing inequality.

The lowest tax rates in some countries are too low to raise any significant revenue and are often part of a rate schedule with a high number of tax rates (for example, Djibouti has six rates; Egypt, Jordan, and Lebanon have seven rates). In most countries, the top tax rate applies at high income levels and likely has little impact on progressivity (as in Egypt, Lebanon, and Morocco; Jordan is an extreme case). To put things in perspective, the low PIT tax bracket in advanced economies is, on average, 0.25 times per capita GDP, and the high tax bracket is 4 times per capita GDP.

In terms of the brackets (all expressed in multiples of GDP per capita), we observe a significant increase in the top-rate bracket and a reduction of the low-rate bracket, with the consequence that the exempt threshold declined from 1.3 percent of per capita GDP in the early 2000s to 0.7 percent of per capita GDP in 2020. All this means that, relative to the early 2000s, more individuals are now subject to the PIT at the low end of the income distribution and fewer are taxed at the top end of the distribution.

Finally, it is worth noting that, as in countries in other regions, the top marginal PIT rates in MENA countries have declined significantly over the last 40 years (see figure 1),[41] but the bulk of this decline took place in the 1980s and 1990s, with the average top rate losing one-third of its value per decade.[42]

39 In these cases, we take the allowance for single individuals without dependants as the income tranche taxed at 0 percent.

40 Tunisia adds a payroll tax of 1 percentage point to its PIT rates, with the effect that the exempt allowance is taxed at 1 percent. We include this payroll tax in the analysis, but given the marginal nature of the payroll tax, we also show the basic exempt allowance as a percentage of per capita GDP.

41 See, for instance, Claudia Gerber, Alexander D. Klemm, Li Liu, and Victor Mylonas, "Income Tax Progressivity: Trends and Implications" (2019) 82:2 *Oxford Bulletin of Economics and Statistics* 365-86. This trend in the reduction of top marginal rates followed similar reductions in high-income countries, which occurred in the 1980s, with landmark reforms in the United States and the United Kingdom.

42 Top rates in the early 1980s were very high in some MENA countries—for example, 90 percent in Iran, 80 percent in Egypt and Tunisia, 75 percent in Algeria, and 70 percent in Sudan.

Electronic copy available at: https://ssrn.com/abstract=4402261

Electronic copy available at: https://ssrn.com/abstract=4402261

TABLE 3 MENA Countries: PIT Rates and Brackets, 2020 Versus 2000

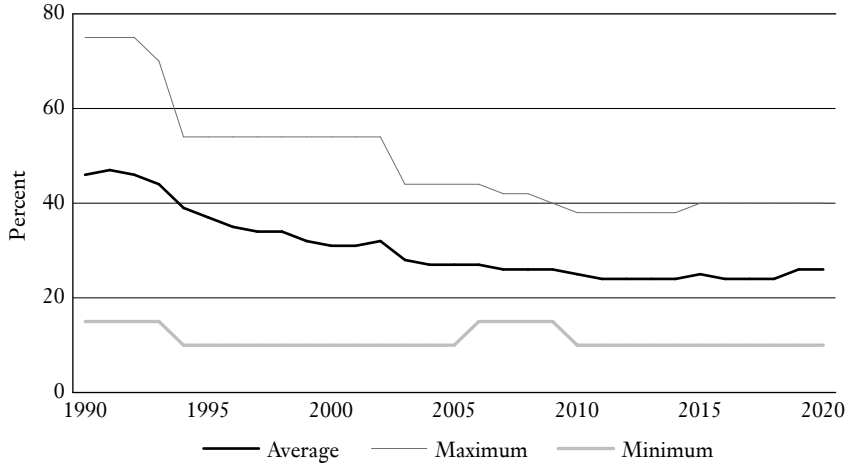
	2020						Early 2000s					
	Rates (percent)			Brackets (multiples of per capita GDP)			Rates (percent)			Brackets (multiples of per capita GDP)		
	Low	Top	Top/low	Exempt	Low	Top	Low	Top	Top/low	Exempt	Low	Top
Algeria	20.0	35.0	1.8	0.29	0.88	3.51	10.0	40.0	4.0	0.44	1.33	14.17
Djibouti	2.0	30.0	15.0	0.08	0.05	0.98	2.0	20.0	10.0	na	na	na
Egypt	2.5	25.0	10.0	0.41	0.93	13.10	10.0	20.0	2.0	0.56	2.23	4.45
Iran	10.0	25.0	2.5	0.77	1.92	3.84	10.0	35.0	3.5	2.83	4.01	28.27
Iraq	3.0	15.0	5.0	0.61	0.67	1.03	3.0	15.0	5.0	0.00	0.23	0.46
Jordan	5.0	30.0	6.0	2.96	4.60	328.87	5.0	25.0	5.0	0.00	1.09	7.62
Lebanon	2.0	25.0	12.5	0.80	1.45	25.54	4.0	21.0	5.3	1.12	0.90	17.98
Libya	5.0	10.0	2.0	0.45	0.45	3.44	8.0	15.0	1.9	0.11	0.44	0.88
Mauritania	15.0	40.0	2.7	0.00	0.13	0.30	5.0	33.0	6.6	7.23	21.68	72.25
Morocco	10.0	38.0	3.8	0.95	1.58	5.68	13.0	44.0	3.4	0.97	1.17	2.92
Tunisia	26.0	35.0	1.3	0.49	1.94	4.86	15.0	35.0	2.3	0.48	3.18	15.88
Yemen	10.0	15.0	1.5	0.23	0.47	0.47	10.0	20.0	2.0	0.40	0.79	2.77
Average	9.2	26.9	5.3	0.67	1.26	32.63	7.9	26.9	4.2	1.28	3.37	15.24

MENA = Middle East and North Africa; PIT = personal income tax; GDP = gross domestic product; na = not available.

Note: Early 2000s: 2000 for Yemen and Lebanon; 2001 for Algeria; 2006 for Egypt, Iran, Jordan, Mauritania, and Morocco; and 2012 for Yemen.

Sources: International Monetary Fund (www.imf.org); International Bureau of Fiscal Documentation (www.ibfd.org); countries' tax laws; and authors' calculations.

FIGURE 1 Evolution of Top PIT Rates in MENA Countries, 1990-2020



PIT = personal income tax; MENA = Middle East and North Africa.

Sources: International Monetary Fund (www.imf.org); International Bureau of Fiscal Documentation (www.ibfd.org); and countries' tax laws.

Income from Wages and Salaries

All MENA countries apply the progressive tax rate structures to wage income, except GCC countries, where wages are not taxed. Generally, "wage income" is defined broadly and includes full-time and part-time remuneration and benefits, monetary or in-kind. However, there are significant exemptions, which reduce the tax base, create distortions in labour markets, and open tax-avoidance opportunities. The rules are complex and country-specific, and it would be impractical to recount them all here. Exemptions include the following: subsidized employment income, income earned in specified geographical areas, pension income, income from public sector employment, in-kind benefits, and income from exercising certain professions (such as teaching). Some of these exemptions are partial, in that only a portion of income is exempt (for example, pension income and public sector wages), or the exemptions apply only to certain subcategories (such as in-kind benefits).

MENA countries use different types of PAYE regimes to collect tax on wages and salaries. Most MENA countries (including Algeria, Djibouti, Lebanon, and Iraq) use a simple calculation method whereby employers withhold taxes on wages on a monthly basis, with no adjustments for wage changes in the taxable year. Some MENA countries (including Egypt, Iran, and Libya) combine monthly withholding with a requirement that employers calculate withholding for the year on a cumulative basis and adjust withholding amounts for each employee.

Countries also differ on requiring individuals who receive wages and salaries to file annual tax returns. Several MENA countries (including Algeria, Iran, Iraq, Jordan, and

Electronic copy available at: https://ssrn.com/abstract=4402261

Lebanon) require employees to file income tax returns. In contrast, other countries (including Djibouti, Libya, Mauritania, Morocco, and Tunisia) exempt employees from filing tax returns if they do not have an additional job or substantial non-wage income.

Business and Professional Income of the Self-Employed

Most MENA countries include income from unincorporated businesses with wage income and tax the consolidated income at progressive tax rates. However, there are exceptions. Djibouti and Mauritania apply a flat rate on income from professional and other business activities, which is set at the CIT rate. Iran, Lebanon, Sudan, and Yemen apply progressive rates and brackets on such income that differ from the rates applied to wage income. The first group of countries are therefore close to a pure dual income tax system, effectively taxing business income at a single rate, lower than the top marginal tax rate on labour income, and without regard to the form of the legal entity earning the income. Countries in the second group are closer to having a purely schedular income tax system, where each source of income is taxed under its own schedule and rules for the calculation of the tax base.

In GCC countries, Oman, Qatar, and Saudi Arabia extend their corporate income taxes to business income earned by unincorporated businesses, but only to the extent that such businesses are owned by non-GCC nationals. In these countries, the absence of an income tax on wages and the non-taxation of non-wage income of nationals remain important sources of distortion and revenue potential, and are likely to shape the design of future tax systems.[43]

Passive Income from Capital

MENA PIT systems vary greatly in the taxation of various types of capital income (especially dividends and capital gains) (see table 4). The tax rules, which are relatively complex, attempt to direct investment to specific use and/or time horizons. These take the form of outright exemptions or low rates and include the following: exemption of interest income on time-bound savings accounts and government bonds; exemption or reduced rates on dividends paid by certain companies (on the basis of their activities), including holding companies through which exempt profits are channelled; and exemption or lower rates on capital gains from the sale of certain types of movable (such as listed shares) or immovable properties (such as real estate

43 We exclude *zakat* (Islamic almsgiving), which in some countries is levied by the tax authority on national residents. The most established *zakat* can be found in Saudi Arabia. It applies to nationals of Saudi Arabia and GCC countries resident in Saudi Arabia. It is calculated at a rate of 2.5 percent of the lower of net assets (computed using balance sheet data) and net business income, and irrespective of the legal form of the entity holding the assets or earning income. It is likely that *zakat* often applies to income; given its low rate, its revenue impact and effect on the overall progressivity of the tax system are limited. *Zakat* is likely very progressive since the revenue is entirely earmarked for transfers to the poor.

Electronic copy available at: https://ssrn.com/abstract=4402261

TABLE 4 MENA Countries, Tax Rates on Income from Capital, 2020

			Capital gains[b]	
	Interest income	Dividend income[a]	Movable property	Immovable property
Algeria	10%	15%	PIT	Exempt
Djibouti	Exempt	5%	Exempt	5%
Egypt[c]	Exempt	5%	Exempt	Exempt
Iran	Exempt	Exempt	Exempt	Exempt
Iraq	PIT	Exempt	Exempt	PIT
Jordan	5%	Exempt	Exempt	Exempt
Lebanon[d]	10%	10%	15%	Exempt
Libya	5%	Exempt	Exempt	Exempt
Mauritania	10%	10%	25%	10%
Morocco	20%	15%	15%	20%
Sudan	PIT	Exempt	2%	2%
Tunisia	PIT	10%	10%	15%
Yemen	Exempt	Exempt	Exempt	Exempt

MENA = Middle East and North Africa; PIT = personal income tax.

Notes: Positive rates are the most common rates in 2020. Standard or maximum rates are often inapplicable given the prevalence of exceptions and exemptions. "PIT" indicates that the income is included in the PIT tax base and taxed at its progressive rate structure.

a Since dividends are paid out of taxable corporate profits (except where such profits are exempt or taxed lightly), the dividend income tax rate at the individual level is another tax on the return to equity shares and should, in principle, be lower than the rate on interest income to ensure ultimate neutrality in the taxation of debt and equity.

b Rates abstract from the fact that capital gains may be taxed at the corporate level as part of corporate profits.

c Interest on government bonds is taxed at 20 percent withholding. Capital gains from listed companies have been suspended since their introduction and until December 2021, with no details as to how they will apply afterward.

d Dividends from holding companies and offshore companies are exempt, which means that reported rates here are often inapplicable.

Sources: International Bureau of Fiscal Documentation (www.ibfd.org); and authors' calculations.

used in a business). While other countries (especially developing countries) provide favourable tax treatment for different types of passive income, the extent of the favourable treatment in most MENA countries makes it relatively easy to avoid capital income taxation.

The implications of light (or no) taxation of capital income for revenue mobilization and reducing income inequality could be profound. With regard to the former goal, as we will discuss later, the revenues from these income sources are negligible in most countries. With regard to the latter goal, there is limited potential to increase the progressivity of individual income taxation without significantly reforming the taxation of capital income. For instance, changing the taxable income brackets and

Electronic copy available at: https://ssrn.com/abstract=4402261

rates that apply to wages and business income is likely to weigh more heavily on wage income, both directly and indirectly through the incidence of the business income tax, and would encourage taxpayers to structure their affairs to have income taxed at lower rates. This will negatively impact the allocation of the productive resources of MENA economies.

Payroll and Social Security Contributions

The analysis of PITs would be incomplete without an examination of other levies on payroll, of which SSCs are the most important. SSCs are levied on a withholding basis on employers and employees in all MENA countries, including GCC countries, where wages are not taxed under a PIT. These levies fund various types of social spending, including pension and old age income, health services, and unemployment benefits. The rates vary substantially, from 8 percent in Bahrain to 35 percent in Algeria (total rate for employers and employees). Other payroll taxes are applied in few countries, and the rates do not exceed 2 percent of gross wages. Generally, payroll levies in the region have a weak link to benefits received and the respective revenues are paid directly into off-budget funds (that is, they do not show up in government revenue and spending budget reports).

In advanced economies, SSCs are a substantial source of revenue, and their contribution to total tax revenue exceeds that of the PIT in most advanced economies, particularly in the European Union. But the policy interest in SSCs goes beyond revenue, because they raise equity and efficiency considerations. The economic literature on the topic is well developed.[44] A key finding is that differential consumption taxes have no extra redistributive benefit beyond a progressive income tax (including SSCs). This result is important for the region, and particularly for GCC countries, where some members have already implemented a single-rate VAT, and some are contemplating widening the application of their income taxes, which are currently limited to profits. In weighing revenue, efficiency, and equity considerations, which are clearly country-specific, the literature points to a substantial role for income tax design, including SSCs.

The Revenue Contribution of PITs

MENA countries vary greatly in the importance of PIT revenues in funding government operations. As set forth in table 5, in some countries (Algeria, Morocco, and Tunisia) the PIT generates substantial revenue (as a percentage of GDP), while in most other countries the PIT raises relatively little revenue.[45] There is also great variation

44 See, for instance, the comprehensive review in Thomas Piketty and Emmanuel Saez, "Optimal Labor Income Taxation," in Alan J. Auerbach, Raj Chetty, Martin Feldstein, and Emmanuel Saez, eds., *Handbook of Public Economics*, vol. 5 (Amsterdam: North Holland, 2013), 391-474.

45 Throughout the paper, we use the dataset produced in Mansour, supra note 3, plus updates. These data are entirely based on information in IMF staff reports, with the distinct attribute that they separate oil revenue (including CIT on companies in extractive industries) from other taxes and non-tax revenues.

Electronic copy available at: https://ssrn.com/abstract=4402261

TABLE 5 The Size of PIT Revenues in MENA Countries

	Percentage of GDP	Percentage of tax revenue
Oil-importing countries		
Djibouti[a]	2.4	20.0
Egypt	2.0	13.1
Jordan	1.2	20.4
Lebanon[a]	1.0	6.9
Mauritania	1.5	11.9
Morocco	3.9	18.1
Tunisia	4.3	17.8
Oil-exporting countries		
Algeria	4.2	30.7
Iran	1.1	17.0
Iraq[a]	0.3	16.1
Libya[a]	…	…
Yemen[a]	1.2	46.9

PIT = personal income tax; MENA = Middle East and North Africa; GDP = gross domestic product.

Note: Figures are simple averages over 2018-2020, and exclude social security contributions and *zakat* (Islamic almsgiving).

a Fragile or conflict state.
… Insignificant.

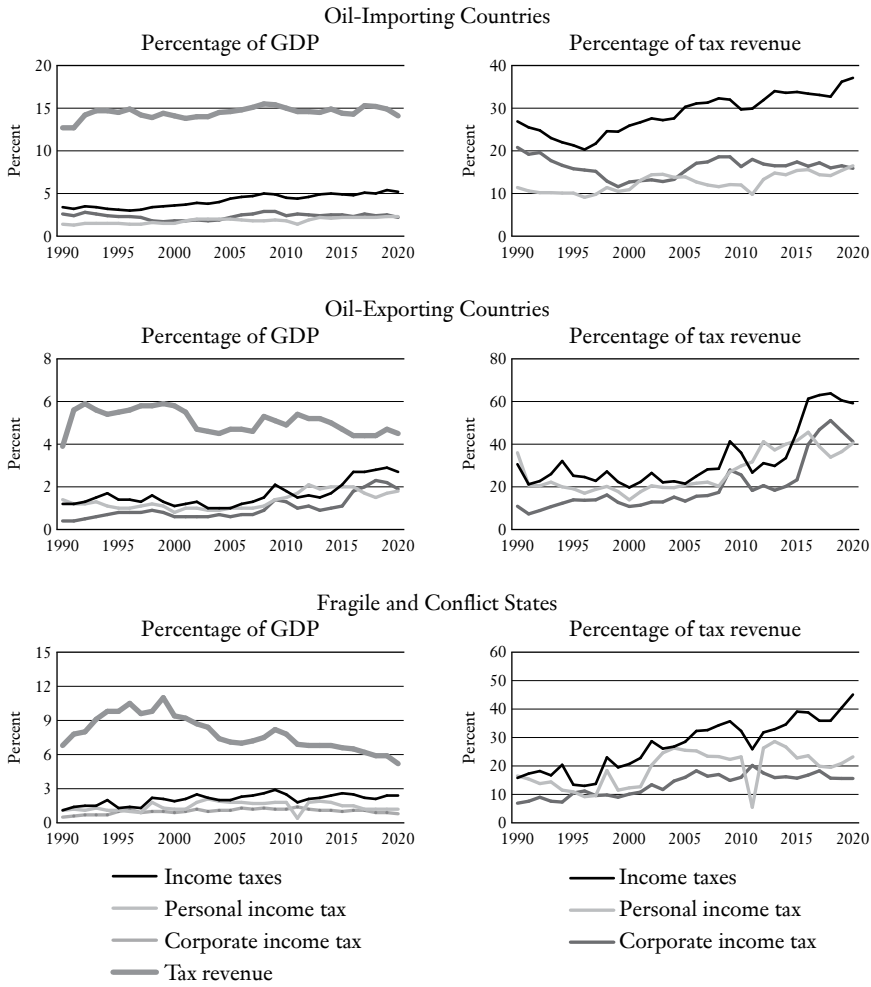
Sources: Mario Mansour, *Tax Policy in MENA Countries: Looking Back and Forward*, IMF Working Paper WP/15/98 (Washington, DC: International Monetary Fund, 2015) and update; and authors' calculations.

in the role played by the PIT in its contribution to total tax revenue, ranging from about 7 percent in Lebanon to 47 percent in Yemen.

Figure 2 shows the evolution of the revenue contribution of the PIT since 1990, in the three country groups outlined in the introduction: oil-importing countries, oil-exporting countries, and FCSs. Oil-importing countries all have well-established PIT regimes and tax administrations, and their PIT revenues are not disproportionately affected by withholding on public sector wages, which tend to be very high in oil-exporting countries. On average, the PIT yield in this group has increased from about 1.3 percent of GDP in the early 2000s to about 2.2 percent in 2020, and the share of the PIT in total tax revenue increased as well, from about 10 percent to 14 percent. At face value, this is a significant development. A closer look at the data suggests that this increase is largely attributable to Morocco and Tunisia. In Tunisia, the basic allowance (expressed as a percentage of per capita GDP) declined tenfold, and the low tax rate nearly doubled. In Morocco, there were no significant changes to the tax structure at the low end of the income distribution. In fact, the low rate declined from 13 percent to 10 percent, and the exempt threshold remained constant in terms of per capita GDP (suggesting that it has been indexed to inflation). Moreover,

Electronic copy available at: https://ssrn.com/abstract=4402261

FIGURE 2 Contribution of Income Taxes to Tax Revenues in MENA Countries



MENA = Middle East and North Africa; GDP = gross domestic product.

Sources: Mario Mansour, *Tax Policy in MENA Countries: Looking Back and Forward*, IMF Working Paper WP/15/98 (Washington, DC: International Monetary Fund, 2015) and update; and authors' calculations.

the top rate was lowered from 44 percent to 38 percent. These two countries are examples of how the reasons for revenue performance can differ significantly.

The revenue contribution of the PIT can also be examined together with that of the CIT and other taxes on income that cannot be attributed to either the PIT or the CIT. Empirical evidence suggests that low CIT rates, relative to top PIT rates (which has been the case in the MENA region), create incentives to incorporate, especially

Electronic copy available at: https://ssrn.com/abstract=4402261

for those individuals whose income can be earned as a business activity.[46] These incentives are stronger when dividends and capital gains (and other forms of payments to shareholders) are lightly taxed. This makes it difficult to disentangle changes in revenue performance of PITs and CITs. Figure 2 also shows the revenue yield of the CIT and all income taxes. For oil-importing countries, where the PIT matters most, there was no significant increase in the CIT, which suggests that the overall increase in income taxes was due to other factors, most likely higher revenue collected from non-wage income—that is, passive capital income and active business income. Indeed, the component of revenue that is not attributable to either the PIT or the CIT grew by 1 percentage point of GDP between 1990 and 2000.

In oil-exporting countries, the PIT as a percentage of GDP increased from 1.5 percent to 3 percent between 1990 and 2000. The reason for this increase differs from the oil-importing countries, as it is largely attributable to Algeria, and to a lesser extent Iran, two countries where public sector wages (including wages from state-owned enterprises) form a significant share of the PIT tax base.

Finally, in FCSs,[47] data coverage is low for the 1990s. Taking 2000 instead as the base year shows that the contribution of the PIT has increased from 1 percent of GDP in 2000 to about 1.5 percent in 2020, and that almost all this increase is attributable to Djibouti, where the nature of state fragility is different from that of other countries in this group—political instability is less acute than in, say, Libya or Iraq, but the country hosts a large number of foreign military bases, arguably with some (indirect) impact on the income tax base.

In summary, the PIT plays a significant role in the tax system in only a few oil-importing countries in North Africa, where this role has also improved over the past two decades. In oil-exporting countries (other than FCSs), the revenue contribution of the PIT reflects in large part the use of the oil rent to provide public sector (and quasi-public sector) employment and wages. In FCSs, the PIT plays a small revenue role, generally representing less than 1 percent of GDP, except in Djibouti, and this role has been unchanged in the past two decades.

Determinants of the Revenue Performance of the PIT

An important question is whether the performance of the PIT since the early 1990s is due to policy measures, or to (largely exogenous) economic factors. We can attempt to answer this question by using the standard empirical literature on the determinants of the tax-to-GDP ratio described above, under the heading "Policy Design Considerations for MENA Countries," or by regressing the PIT-to-GDP ratio against a set of variables. We opt to focus on standard economic determinants in the literature, including the natural log of per capita GDP (as a change in living standards), the share

46 See, for instance, Ruud A. de Mooij and Gaëtan Nicodème, "Corporate Tax Policy and Incorporation in the EU" (2008) 15:4 *International Tax and Public Finance* 478-98.

47 The group of fragile states includes Djibouti, Iraq, Lebanon, Libya, and Yemen.

Electronic copy available at: https://ssrn.com/abstract=4402261

of the primary sector in GDP (as a proxy for the difficult-to-tax share of GDP), the share of self-employment in total employment (as modelled by the International Labour Organization), the public wage bill as a percentage of GDP, and inflation as measured by the consumer price index. In terms of tax policy variables, we include the PIT-exempt threshold, the top tax brackets (as multiples of per capita GDP), the low and top tax rates, and the interaction between the exempt threshold and the lowest positive rate. Other control variables include CIT revenue-to-GDP, and dummies for SSC deductions, oil exporters, and FCSs.[48]

The results[49] show that tax policy variables are uncorrelated with PIT-to-GDP revenues, except for the top PIT tax rate, which is positively correlated—an increase of 1 point in the top tax rate is associated with an increase in the average revenue-to-GDP of about 10 to 15 percent, or 0.02 to 0.05 percentage points of GDP. In contrast, the key economic variables are strongly correlated with the ratio of PIT to GDP, with the right expected sign, except for the share of the primary sector in GDP, which is positive but weakly significant.[50]

An interesting (and expected) result is the strong and positive correlation of the public sector wage bill with PIT revenues, with a coefficient of 0.42 in the preferred specification—that is, an increase in the wage-bill-to-GDP ratio of 1 percentage point is associated with an increase in the PIT-to-GDP ratio of 0.42 percentage points. This coefficient represents both the PIT and SSC effect, as well as bracket creep—that is, as their wages increase, government employees are pushed into higher tax brackets as a result of a lack of bracket indexation in most countries. We can illustrate this interaction by focusing on Algeria, Morocco, and Tunisia as examples:

- *Algeria.* Public sector wages increased from 6.8 percent of GDP in 2000 to 10.6 percent of GDP in 2018, which translates into 1.6 percentage points in the PIT-to-GDP ratio (that is, 3.8×0.42). During the same period, the PIT-to-GDP ratio increased from 0.85 percent to 4.5 percent. This means that 43 percent of the increase in the PIT-to-GDP ratio is associated with the increase in the public sector wage bill.
- *Tunisia.* Public sector wages increased from 11 percent of GDP in 2000 to 14 percent of GDP in 2018, which translates into 1.25 percentage points in the PIT-to-GDP ratio (that is, 3×0.42). During the same period, the PIT-to-GDP ratio increased from 3 percent to 4.75 percent. This means that about 70 percent of the increase in the PIT-to-GDP ratio is associated with the increase in

48 The statistical approach is described in Benedek et al., supra note 26. We ran the regressions over 1990-2020 and 2000-2020, with the latter period having fewer missing data; the results are nearly identical.

49 Available upon request from the authors.

50 The share of value added by agriculture is negligible in GCC countries and varies between 5 percent and 15 percent in North African and eastern Mediterranean countries. We do not have an explanation for the correlation of this variable with PIT revenue.

Electronic copy available at: https://ssrn.com/abstract=4402261

the public sector wage bill. This should be interpreted as an upper bound, as (unlike in Algeria) other direct tax revenue, which cannot be easily attributed to individuals and corporations, also increased in Tunisia, from about 0.7 percent to 3.3 percent of GDP.

- *Morocco.* In contrast to the previous two examples, the public sector wage bill in Morocco remained stable between 2000 and 2018, at slightly over 11 percent of GDP (with some fluctuation in between). Yet the PIT-to-GDP ratio increased from 2.9 percent to 3.9 percent of GDP.

These results and examples highlight the importance of understanding the underlying factors affecting PIT revenues, and their interpretation in light of both the nature of the contribution of the PIT to tax revenue and the overall progressivity of the tax and spending system—an issue we now turn to.

Are PITs in the MENA Region Progressive?

A PIT is progressive if the average tax rate increases with incomes.[51] Measures of progressivity can be "statutory" or "effective." Statutory progressivity is dictated by what policy prescribes in law. It is useful as ex ante analysis of how policy choices affect economic outcomes and incentives, especially how real decisions (for example, participation in the labour market) and non-real behaviour (such as hiding income without changing one's employment or business situation) of individuals are likely to respond to policy. Comparison of statutory progressivity across countries is often analyzed using a common income distribution, such as multiples of per capita GDP or income denominated in one currency. This ensures that progressivity measures reflect only the impact of the tax factor.[52]

Effective progressivity, in contrast, reflects the impact of all factors that affect tax revenue, including the interplay between tax rates and tax brackets and income distributions.[53] It requires administrative data (often from tax returns) and large samples of income distributions—which can be either specific to the country and represent its own income patterns, or representative of a group of countries. Effective progressivity is useful for the analysis of how PIT systems affect the actual distribution

51 We include in the analysis PIT and SSCs, but exclude other taxes and spending policies, which also affect levels of progressivity. Spending policies are particularly important in certain settings; see, for instance, in the case of Chile, Eduardo Engel, Alexander Galetovic, and Claudio Raddatz, "Taxes and Income Distribution in Chile: Some Unpleasant Redistributive Arithmetic" (1999) 59:1 *Journal of Development Economics* 155-92.

52 Using a common currency for such comparisons is preferable, since GDP itself can be somewhat affected by income taxes—although the correlation is likely very low, compared to using wage or personal income distributions.

53 To the extent that income distributions may be affected by compliance behaviour, such behaviour also has an impact on effective tax rates.

Electronic copy available at: https://ssrn.com/abstract=4402261

of pre-tax incomes, which in a dynamic setting are themselves dependent on taxes. Vellutini and Benítez and Gerber et al. provide a summary of the literature of various measures of statutory and effective progressivity, as well as their uses.[54]

Statutory Progressivity

Figure 3 shows the statutory average tax rates (SATRs) in MENA countries, with and without employee-paid SSCs (SSCe), for 2020 and early 2000.[55] The figures are representative of tax rates applicable primarily to labour income—capital income is often taxed at flat rates, depending on its type. For comparability across countries, the rates are estimated for all countries over incomes ranging from US$0 to US$100,000, in increments of US$50.[56]

Consistent with the discussion earlier, PIT systems are progressive in a statutory sense. This progressivity is steep at the low end of the income schedule and then rises gently starting at income levels around US$10,000 (2.7 times average per capita GDP in 2020), with the SATR reaching a maximum of about 23 percent at income levels above US$100,000. Compared to the early 2000s, the SATR curve (excluding SSCe) shifted upward in 2020 by 5 percentage points and is steeper at income levels below US$10,000. Two key factors explain these changes: (1) the increase in the low PIT rate from 7.9 percent to 9.3 percent, and (2) the reduction in the exempt threshold by 0.4 percentage points of per capita GDP. To the extent that countries raise more revenue from lower tax rates (which affect all taxpayers), these changes could explain in part why PIT revenues have remained constant on average since the early 2000s—especially since capital income is largely untaxed.

Adding SSCe[57] to standard PIT rates has a dramatic effect on both the slope and the level of the SATR curve. Because most countries have ceilings on salaries subject to SSCe,[58] the curve is steeper at low income levels and exhibits discontinuities around the average level of the ceiling. The incentive implications of tax rates exceeding 17 percent at very low income levels (essentially, from the first US dollar earned to

54 Charles Vellutini and Juan Carlos Benítez, *Measuring the Redistributive Capacity of Tax Policies*, IMF Working Paper WP/21/252 (Washington, DC: International Monetary Fund, 2021); and Gerber et al., supra note 41.

55 Owing to a lack of data, the figures for 2000 are based on tax rates, thresholds, and SSCs for years selected from 2000 to 2012. Figures for 2020 are all based on 2020 tax policy parameters. Figures show average tax rates applicable to labour and business income (for countries where the same schedule applies). Capital income taxes are excluded since they apply at flat rates in most countries.

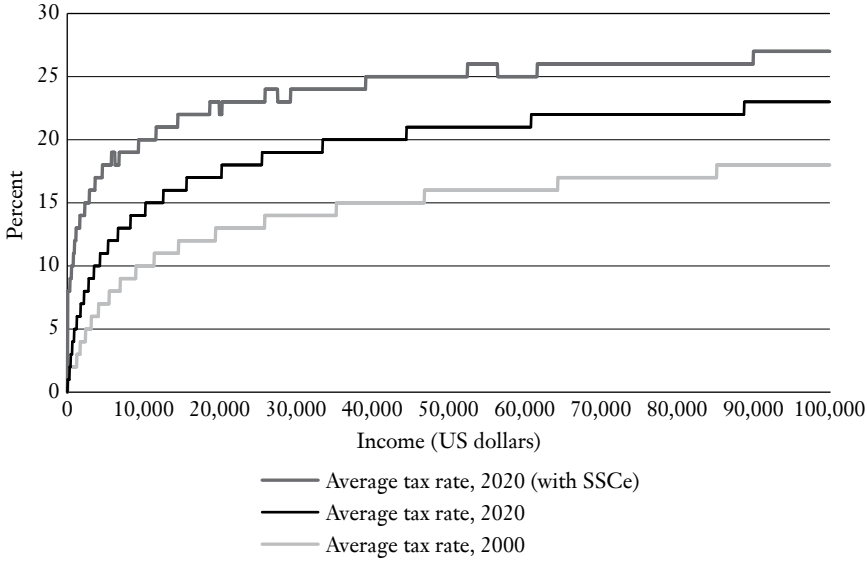
56 This implies incomes ranging from 45 to more than 720 times per capita GDP.

57 We do not include in the analysis SSCs paid by employers, which are relevant for the total cost of labour, but less so (but not entirely) for individuals' post-tax income.

58 Only Egypt has a floor wage above which SSCs apply (in addition to a ceiling), but it is very low at 0.6 times the exempt PIT threshold. Several countries have ceilings, however, with an average of about 5.5 times per capita GDP.

Electronic copy available at: https://ssrn.com/abstract=4402261

FIGURE 3 Statutory Average Tax Rates in MENA Countries



MENA = Middle East and North Africa; SSCe = employee-paid social security contributions.

around US$4,000 or, roughly, average per capita GDP) are arguably profound and could explain in part the low labour participation rates observed in the MENA region.[59]

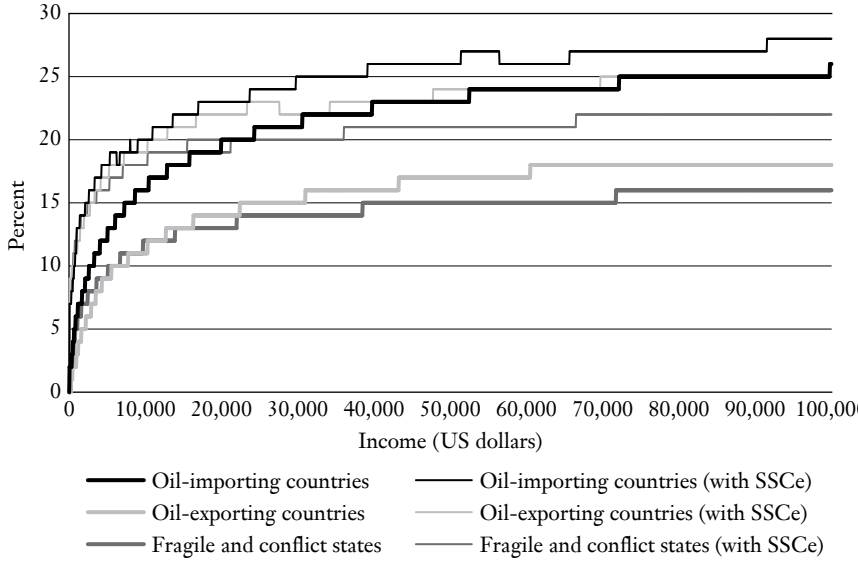
Figure 4 shows the same distribution of SATRs for oil-importing countries, oil-exporting countries, and FCSs for 2020 only (all FCSs except Lebanon are oil exporters). The primary observation is that steep progressivity at low income levels is present in all these country groups, but the level of the SATR at higher incomes is higher in oil-importing countries. Moreover, SSCe have much less of an effect on the SATR in this group of countries, relative to the other two—perhaps an indication that oil producers and FCSs view more the regular PIT and SSCe as substitutes.

Comparative group analysis masks differences across countries, which we illustrate in figure 5 with three countries: Morocco, where the PIT plays a substantive revenue role; Libya, a fragile state where PIT revenues are negligible; and Jordan, where both economic conditions and tax administration capacity give it a meaningful PIT, but whose PIT revenue yield is low relative to other comparable countries. The PIT in Morocco (excluding SSCe) is progressive at relatively low income levels, and top rates are comparable to those in advanced economies. The tax also provides for an exempt threshold roughly equal to per capita GDP (higher than the threshold in all MENA

59 The labour force participation rate in MENA (excluding GCC countries) was 49 percent in 2019, compared to a world average of 67 percent.

Electronic copy available at: https://ssrn.com/abstract=4402261

FIGURE 4 Statutory Average Tax Rates in MENA Countries, by Country Group



MENA = Middle East and North Africa; SSCe = employee-paid social security contributions.

countries except Jordan), ensuring that individuals with average incomes pay little tax. In contrast, Jordan has a much higher exemption threshold (at 3 times per capita GDP), which exempts potentially a large share of the population from income tax, and its top tax rate bracket stands at nearly 330 times per capita GDP.[60] These design features of the PIT in Jordan explain its low revenue yield. The Libyan SATR curve is even flatter and lower, a direct result of its low top rate of 10 percent.

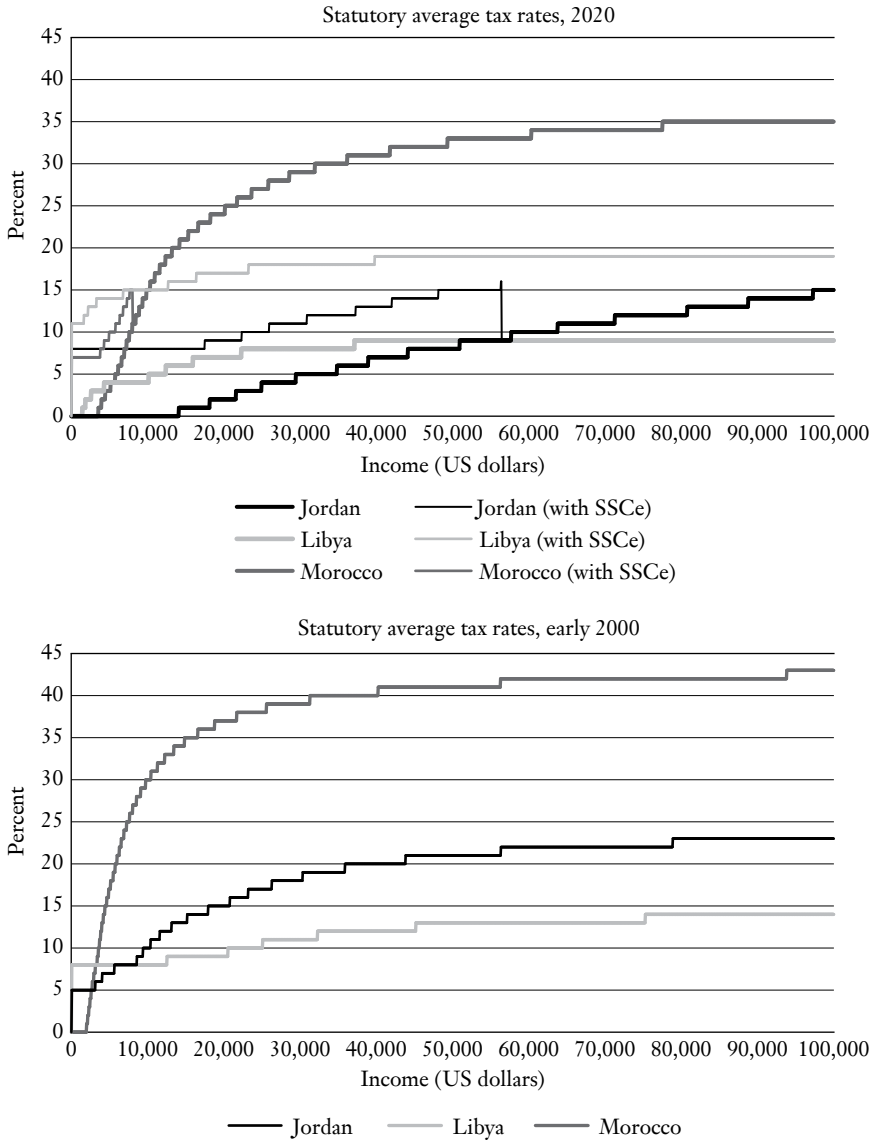
Changes in marginal tax rates (that is, the progression of SATRs) in Morocco, Libya, and Jordan also provide an interesting lesson. In Morocco, marginal tax rates have declined relative to the early 2000s, yet revenue performance has held up. This is the virtuous cycle referred to earlier, where tax design benefits from economic growth and vice versa, allowing countries over time to reduce marginal tax rates while preserving or even increasing revenue and improving compliance.

Finally, it is interesting to note that including SSCe in the SATRs significantly changes the shape of the curves for Jordan (which caps SSCe at very high incomes) and Libya (which has no cap on SSCe), while SSCe in Morocco are capped at 2.4 times per capita GDP—roughly the start of the income bracket taxed at 34 percent.

60 This is a good example of why changing the top tax rate is unlikely to improve progressivity. For an empirical study of the US PIT, see William G. Gale, Melissa S. Kearney, and Peter R. Orszag, "Would a Significant Increase in the Top Income Tax Rate Substantially Alter Income Inequality?" (September 2015) *Economic Studies at Brookings* 1-4.

Electronic copy available at: https://ssrn.com/abstract=4402261

FIGURE 5 Statutory Average Tax Rates in Libya, Jordan, and Morocco



SSCe = employee-paid social security contributions.

Electronic copy available at: https://ssrn.com/abstract=4402261

Effective Progressivity

Effective progressivity is achieved when effective average tax rates (EATRs) increase with income levels. It is challenging to measure effective progressivity because it requires information on actual pre-tax and post-tax income distributions—reflecting all sources of individual income, from labour, capital, and inheritances. The most common method to estimate EATRs uses tax-return (administrative) data, which contain pre-tax income and all the tax rules affecting the passage from pre-tax to post-tax incomes.[61] A drawback of this measure is that it renders comparisons across countries difficult—because it depends on country income distribution, progressivity can be achieved in different ways. This explains why actual income distributions are the most appropriate to calibrate PITs, to properly reflect country realities and policy choices.

An alternative method to estimate EATRs combines country tax parameters with a representative distribution of pre-tax income. This "transplant-and-compare" method[62] allows for the calculation of a progressivity index, which reflects primarily the shape of the SATR curves estimated above as it applies to plausible pre-tax income distributions. It also allows for the estimation of a redistribution index, which accounts for the revenue importance of the PIT—measured as PIT revenue per taxpayer divided by per capita GDP. The intuition is that a PIT that yields very little revenue, even if it is progressive in law, is unlikely to have a significant redistributive role (see, for example, Libya, Jordan, and Yemen).

Verdier et al.[63] use this method with results broadly consistent with the results reported above. In particular, PITs in most MENA countries, including in some fragile states (such as Lebanon and Iraq), are progressive, but their redistributive capacity is small, owing to the small revenue contribution of the PIT—with Morocco, Tunisia, and Mauritania being exceptions. One caveat of this method is that it does not account for the sources of PIT revenues—a PIT whose revenues over the past two decades come primarily from higher government wages can have the same redistributive capacity of a PIT whose revenues come from private wages. This caveat is relevant in the context of weak administrative capacity, because governments can simply increase PIT revenues by increasing the public sector wage expense.

61 Tax policy affects pre-tax income because taxes change behaviour, which affects both the level of income earned and how it is earned.

62 See Vellutini and Benítez, supra note 54, for a detailed description and application of a simplified "transplant-and-compare" method to a large sample of countries. They examine some of the limitations of this method, including compliance issues that affect the revenue contribution of the PIT (especially the challenges in taxing non-wage incomes of higher-income individuals, including passive capital income and active business income). This makes the approach more useful in examining the progressivity of labour income taxation.

63 Supra note 3.

Electronic copy available at: https://ssrn.com/abstract=4402261

WHERE NEXT FOR PITs IN MENA COUNTRIES?

The analysis above has shown that PITs in MENA countries differ significantly in terms of their revenue contribution and progressivity, and hence in their effective redistributive capacity. Generalized "one-size-fits-all" policy options are therefore unlikely to be useful or successful. Policy options will differ depending on a country's relative weighting of PIT objectives (revenue, efficiency, equity, and state building) and administrative capacity, and will reflect a country's history and current position and the ability of its political institutions to adopt tax and spending policies that facilitate inclusive economic growth. It is also important to make personal income tax reform more prominent in the political debate on fiscal policy, and there has been progress over the past decade.[64]

Competing PIT Objectives

Where one goes often depends on where one starts. The current role played by the PIT strongly influences PIT options. It is also important to consider PIT options in the context of a country's existing tax regime. For example, developed countries and some developing countries (including some MENA countries) had a PIT in place before they adopted a VAT. This provided an opportunity to address potential VAT regressivity concerns by changing the PIT. In contrast, several MENA countries have adopted VATs without having an existing PIT.

As set forth above, under the heading "Policy Design Considerations for MENA Countries," countries can use the PIT to achieve different objectives, including raising revenue, reducing income inequality, and state building. The exercise below reviews the PIT design choices if a country adopts just one objective as the primary goal. It then examines areas where the design choices may overlap or conflict. Table 6 matches PIT policy objectives with four PIT design elements.

If a country's primary goal were to raise revenue, the basic PIT design would include broad coverage of both persons and types of income subject to tax. Countries can increase the proportion of the population subject to income tax by adopting a zero or relatively low PIT threshold. Income subject to tax would include income from capital and foreign-source income.

In terms of tax rates, Diamond and Saez provide a useful framework for a country's choice of a revenue-maximizing top tax rate.[65] This is the tax rate that maximizes revenue from top-bracket taxpayers. Determining the revenue-maximizing rate requires balancing the deadweight burden of higher tax rates against the increased revenue. The challenge is determining the tax elasticities of the top-income taxpayers. The elasticity depends on both real and economic responses as well as the availability of

64 Mick Moore, "Taxation and the Political Agenda, North and South" (2004) 31:1 *Forum for Development Studies* 7-32.

65 Peter Diamond and Emmanuel Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations" (2011) 25:4 *Journal of Economic Perspectives* 165-90.

Electronic copy available at: https://ssrn.com/abstract=4402261

TABLE 6 PIT Objectives and Policy Choices

Objective	Tax threshold	Types of income subject to tax	Top marginal rates	Investment in tax capacity
Maximizing revenue	Zero or low, subject to administrative constraints	Broad coverage, subject to compliance constraints	Revenue-maximizing rate	Substantial, depending on time frame
Reducing income inequality	Relatively high to exempt low-income individuals	Broad coverage, subject to compliance constraints	Relatively high	Substantial
State building	Low, to maximize taxpayer-citizen overlap	Broad coverage, subject to compliance constraints	Relatively high, but lower than the revenue-maximizing rate	Substantial

PIT = personal income tax.

tax-avoidance and tax-evasion opportunities. An important insight for PIT design is that where the opportunities for tax avoidance and evasion are great, the optimal tax rate would be lower.

Countries seeking to maximize revenue would make investments in tax capacity to improve enforcement and compliance. These could include adopting or improving reporting and withholding regimes as well as facilitating electronic or "return-free filing" and improving audit and collection capabilities. Policy makers' time horizons play an important role because revenue-maximizing strategies (particularly investment in tax capacity) may differ depending on short-term and long-term revenue objectives.

Countries seeking to use the PIT primarily for redistribution purposes would opt for progressive tax rates (but not necessarily higher marginal tax rates) and a relatively high PIT threshold. Choosing a top marginal rate requires balancing the equity gains from higher taxes on high-income individuals and the efficiency losses from changing work and investment decisions.[66] A relatively high tax threshold would reduce or eliminate the income tax burden on low-income individuals. Effective taxation of high-income individuals requires a broad tax base that includes income

66 In their efforts to reduce income inequality, many developed countries use tax subsidies to increase investment in human capital and to encourage low-income workers to work more. While in the early years of a PIT, having a high exempt threshold may be the most effective means of not taxing low-income workers, in later years, countries can consider using the tax system to subsidize low-income workers.

Electronic copy available at: https://ssrn.com/abstract=4402261

from capital and foreign-source income as well as effective taxation of sole proprietorships and partnership income (either in the PIT or included in a business enterprise tax covering business income from corporate and non-corporate entities).

It is important not to focus solely on the tax system (or the progressivity of a single tax instrument) in using fiscal policy to reduce inequality. Spending programs can be more effective in reducing inequality than taxes. For many developed countries with effective social spending programs, it likely makes sense to have less progressive (or regressive) taxes fund progressive spending programs.[67] This is the case, for instance, in GCC countries, where tax revenue is likely to remain small for the foreseeable future.

If countries want to use the tax system to improve government transparency and accountability, it is desirable to increase coverage of the PIT to increase the overlap between taxpayers and voting citizens. Increased transparency of taxes and spending programs and a better understanding of the incidence of taxes and beneficiaries of spending programs will strengthen the fiscal component of the social contract.

MENA countries likely vary greatly in having the necessary preconditions for using the PIT to foster state building. The role of the PIT in improving government accountability and transparency works best in those countries where the social contract has evolved from political support in exchange for jobs or subsidies for food and petroleum to political support of taxes in exchange for well-designed social programs. In many countries, a key factor in improving the social contract is the growth in the size of the middle-income class who may be "willing" to pay more in taxes in exchange for more and better social programs that benefit taxpayers (either directly or indirectly for programs that taxpayers value).

Depending on its design features, a PIT has the potential to improve or weaken the social contract that facilitates state building. A PIT that taxes only workers in the formal sector and government employees will be much less effective than a PIT under which those at the top pay, or are perceived to pay, more in taxes (in both absolute and relative terms).

So where does this leave us in thinking about how the weighting of different objectives will influence PIT design choices? The major policy design differences among the objectives are in the choice of tax thresholds and the top marginal tax rates. The objectives of maximizing revenue and state building call for very low tax thresholds, while those emphasizing income redistribution favour high tax thresholds. In contrast, the objectives of redistributing income and state building call for relatively high top tax rates, while the choice of top rates for maximizing revenue may be lower depending on country-specific factors. The weighting of policy objectives has relatively little effect on other PIT policy choices. All policy objectives would call for broad coverage of types of income subject to tax and for making substantial investment in tax capacity.

67 Junko Kato, *Progressive Taxation and the Welfare State: Path Dependence and Policy Diffusion* (Cambridge, UK: Cambridge University Press, 2003).

Electronic copy available at: https://ssrn.com/abstract=4402261

Possible Approaches for Different Countries

Beyond the key policy parameters outlined above, countries can focus on four key decisions to consider in adopting or expanding a PIT regime:

1. *Whether to adopt a semi-comprehensive PIT or a dual income tax regime that applies different tax rates to income from labour and income from capital.* This decision is strongly influenced by choices made on taxing passive and active business income. It is useful to assess first where the income tax system stands along the spectrum, from comprehensive to dual tax.
2. *How to tax the active business income of sole proprietorships and partnerships.* The two primary options are to tax non-corporate business income under the PIT or to adopt a business profits tax that would apply to all business income without regard to organizational form.
3. *How to tax passive income, such as dividends, interest, rents, royalties, and certain types of capital gains.* Countries choosing to tax passive income have several options. Such income could be included in the individual's income tax base, similar to the treatment of labour income, and taxed at progressive rates. A second option applies a separate flat rate to certain types of passive income, which can be the same across all types or differ by type of capital income—calibrating the rate with the top PIT and CIT rates is key to effective design. Countries could require the individual receiving the income to pay tax directly, or they could collect taxes through withholding by the payer.
4. *The type of PAYE regime to apply to wages and salaries.* The simplest PAYE regime provides for final withholding by employers with few or no adjustments for personal circumstances or other income. At the other end of the continuum, the PAYE regime provides for provisional withholding and employees would still be required to file income tax returns. In the middle are PAYE regimes that allow employers to adjust for personal circumstances and provide for provisional withholding for those employees with substantial income from second jobs or other sources.

In all cases, countries should design tax laws that provide clear guidance to taxpayers and tax authorities about potential tax obligations under the PIT and adopt administrative regimes that make compliance and enforcement as simple and effective as possible.

The remaining part of this section suggests possible PIT design and policy choices for the country groups examined throughout the paper.

Oil-Exporting Countries with No PIT

This group of countries (GCC countries) has the most flexibility in PIT design, with political rather than administrative constraints playing a major role in making PIT design and policy choices. Policy alternatives for this group include mimicking a PIT without a PIT and adopting a starter PIT.

Electronic copy available at: https://ssrn.com/abstract=4402261

Mimic a PIT Without a PIT

This approach taxes personal income under tax instruments other than a PIT. Economists have long recognized that consumption taxes are akin to taxes on labour (a high correlation exists between income and consumption levels). Several GCC countries (Bahrain, Saudi Arabia, the United Arab Emirates, and Oman) have recently adopted VATs and excise taxes on alcoholic and sugar-sweetened drinks and tobacco. In addition, all GCC countries have adopted (or increased in the past decade) SSCs, which, to the extent that they are not tied to benefits, operate as a flat tax on labour income. The combination of SSCs and a VAT in GCC countries operates as a stealth personal income tax. It is difficult to speculate about the policy motivations of these countries to tax income in such a way, but it is likely that political considerations play a role.

GCC countries can also tax non-labour personal income without a PIT. One relatively easy way to accomplish this objective is to extend the business income tax on sole proprietors and partnerships (including professionals) that applies to non-GCC nationals to GCC nationals in countries where it currently applies (Oman, Qatar, and Saudi Arabia), and to introduce a similar tax in other GCC countries.[68] Flat-rate taxes on business income that apply without regard to organizational form are similar to the business tax regime adopted in Mauritania and Djibouti (where they coexist with a broader PIT).

One advantage of this option in the GCC is that the combination of VAT/SSCs and business profit tax independent of legal form mimics an income tax that can be progressive, in that individuals with business income could face a higher tax rate on income relative to individuals who earn wage income only. Although this would make the tax system (as a whole) progressive, the potential for greater redistribution would still come from the spending side of the budget—until times are more politically opportune to introduce PITs.

GCC countries can also adopt schedular taxes on certain types of portfolio income (through final withholding), real property taxes, wealth taxes, and inheritance taxes as proxies for direct taxes on personal income. While various forms of real property taxes already exist in some countries, the political challenges of introducing other forms of taxes on wealth as proxies for income taxes are likely to be similar to or bigger than the challenges of introducing a PIT. It is therefore more realistic in the medium term to focus on how to build the tax system toward effective and explicit PITs.

Starter PIT

A starter PIT is also an option for GCC countries. It would begin with a simple PAYE final withholding tax with a high threshold exemption on labour income of public

68 International Monetary Fund, "Diversifying Government Revenue in the GCC," supra note 3, estimates that the revenue yield of a business profit tax for GCC would be around 3 percent of GDP.

Electronic copy available at: https://ssrn.com/abstract=4402261

and private employees. It could initially apply a relatively low tax rate that gradually increases to align PIT and CIT top marginal rates. Policy makers would need to examine the combined tax burden on labour income of a new PIT and existing SSC taxes to calibrate the basic design elements of the PIT (threshold and rates). Countries can combine this labour withholding tax with a tax on business income as discussed above, and final withholding taxes on certain types of passive income.

Oil-Exporting Countries with PITs

For oil-exporting countries that already have a PIT (all of which are fragile states, except Algeria and Iran), a gradual approach that considers administrative capacity and political economy factors is likely the most feasible. Fragile states face the greatest challenges and have the fewest options for tax reform.[69] The starting point is to examine the strengths and weaknesses of the current tax regime and assess how political challenges and fragility have disrupted tax collection.

For fragile countries needing to reset their tax regime, the likely centrepiece would be a PAYE withholding tax at flat or (a few) progressive rates on the wages of employees in the public sector and employees of larger employers, including state-owned enterprises. For these countries, it likely makes sense to defer taxing non-wage income under a PIT, with the possible exception of schedular taxes on certain types of passive income (that is, final withholding taxes on interest and dividends).

The overriding guide for these countries, given administrative capacity and political instability, should be simplicity of tax design and collection. In this regard, countries should eliminate minor taxes that raise little revenue but have substantial administrative challenges and costs, in order to reduce compliance costs and improve enforcement. This is particularly important for earmarked taxes, which fall on wages or turnover of businesses (incorporated or not), and which weaken the key taxes that should raise the bulk of revenues, including withholding on wages. Equally important is to dispense with exceptions and exemptions from the withholding tax on income, and not provide deductions from the tax base (or tax credit), other than the bracket taxed at zero—which should be calibrated to exclude a given number of individuals from the tax net.

Depending on administrative capacity, countries could consider having local governments take on some taxing and spending responsibilities. This would create a stronger link between the country where taxes are collected and the country where revenues are spent. This also makes sense in the context of asymmetric political fragility across the territory, as in the case of Iraq. In effect, this amounts to vertical tax integration to alleviate the impact of fragility on the role of the central government in providing local services.

Algeria differs from other oil-exporting countries in that its PIT-to-GDP revenue ratio was over 4.5 percent in 2020 (compared to less than 1 percent in 2000). As we

69 Mario Mansour and Jean-Luc Schneider, *How To Design Tax Policy in Fragile States* (Washington, DC: International Monetary Fund, 2019).

Electronic copy available at: https://ssrn.com/abstract=4402261

noted above, understanding what caused the increased tax revenue and how it relates to the public versus private sector is key to thinking about how to improve the PIT in Algeria. One area of possible tax reform is improving the tax policy and tax administration related to the taxation of non-wage personal income under the PIT—that is, passive capital income and business income of unincorporated businesses.

Oil-Importing Countries

For oil-importing countries that are not fragile, the revenue contribution from PITs varies greatly. For countries that raise substantial PIT revenue, the focus of reforms should be on enhancing PIT neutrality in the taxation of various forms of capital income and redistributive capacity, in coordination with SSCs. In this regard, countries can expand the tax base through more efficient taxation of active business income and passive capital income, and limit the use of deductions (which are highly regressive) to achieve certain policy objectives. Where additional revenues are not sought, top (combined PIT/SSC) marginal tax rates on labour income could be reduced to enhance labour market incentives—as Morocco did with its top PIT rate over the past two decades.

For oil-importing countries that tax active business income of sole proprietorships and partnerships under the PIT, it is important to compare the relative tax burdens for business income under the PIT and CIT regimes. Here, it may be desirable to reduce or eliminate tax rate differences under the PIT and CIT. As proposed above, countries could consider removing active business income from the PIT and taxing that income under a business profits tax (applicable to all business income regardless of organizational form).

The PITs of several oil-importing countries are de facto dual income tax regimes that tax labour income at progressive tax rates but tax (generally through withholding) most forms of income from capital at different rates ranging from 0 percent to 20 percent. Moving toward a formal dual income tax regime has the advantage of eliminating differential tax treatment for different types of income from capital.

CONCLUSIONS

In developed countries, PITs play an important role in raising revenue, reducing inequality, and fostering greater bargaining between citizen-taxpayers and governments. In contrast, in many developing countries, PITs raise little revenue, play little or no role in reducing inequality, and are not part of the political discourse. Among developing countries, MENA countries, with a couple of exceptions, are at the far end of the spectrum of revenue and political irrelevance.

The prospects and possibilities of MENA countries either adopting a new PIT regime or strengthening existing regimes depend greatly on the time horizon of policy makers and their enthusiasm for using the PIT for redistribution and state building, or for making the PIT more equitable by narrowing the gap in the relative PIT burdens between high taxes on labour in the formal sector and much lower taxes on other sources of income. For policy makers focusing on short-term revenue

Electronic copy available at: https://ssrn.com/abstract=4402261

needs and having little interest in using PITs for other purposes, the likely preferred option is to raise revenue under existing VATs and excise taxes and address inequality and redistribution through targeted social spending programs. It is probably not worth the political, economic, and administrative costs of reforming the PIT for modest revenue gains.

But for policy makers with a longer-term perspective, we believe that PITs can play a significant role in a country's tax regime. Countries have to start somewhere. We appreciate that small steps taken in the next few years may increase the likelihood of a more robust PIT in the future.

As for possibilities, countries in the MENA region vary greatly. They differ economically, politically, and demographically, and they have taken different approaches to raise revenue for funding government operations. In some MENA countries, PITs are an important part of the tax system, while in other countries PITs play little or no role. This great diversity means that countries will make different choices whether to adopt a PIT regime or to strengthen existing PIT regimes.

The starting point matters greatly. Countries without PITs have the greatest flexibility in designing PIT regimes. Countries with robust regimes have different opportunities to improve the scope of the PIT than countries with less effective PIT regimes. Countries also will differ on the objectives of a new or improved PIT. Countries using the PIT primarily to raise revenue will make different tax design decisions than countries using the PIT to reduce inequality or to foster state building.

This paper examined how the PIT has evolved in the MENA region over the past two decades. While PIT revenues have remained stagnant, the taxation of individual income has changed significantly. First, top marginal tax rates on the labour and business income of individuals have declined substantially. This trend started in the 1980s, when tax rates were very high in MENA countries, and mirrors the rate reductions that have occurred in advanced, developing, and transitional economies throughout the world. Over the same period, there have been few changes in the taxation of passive capital income, and the revenue potential from this source remains low throughout the region (estimated at less than 1 percent of GDP on average and concentrated in oil-importing non-fragile states).

Second, SSCs are applied in all MENA countries, they have increased over the past two decades, and some countries have introduced additional payroll taxes, albeit at low rates. Generally, there is a weak (or no) link between contributions and social benefits received. In the GCC region, where VATs now exist, the combination of SSCs and VATs is economically equivalent to a flat tax on labour income in the formal sector, with combined VAT/SSC rates ranging from 9 percent in Qatar to 25 percent in Saudi Arabia. This will greatly influence how GCC countries shape the taxation of personal income in the future.

Third, while levels of income and wealth inequality have increased throughout the region over the past two decades, PIT progressivity remains relevant only at low-income levels, and partly as a result of this, largely irrelevant as a revenue tool. The combination of reduced tax rates, very low or no taxation of income from capital and business activities, and increases in SSCs (on average over the past two decades,

Electronic copy available at: https://ssrn.com/abstract=4402261

2 percentage points for the employee share and 2 points for the employer share) results in tax systems that do little to shift the tax burden to those with higher incomes and raise more revenue.

Finally, throughout the region, constraints on tax reform are more likely political than administrative and are inexorably tied to decisions on maintaining or increasing funding for government spending programs. The political challenges vary greatly among MENA countries. Changing the social contract (including the fiscal component) is challenging in all countries but may be even more difficult for those MENA countries that provided government services and subsidies at no or low cost and that may lack the necessary institutions to foster tax bargaining between taxpayers and governments.

APPENDIX

TABLE A1 List of MENA Countries and Subgroups

MENA countries	Country code	Oil-exporting countries	Oil-importing countries	Fragile and conflict states
Afghanistan	AFG		Afghanistan	Afghanistan
Algeria	DZA	Algeria		
Bahrain	BHR	Bahrain		
Djibouti	DJI		Djibouti	Djibouti
Egypt	EGY		Egypt	
Iran	IRN	Iran		
Iraq	IRQ	Iraq		Iraq
Jordan	JOR		Jordan	
Kuwait	KWT	Kuwait		
Lebanon	LBN		Lebanon	Lebanon
Libya	LBY	Libya		Libya
Mauritania	MRT		Mauritania	
Morocco	MAR		Morocco	
Oman	OMN	Oman		
Qatar	QAT	Qatar		
Saudi Arabia	SAU	Saudi Arabia		
Somalia	SOM		Somalia	Somalia
Sudan	SDN		Sudan	Sudan
Syria	SYR		Syria	Syria
Tunisia	TUN		Tunisia	
United Arab Emirates	ARE	United Arab Emirates		
Yemen	YMN	Yemen		Yemen

MENA = Middle East and North Africa.

Note: Somalia, Sudan, Syria, and Afghanistan are part of the International Monetary Fund's classification of MENA countries but were excluded from the sample owing to data unavailability.

Electronic copy available at: https://ssrn.com/abstract=4402261