INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/252

IRAQ

SELECTED ISSUES

August 2017

This Selected Issues paper on Iraq was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on July 25, 2017.

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International Monetary Fund
Washington, D.C.

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IRAQ

SELECTED ISSUES

July 25, 2017

Approved By
Middle East and Central Asia Department

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IRAQ: REINING IN CURRENT EXPENDITURE TO CREATE FISCAL SPACE FOR INCLUSIVE GROWTH[1]

Iraq's public spending is high in international comparison and is driven by its two largest components: compensation of public employees and social transfers. The public-sector payroll is poorly controlled and, therefore, has been growing dynamically. Moreover, the number of positions may not reflect the number of employees performing a job in the absence of centralized human resources management that would prevent absenteeism or fraud. Relatively high public-sector wages and job security make other alternatives appear undesirable, leading to subdued private sector job growth. The reform of social welfare cash transfers promises to improve these schemes' large targeting errors and results in greater capacity to address poverty at a lower fiscal cost. The same improved targeting mechanisms will provide an avenue to reforming costly quasi-cash social expenditures, too—most importantly: food and fuel subsidies. The government will need to introduce further amendments to the draft pension bill and will also need to critically review schemes benefiting victims of war and political persecution to improve their targeting, limit their potential for abuse and negative labor supply impact. The above measures are crucial preconditions to creating fiscal space for setting Iraq on the path of sustainable, diversified, private sector led growth.

A. Introduction

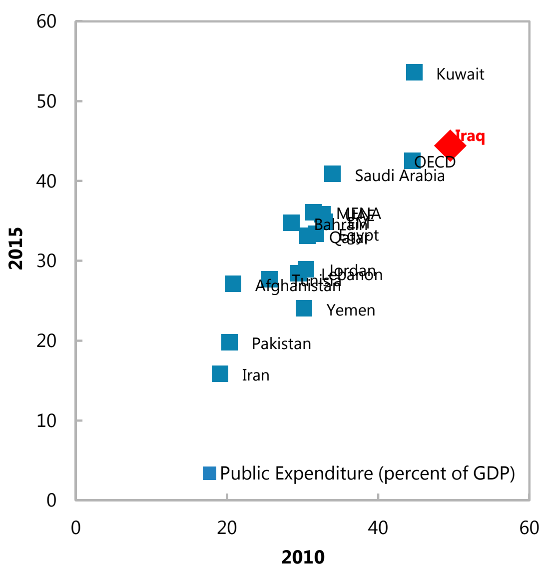
1. Iraq's public sector is very large in proportion to the economy. Public spending, at 40 percent of GDP, is among the highest in the region and exceeds most other comparators. Spending cuts introduced from 2014 left the public-sector wage bill untouched, focusing on goods, services, and non-oil investments. The government wage bill is not only the largest component of recurrent spending, but it has also been the most rapidly growing item since 2005.

2. Public expenditures are heavily skewed towards the wage bill and welfare transfers. Spending on goods and services is below the regional average of 3.5 percent of GDP and even further away from the emerging markets average of 5.1 percent of GDP—but public wages stand out, even across MENA comparators. In terms of social spending, Iraq is above the regional average of 3.4 percent of GDP and closer to the emerging markets average of 6.9 percent of GDP—although the validity of these comparisons is somewhat compromised by the wage subsidies received by state owned enterprises which function as partial substitutes for social welfare transfers.

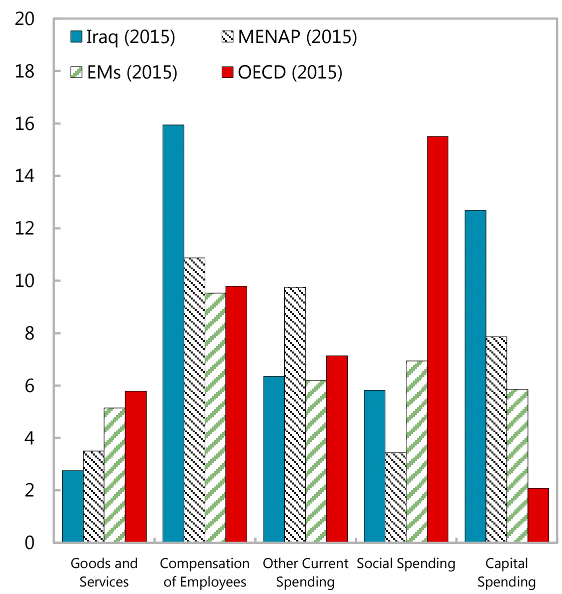
[1] Prepared by Csaba Feher.

Figure 1. Iraq: A Large Public Sector Dominates the Economy

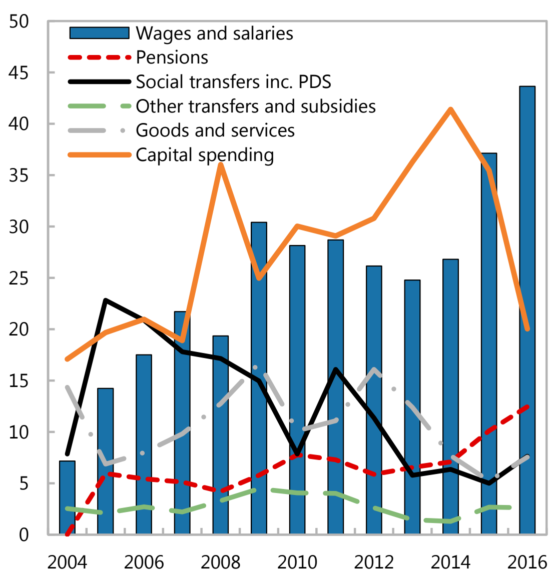
Despite expenditure cuts, public expenditures exceed levels observed in regional and developmental comparators



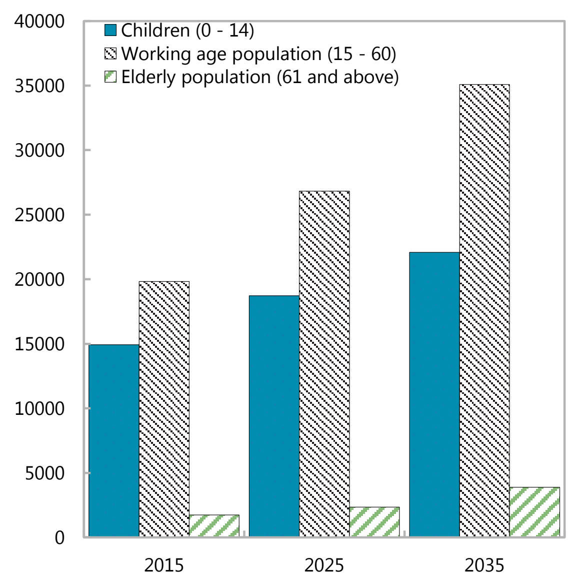
Spending on public sector wages, as percentage of GDP, exceeds regional and emerging market averages.



As a share of total public spending, only pensions and public sector wages grew consistently, with the wage bill representing close to half of all public spending in 2016



The share and size of the working age population is projected to increase sharply, presenting both opportunities and challenges



Sources: Ministry of Finance, IMF Expenditure Assessment Toolkit, United Nations Population Projections (2012).

3. The country's social welfare benefits are poorly targeted and, in the case of public sector pensions, unsustainably generous. By reducing leakage of social assistance cash and quasi-cash benefits to higher income groups, the same fiscal envelope could cover a larger share of poor households and provide more adequate benefit. There is growing pressure for new, fiscally costly schemes, benefiting survivors of war martyrs and people who were imprisoned or otherwise suffered from political persecution. Revising pension parameters would not only reduce the fiscal cost of the public-sector pension scheme, but also improve the system's equity characteristics.

4. Sustainable growth and social stability hinges on private sector job creation. The outsized public sector, the poorly targeted social transfers, and the declining quality of health and education services negatively impact labor participation and private sector growth. Considering Iraq's demographics, it is crucial to create high-productivity, private sector jobs at a rate at least reflecting demographic trends. The public sector—and the state, in general—can be a prime promoter of private-sector led growth; currently, however, this is not the case, and the state's omnipresence hinders rather than aids private sector job creation.

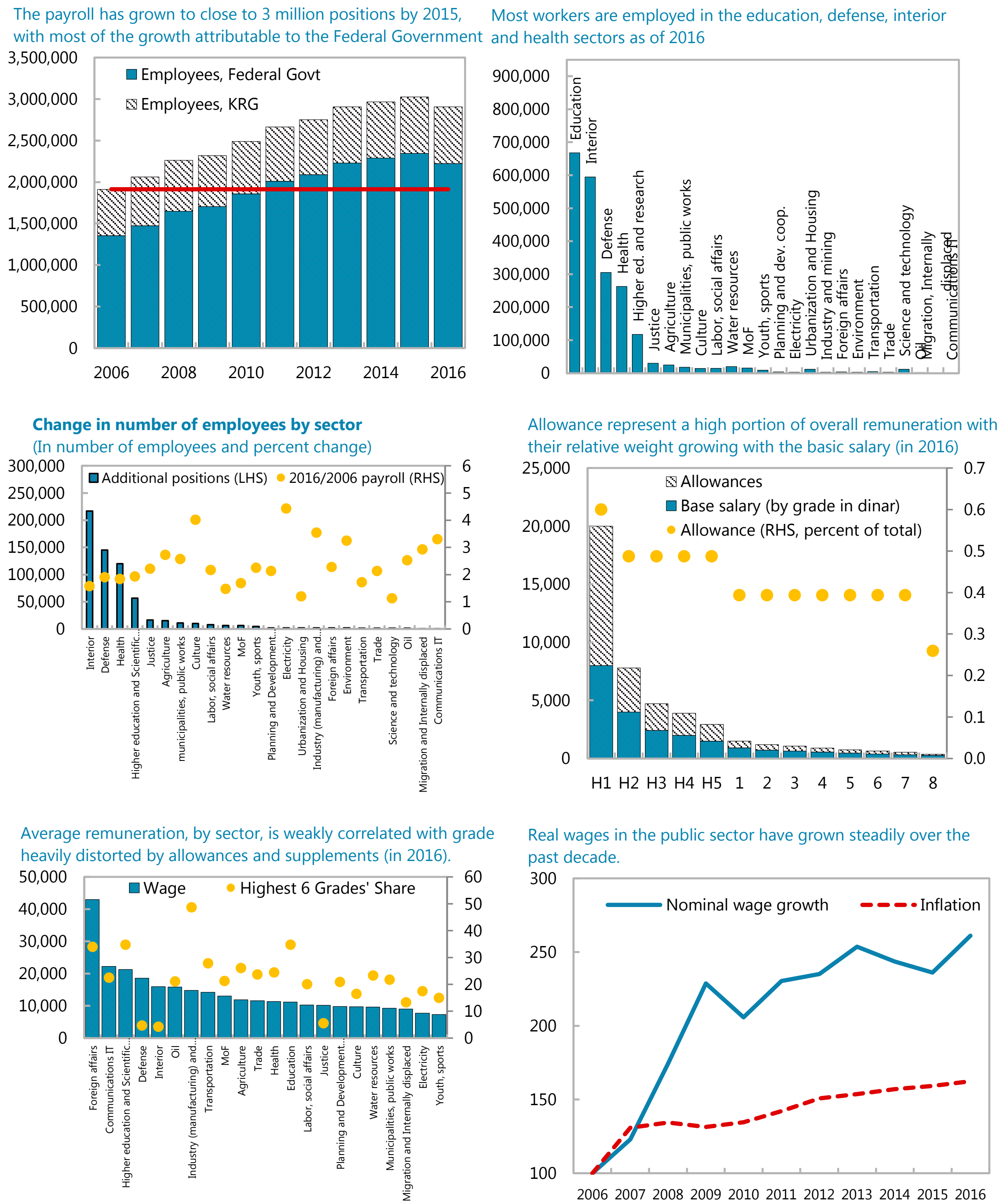
B. Public Sector Wages

5. The public sector is the largest employer, generating a wage bill which is high even by regional standards. Today, close to 3 million people are employed in the public sector, representing approximately 42 percent of all jobs. Adding state-owned enterprise (SOE) employees would bring total employment in the public sector to 3.5 million, close to one-half of all jobs in the country. The core public sector's wage bill, estimated at approximately $28.8 billion (ID 34 trillion) in 2016, is not only the largest but has also been the fastest-growing expense item in the government budget. Between 2004 and 2016, the wage bill's share of the government budget more than quintupled, from 7 to over 40 percent.

6. The largest employers are the education, defense, and interior ministries, with close to 2 million employees or 67 percent of the total payroll. Whereas security-related employment is large as a share of the total, the security-related payroll's expansion took place mostly prior to 2011 and has only continued among non-security related ministries since then (Figure 2). Out of 2.9 million public employees, 46 percent are employed in civilian ministries, 30 percent work for the defense and interior ministries (in both civilian and armed positions), and the remaining 24 percent was unclassified. Defense-related employment seems to have registered no growth since 2011, even if all unclassified workers are assumed to be in the security sector.

7. The growth of the wage bill has also been driven by an increase, in real terms, of average compensation per employee. The real value of the average total compensation received by public employees has grown, between 2006 and 2016, by 60 percent.

Figure 2. Iraq: The Public-Sector Wage Bill is Driven by Poorly Controlled Hiring and Generous Benefits



Sources: Ministry of Finance, Annual Budget Laws.

8. Allowances represent a high portion of the compensation package, weakening the performance-remuneration link. Allowances range between 35 percent and 150 percent of the base salary, with the relative weight of allowances growing with grades. Given that some allowances are linked to marital status, number of dependents and other socioeconomic factors, total compensation has a relatively weak link to position or performance. This compensation profile ensures that the wage premium—including allowances and supplements—remains constant at approximately 11 percent in all grades (about the same level as observed in other emerging market countries).

Recommendations

9. The government needs to implement a staff reduction plan through natural attrition and eliminate vacated positions[2]. The effectiveness of this measure depends on the age structure of public employees and the room for overriding this policy on an exceptional basis. In cases where clear staffing targets can be established, government may link the expiration of the partial hiring freeze to reaching these predetermined levels.

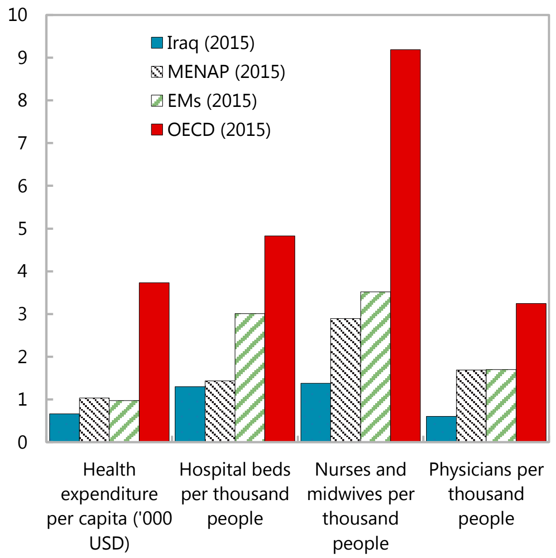
10. The government needs to complete a payroll census and design a simple but robust human resource management system. Given the number of public employees, it is crucial to establish a risk-based audit timetable whereby a sample would first inform the Board of Supreme Audit of the sectors where fraud is most frequent and then focus on these areas early on. It is equally important that a standardized action plan is established for cases of fraud, with clearly established legal and financial consequences.

11. The government needs to conduct a functional and procedural review and build a human resource strategy based on that. Only an HR strategy based on a needs assessment can lead to increased service quality, and a sustainable wage bill. The strategy needs to ensure that hiring, firing, and promotion decisions become purely merit-based and limit sectarian hiring practices. The reform strategy must also review public sector compensation policies, reducing public sector wage premiums, to rein in wage bill growth and to boost interest in private sector employment.

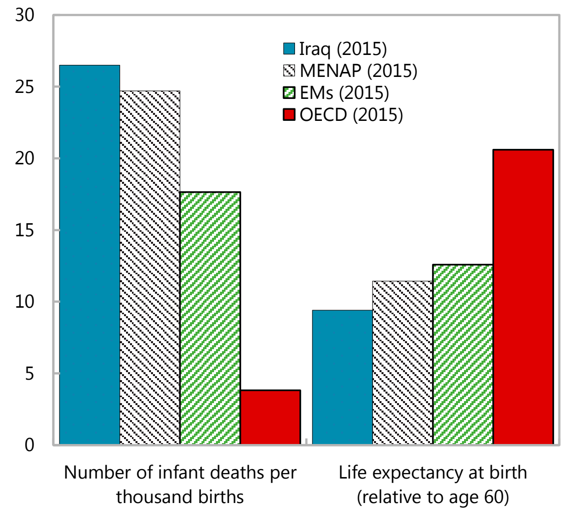
[2] The government's newly introduced voluntary paid administrative leave is unlikely to permanently reduce the payroll. The program, at best, will only achieve a temporary reduction in the wage bill. It is also unclear why workers would be willing to forgo the portion of their compensation above the base wage (as stipulated by the program) in the absence of private sector jobs.

Figure 3. Iraq: The Health and Education Sectors Are Struggling

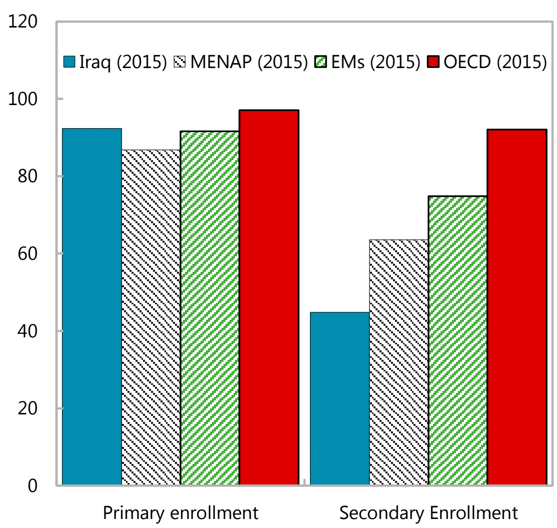
Iraq underperforms all comparator in terms of various health care inp



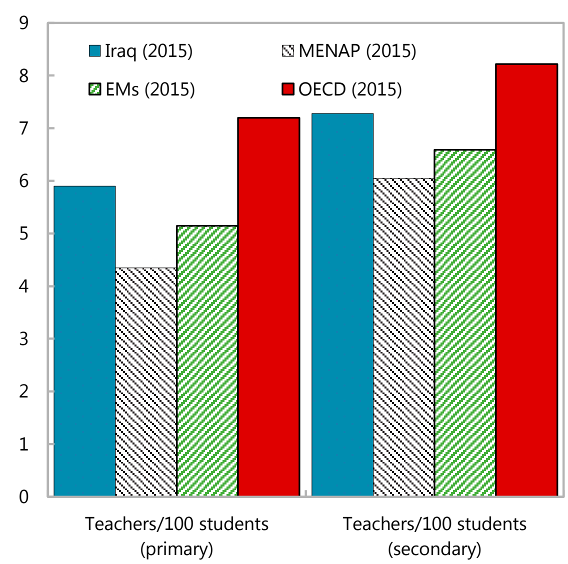
Insufficient health spending translates into poor outcome indicators



While Iraq managed to maintain high primary enrollment ratios even adverse conditions, secondary enrollment has dropped well below th average and Iraq's own earlier indicators.



At the same time, teacher numbers remained high.



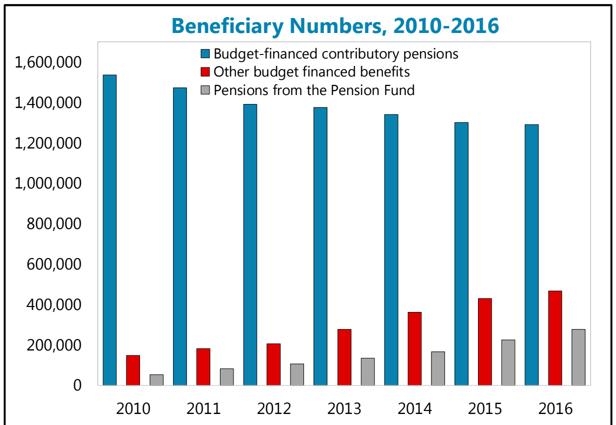
Sources: Annual Budget Laws, IMF Expenditure Assessment Toolkit.

C. Social Welfare Schemes—Pensions

12. The pension system is notionally universal but widely different coverage rates in the public and private sector schemes result in a low capacity to protect the elderly against poverty. Whereas coverage in the State Pension Fund (SPF), catering for the public sector, is close to universal, the Social Security Department (SSD) only covers approximately 3 percent of private sector workers. Thus, about 5 million people out of a total labor force of 8 million are without pension insurance.

13. The main drivers behind the pension schemes' fiscal unsustainability are permissive eligibility criteria and generous benefits. The statutory retirement age of 50 is low; the minimum full-career pension is obtainable after 15 years of service and is equal to approximately 60 percent of the average wage; accrual rates, at 2.5 percent, are exceedingly high, resulting in high replacement rates. Given that pensions are based on final earnings, pensions can exceed individuals' average career salaries. Survivor pensions are expansive, generating multiple, potentially life-long benefits, based on a single contributor's primary entitlement**.**

14. The number of non-contributory pensions paid to survivors of martyrs, and to victims of political persecution and their survivors, have more than tripled since 2010. As the liberation of Iraq progresses, the number of claims is bound to increase significantly. In this respect, it is important to ensure that these benefits are designed with welfare efficiency and fiscal space considerations in mind. It is equally important that the benefits paid to younger recipients provide sufficient incentives for labor supply instead of creating a rentier class—as has been the case in several post-conflict situations.



Source: Ministry of Finance.

15. The Law on Martyr's Foundation uses a broad definition of martyrs and extends survivor benefits to a large group of family members. Eligibility can be granted to survivors of people who lost their lives due to offences committed by the Baath Party, deceased members of the Popular Mobilization Forces, and people politically persecuted in the past five decades. Eligible survivors include parents, siblings, spouses, children, and grandchildren. This definition practically extends benefits and privileges decades into the future for those who are deemed eligible. Verifying eligibility may be difficult, especially considering unreliable payroll records and in case of offences suffered several decades ago. This may open the scheme for the allocation of unwarranted benefits.

16. Benefits and privileges are very broad, spanning almost every aspect of life. Benefits under the law can include pensions, housing, land, construction grants, civil service job placements and transfers, free domestic and international transportation for education, and health care purposes. Additional privileges entail tax easements, tuition and entry examination waivers, etc. The scope and complexity of benefits—which are often conditional on age, health status, ability to construct or commission dwellings, etc.—may also lead to undue discretion in the awarding process.

Recommendations

17. The draft unified social insurance law of November 2016 needs further improvements, especially in terms increasing retirement ages to 63 years for both men and women. The current draft has numerous commendable features—including retirement age increase, lower accrual rates and survivor benefit ceilings, as well as the introduction of regular benefit indexation from 2023 onward—but may be further improved. Importantly, the current regulation leaves the earliest retirement age unchanged at 50 years of age. Although the minimum service time would increase to 25 years, this is insufficient to increase the effective retirement age.

18. It is recommended that the government abolish the full career minimum pension and replace it with a means-tested cash benefit. The draft maintains the full career minimum pension, i.e. the minimum pension accessible to public employees with at least 15 years of service, and its level (ID 400,000 or $340 per month), which is fiscally costly and weakens the contribution-benefit link.

19. In addition to the standard retirement age, the draft also creates exemptions permitting early retirement and maintains the current regulation's mandatory retirement age. As a rule, early retirement should be limited to no more than 5 years, with appropriate deductions,[3] ensuring actuarial neutrality and discouraging early withdrawal from the labor force. The draft also stipulates a mandatory retirement age of 65. This is unnecessary for the private sector where the employer can clearly decide whether an older worker's productivity justifies continuing employment. In the public sector, where high levels of job protection make separation more difficult, the mandatory retirement age should be replaced with less stringent job protection so that employers have more freedom to decide whether the individual's expertise warrants employment beyond the statutory retirement age. This approach would allow retaining highly experienced workers and may encourage longer working lives.

20. It is recommended that eligibility for survivor pensions be tightened. Most social insurance systems award pensions to surviving young spouses only temporarily, to allow time for adjustments in labor supply decisions and in consumption patterns. It is also recommended that the prohibition of employment while in receipt of a (temporary) survivor pension is removed and the definition of eligible survivors is revised, to exclude siblings.

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[3] Depending on the mortality of the retirees, deductions typically range between 0.4 and 0.6 percent of pensions per every month of early retirement.

21. In terms of benefits for martyrs and politically persecuted persons, the benefits and privileges require a critical review. It is recommended that the (a) eligible relatives are limited to spouses and children, (b) one-off cash and quasi-cash transfers are abolished, (c) all education and health care privileges, and tax easements—which are not available to other pensioners—are terminated, and (d) the administration of the Martyr's Foundation is transferred to government agencies.

D. Social Welfare Schemes—Other Programs

22. The main cash welfare transfer program (SPN) is undergoing a comprehensive overhaul. The scheme was, until recently, based on categorical targeting and incurred large inclusion errors. The new, Proxy Means Testing (PMT) targeting formula introduced in 2015–16 with World Bank technical assistance addresses this issue.

Recommendations

23. The government will need to develop information systems enabling regular targeting assessments. The World Bank's technical assistance creates a solid foundation for a more efficient targeting system—however, its long-term success will depend on local capacity to regularly assess and revise, as necessary, the targeting criteria. It is also crucial to enlarge the network of social workers to improve control over eligibility and uptake, as well as to ensure access and accommodate on-site visits and assessments.

E. Subsidies—Public Distribution Systems

24. The most important welfare scheme, in terms of coverage, poverty alleviation, and the second largest in terms of fiscal cost, is the Pubic Distribution System (PDS). PDS entitles recipients of ration cards to quantities of selected commodities (flour, sugar, cooking oil, and processed milk for children) at subsidized prices in function of the size of their household. In 2016, PDS reached approximately 33 million people, 90 percent of households,[4] and accounted for over 70 percent of total caloric intake for the bottom two consumptions deciles. The program's overall cost to the budget was reported at 0.6 percent of GDP in 2016. Since local produce is purchased at administratively set prices, PDS also doubles as an agricultural subsidy scheme.

25. Despite excluding high earners from the program, the main shortcoming of PDS remains its lack of targeting, which leads to unnecessarily high outlays and an inequitable distributional impact. From 2016, public and private sector workers earning above 1.5 million IRD per month were excluded from PSD receipt. This change, while moving the scheme in the direction of better targeting, only made a minor impact on the fiscal cost and distribution impact of PSD. PDS would benefit from the rollout of the World Bank supported social assistance reform: the improved

[4] This coverage rate will increase with the liberation of the areas currently controlled by ISIS because recipient numbers will rise while the reference population (the total population of the country) will not. Consequently, coverage is likely to climb back to its pre-conflict level of close to 99 percent.

targeting mechanisms can be readily applied to PDS, too, from 2018 onward. This will allow for coordination, in terms of eligibility and benefit levels, between SPN and PDS which is currently absent.

Recommendations

26. The program's targeting efficiency needs to improve. Estimates based on 2014 subsidy and consumption data identify savings about ID 1.1 trillion (0.4 percent of GDP) assuming current coverage is cut by one-fifth as a proxy assumption in the absence of income distribution data. Given that approximately 40 percent of SPN recipients were found to be ineligible based on that scheme's newly introduced proxy means testing criteria, the above estimates appear achievable.

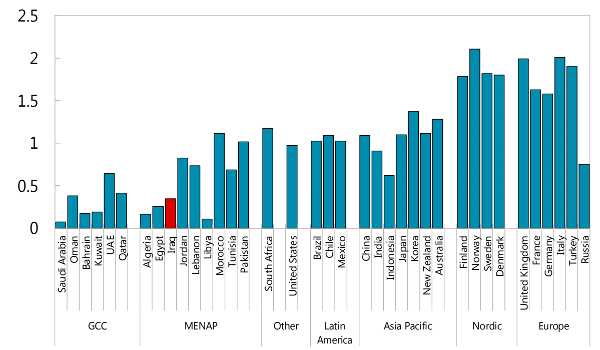
27. The PDS basket needs revisions in terms of the quantity, quality, and composition. The quantities and quality of PDS components may exceed the actual caloric needs of recipients: for instance, the wheat allocation reportedly exceeds actual needs by approximately 20 percent, fueling a secondary market and generating unnecessary expenditures of approximately 0.3 percent of GDP. A review may unearth similar errors. Likewise, the quality and composition of the PSD basket may not equally correspond to all recipient households' needs.

28. The timing and procurement of imported goods need to improve. Demand for foodstuff and the supply of domestic agricultural products follows predictable trends and seasonalities. Similarly, trends in international commodity prices are also observable—thus, relying on risk-based projections, it is possible to time the purchase of agricultural products (as well as derivative contracts) in a manner that reduces costs without jeopardizing food security.

F. Subsidies—Energy Subsidies

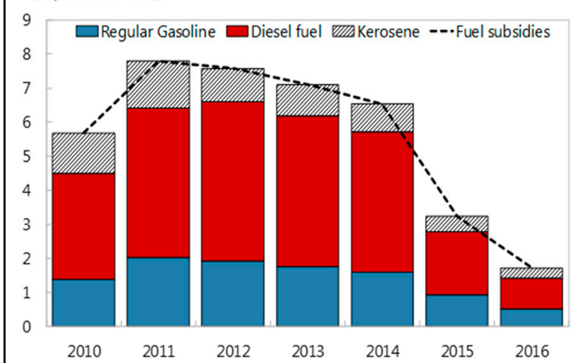
29. Fuel subsidies in Iraq are administered under a complex system, move in tandem with global oil prices, and complicate budget policy. Fuel prices at the pump in Iraq are low compared to other countries in the region. The structure of fuel subsidies is complex, spanning the entire chain of production, refinery, and distribution phases. Per staff estimates, the explicit (on budget) and implicit (opportunity) costs of low energy prices amounted to 1.7 percent of GDP in 2016. Given the system of local administered fuel prices, fuel subsidies in Iraq increase a lot whenever global oil market prices pick up and fall as oil prices decline, a volatility that complicates budget spending management and adds to the fiscal burden.

Pump Price for Diesel Fuel 1/
(In USD per liter, 2016)



Sources: World Bank, World Development Indicators Database.
1/ Reflects pump prices of the most widely sold grade of diesel fuel. Prices have been converted from the local currency to U.S. dollars.

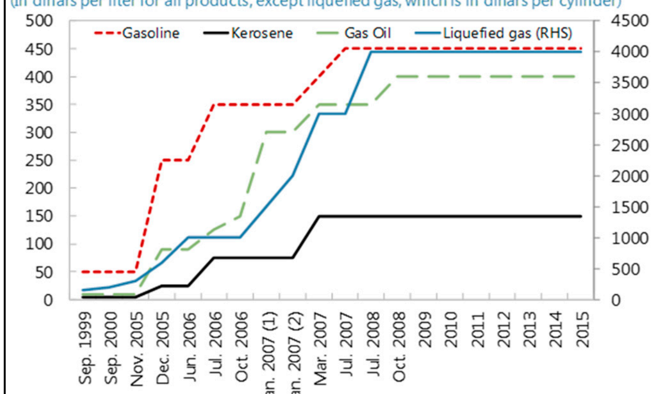
Iraq: Fuel Subsidy Estimates, 2010-2016 1/
(In percent of GDP)



Sources: IEA, Iraqi authorities, and IMF staff calculations.
1/ Calculations based on price-gap approach.

30. Some progress has been made to reform electricity sector subsidies with the introduction of a new, more progressive tariff structure in January 2016, the results of which remain to be seen. The new, more progressive tariff structure has much higher rates levied on top-end consumers, yet the tariffs collected will cover only 11 percent of the costs. Subsidies with all inputs valued at market price are projected to be 5.2 percent of GDP in 2017. Production costs for power generation could be minimized further once gas flaring is reduced and the captured gas is used as fuel for power generation in lieu of costlier imported gas or fuel. The reform is expected to have minimal effect on lifeline consumption and a limited social impact, according to the World Bank.

Historic Price Adjustment in Fuel Products, 1999-2015
(In dinars per liter for all products, except liquefied gas, which is in dinars per cylinder)



Source: Ministry of Oil.

Recommendations

31. Revisiting the fuel pricing formula at a time when global oil market prices are low can ease the transition towards a more efficient energy sector. Acknowledging the difficulties in sustaining subsidies for extended periods, the authorities raised fuel prices successively in the past. Experience indicated that raising prices sequentially has not helped with sustainability of subsidy reforms, and has proven politically difficult to implement. However, with global oil prices subdued, embedding an automatic price adjustment mechanism—one that ties future adjustments in local fuel prices to changes in global fuel prices—would help instill discipline to budgeting, provide clarity on the move towards better market mechanisms to pricing, and better guide expectations. Such a strategy would be more effective particularly if accompanied by structural reform plans for the energy sector that identify structural deficiencies, restructure some companies, and revisit pricing along the entire energy chain.

32. The large gap between electricity tariff collection and production costs need to be reduced in priority by increasing collection rates and using currently flared gas for power production. When tariff collection and production of cost will have sufficiently improved to bring tariffs above production cost, the authorities should introduce a price formula to maintain tariff collection above production costs.

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IRAQ: TAX AND CUSTOMS POLICY AND ADMINISTRATION—REFORM PRIORITIES[1]

Iraq's natural resource wealth has benefited the economy, but its dependence on it has also contributed to macroeconomic volatility, a small non-oil economy, a shallow financial sector, and a difficult business environment, which resulted in marginal non-oil budget revenues. This paper analyzes the current tax system in Iraq to shed light on key weaknesses and provide proposals for reform and revenue mobilization which would help diversify state revenues. Proposed recommendations focus on simplifying direct taxes, increasing non-oil revenues from indirect taxation, and strengthening tax and customs administrations. This would help create adequate fiscal space and reduce the reliance of budget revenues on oil export receipts.

A. Motivation and Context

1. **Iraq's abundant natural resources have been a blessing and a curse; the small non-oil sector, and a subpar tax system, constrain the ability to mobilize non-oil revenue**. Iraq's rich natural resource endowment has exposed it heavily to the fall in oil prices since 2014. Oil revenue, which constitutes more than 90 percent of total fiscal revenue, has plummeted, causing a sharp increase of the budget deficit from 6 percent of GDP in 2013 to 14 percent in 2016; of public debt from 31 percent of GDP in 2013 to 67 percent in 2016; and a fall in foreign exchange reserves from $78 billion in 2013 to $45 billion in 2016. The exposure of the economy to the fall in oil prices has highlighted the very low level of non-oil tax revenue, and the need—as well as the potential—to increase it to support government spending.

2. **This paper analyzes the existing tax regime in Iraq to shed light on key weaknesses and provide concrete proposals for reform and revenue mobilization.** It highlights priorities to increase non-oil tax revenue, starting with a review of Iraq's relative tax revenue performance (Section B), before moving on to assess and propose reforms for each tax (Section C). It ends with a list of specific reform priorities for tax policy and administration (Section D).

B. Tax Collection is Very Low in Iraq

3. **Total tax revenue—and particularly non-oil tax revenue—is very low in Iraq, relative to comparators.** Total tax-to-GDP ratios in Iraq have historically not exceeded 1 percent, a low share of the economy compared to the average ratio in the MENAP[2] region where it is more than 10 times

[1] Prepared by Mario Mansour, Aqib Aslam (FAD), Patrick De Mets (METAC), Amgad Hegazy and Gregory Basile (MCD). Findings are based on outcomes of a Technical Assistance Mission on Taxation Reform led by FAD which took place in Baku, Azerbaijan, during February 5–9, 2017.

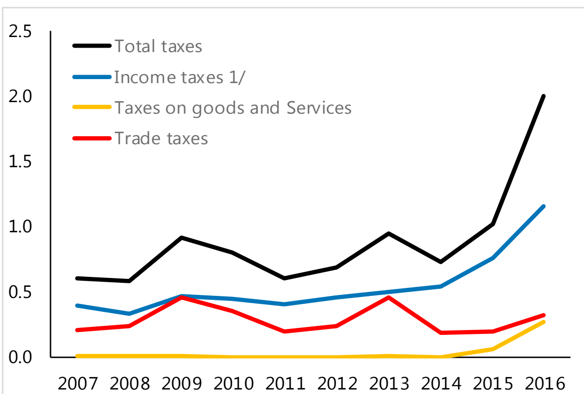
[2] Middle East and North Africa, and Pakistan.

larger (Figure 1). Even comparing Iraq with a smaller set of countries[3] having similar economic attributes (hereafter called *comparators*) reveals the extent to which tax revenues underperform in Iraq by wide margins (Figure 2). A closer look at the breakdown of taxes by type shows that personal income tax (PIT) in comparators average 3.5–4.5 percent of GDP compared to less than 0.5 percent for Iraq. Corporate income taxes (CIT) in comparators ranged between 4–6 percent of GDP (2009–16) on average, versus negligible ratios for Iraq. Likewise, taxes on goods and services were around 7 percent of GDP, compared to ranges of 0.2–0.3 percent of GDP in Iraq. Non-oil tax revenues make up less than 1 percent of GDP in Iraq, or less than 1.5 percent of the non-oil economy.

Figure 1. Tax Burden and Tax Composition in Iraq, 2007–16

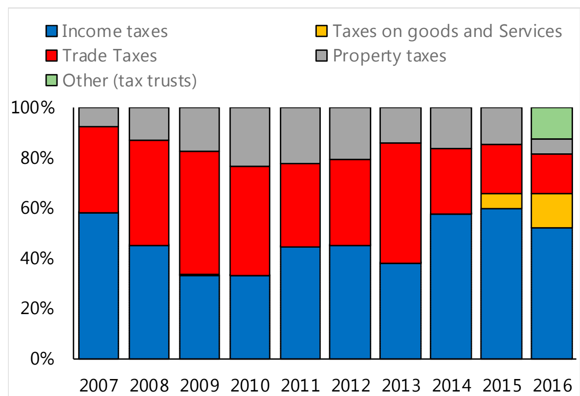
Tax-to-GDP Ratios

(Percent)



Share of Tax Revenues by Type

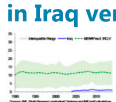
(Percent; share of total tax revenues)



1/ Includes property taxes.

Sources: Iraqi Authorities.

Tax-to-GDP in Iraq versus the Middle East, North Africa, and Pakistan (MENAP)



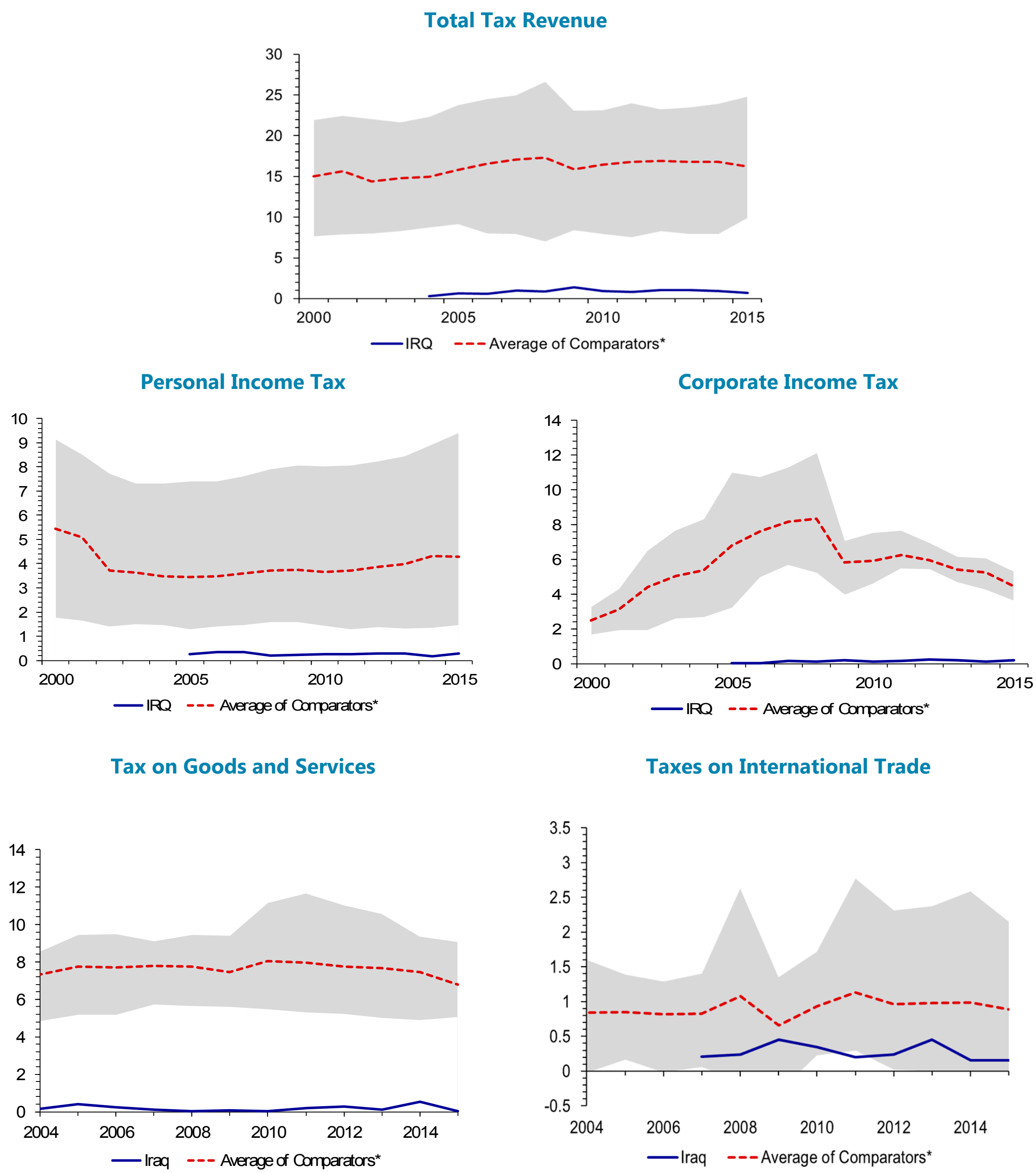
Sources: IMF, World Revenue Longitudinal Database and IMF staff calculations.

1/ Middle East (excl. Iraq), North Africa, and Pakistan.

[3] Different groups of countries from various regions (Middle East, Developing Asia, Emerging Europe, BRICS, etc.) are chosen for comparison based on economic size (both nominal and real terms, and in purchasing power parity terms), population, and per capita income. Data availability limits comparisons.

Figure 2. Comparative Tax Ratios: Iraq and Comparators (Regional Averages)[1/]

Tax-to-GDP Ratios (Percent)



Sources: IMF, World Economic Outlook and IMF staff calculations.

*Unbalanced sample of comparators (Colombia, Kazakhstan, Kenya, Peru, South Africa, and Tanzania).

4. The reliance on oil revenue, a low tax base, a weak legal basis, and low tax and custom administration efforts explain the very low level of tax revenue in Iraq.

- ***Widespread tax exemptions, and a small non-oil economy (tax base) that reduce tax coverage*:** Iraq's tax system is riddled with tax exemptions, deductions, allowances, tax holidays, and tax breaks. Almost half of the economy, on average, spans oil-related activity. Out of the remaining non-oil economy, only 15 percentage points of such activity is subject to taxation.[4] State-owned enterprises and the agricultural sector are tax exempt. The small industrial (non-oil manufacturing) sector has come to a standstill following successive years of contraction. Construction and tourism have been hit due to the ongoing conflict with ISIS. The financial sector is shallow and dominated by state-owned banks.

- ***Too much focus on direct taxes, too little focus on indirect taxes, and a complicated customs code*:** while still burdensome and plagued with many difficulties in practice, taxes withheld at the source are easier to collect and administer. This has been the case with Iraq's tax system; roughly half of total taxes collected in recent years came from taxes on employment income and profits (Figure 1). Indirect taxation is weak because they are levied in an ad hoc manner, on a few items, and only when the need arises (during crisis episodes). Indirect taxation is also weak because the customs code is too complex in nature, with many exemptions, and the customs administration faces other complications.

- ***Lack of a clear legal framework governing taxation*:** most sales taxes and excises levied in Iraq are passed in the annual budget law and are temporary (usually for one year). They therefore lack a strong legal basis that would allow continuity of implementation of tax policy and enforcement of tax administration beyond the annual budget cycle.

- ***Weak tax and customs administrations*:** the reliance on oil receipts during good times has led to a neglect of tax and custom administration efforts to raise non-oil revenue, illustrated by the lack of computerized information systems at the tax and customs administration. The effective customs tariff rate in Iraq is less than 1 percent of the value of imports (see analysis in Section C).

- ***Low tax compliance:*** the reliance on oil receipts during good times and the absence of enforcement has yielded poor tax compliance among tax payers.

C. The Structure of the Iraqi Tax System: Overview and Reform Priorities

Direct Taxes

5. Despite the weak tax take in Iraq, direct taxes are the most dominant instrument for mobilizing revenues, contributing half of non-oil tax revenue. Contrary to general features of tax systems in other comparable countries, taxes on personal income (PIT) and corporate income

[4] Iraqi Tax Authority's estimate.

(CIT) in Iraq are the more dominant types of tax that generate about half of non-oil tax revenue (Figure 1). PIT comprised 29 percent of total non-oil tax revenue during 2015–16, while CIT contributed 21 percent, on average.[5]

Personal Income Taxes (PIT)

Issues:

6. Taxes on personal income are progressive, and the most straightforward and simplest to collect given that they are mostly withheld at the source. PIT is levied on wages of both public and private sector employees, as well as professional income and income from business activity. It has a progressive schedule with five rates: 0, 3, 5, 10 and 15 percent. However, where certain professions are suspected of underreporting taxable income, the authorities operate a presumptive system.

7. Many deductions erode the tax base. Total tax revenue from personal income in Iraq amounts to less than 0.5 percent of GDP (1 percent of non-oil GDP), compared to an average of 4 percent of GDP for a comparator set of countries with similar economic attributes (Figure 2).[6] A major reason for such underperformance is tax exemptions and deductibles. For instance, while pension contributions are fully deductible from taxable income, retirement income is tax exempt. In addition, accumulated investment income and capital gains are not subject to taxation. Therefore, while there may be a single applicable rate structure, several allowances and deductions exist—for example, contingent on gender, marital status, and number of children—which create a schedular PIT system with multiple effective tax rates, which not only reduces tax collection but more importantly complicates tax administration.

Reform priorities:

- Consider reducing the number of rates from 5 to 3, while preserving progressivity.
- Address enforcement and compliance weaknesses: simplify the system by removing exemptions, rather than raising tax rates.

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[5] The General Tax Commission administers income taxes in Iraq, which are governed by Income Tax Law no. 113 (1982) and its amendments. Amendments include Law no. 1 (2007) related to withheld taxes and deductions; Law no. 10 (2007) related to court hearings over disputes on tax valuation; Law no. 2 (2008) on accounting treatment for taxation of foreign entities; Law no. 12 (2009) related to amendments to allowances and deductibles on life insurance payments; Law no. 19 (2010) levying a tax on International Oil Companies operating in Iraq, and Law no. 48 (2015) on increasing tax exemptions, among others. Other taxes governed under separate laws include the Real Estates Tax Law no. 162 (1959); Properties (Vacant Land) Tax Law no. 26 (1962), and amendments; Estimation of the Real Estate Value Law and Benefits no. 85 (1978); and Instructions on the Tax Calculation of the Real Estate Transfers and Benefits, no. 12 (2004).

[6] Different groups of countries from various regions (Middle East, Developing Asia, Emerging Europe, BRICS, etc., are chosen for comparison based on economic size (both nominal and real terms, and in purchasing power parity terms), population, and per capita income. Data availability limits comparisons.

- Introduce single basic income exemption (consolidate allowances).
- Subject retirement income to personal income tax.
- Analyze revenue and distributional implications of reducing rates and streamlining allowances.
- Enhance ability to collect existing PIT before imposing new taxes or raising existing rates.

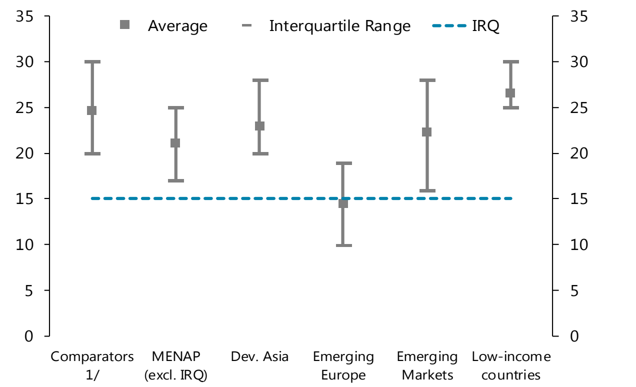
Corporate Income Taxes (CIT)

Issues:

8. The tax rate on corporate income (profits) is competitively set in Iraq at 15 percent, but the taxable base suffers from many exemptions. The low rate—relative to peers even in the MENAP region—is advantageous and competitive. However, like the PIT, the system allows for tax incentives, holidays, and exemptions, especially for investments (e.g. in the public sector). Total tax revenue from CIT in Iraq amounts to less than 0.2 percent of GDP (0.4 percent of non-oil GDP), compared to 5–8 percent of GDP for comparators in recent years (Figure 2).

Corporate Income Tax: Distribution of Top CIT Rates, 2015

(Percent)



Sources: IMF, World Economic Outlook and IMF staff calculations.

*Unbalanced sample of comparators (1/ Comparators economies: Colombia, Kazakhstan, Kenya, Peru, South Africa, and Tanzania)

Reform priorities:

- Preserve low rate (15 percent) for competitiveness.
- Discontinue tax holidays (no need, given carry forward of losses are allowed for up to 5 years).
- Remove tax exemptions for certain public sector enterprises to create a level playing field.
- Consider levying a minimum tax on turnover (e.g. for large companies, whose turnover exceeds a certain threshold).
- Enhance ability to collect existing CIT before imposing new taxes or raising existing rates.

Indirect Taxes

9. Indirect tax collection—from sales taxes, excises, and customs duties—is very low, with weak legal basis and coverage, various tax exemptions (in customs), and feeble enforcement capacity.

Sales Taxes and Excises

Issues:

10. A limited number of indirect taxes were levied in 2015. There is no sales tax law in Iraq. Several taxes and excises are levied on specific goods, as part of an administrative decree (Instruction no. 5, 2015). This covered airline tickets (at a rate of 15 percent), cigarette products and alcoholic beverages (300 percent, on domestic production and on imports), automobile sales (15 percent on import value), mobile telephone services (20 percent on scratch cards and phone bills), and on subscriptions for internet usage (also at a rate of 20 percent). There is also a sales tax on hotel and restaurant services (10 percent).

11. Most of these taxes were enacted through the annual budget law, with no separate legal basis for implementation. The levies were not applied as part of a stand-alone regulation or law that would have ensured the continuity of enforcement of the taxes beyond the annual budget cycle. This has created weaknesses in enforcement by the tax administration.

12. Following their enactment, taxes have been repealed in the past, while others underperformed. Examples include taxes on cigarettes and alcohol that were abolished with the entry into force of the Customs Law of 2010 (starting 2016). Other taxes have under-performed, except for the sales tax on telecommunications.

Reform priorities:

- ***Implement selective sales taxes or excises on a few items that are relatively easy to tax:***
    - Telecom and hotels, at a single rate (e.g. 10 to 15 percent tax a hotel's "turnover", not a hotel's number of "stars").
    - Automobiles, at a rate of 15 percent of value (or at a "specific" rate based on engine size, if valuation proves difficult).
    - Sugar-sweetened beverages, at a specific rate (e.g. $0.05 or $0.10 per liter).
    - Tobacco products, at 25 percent of value; and cigarettes, at a specific rate (e.g. $0.25–0.50 per pack).
    - Alcohol products, at 25 percent of value or at various specific rates (depending on the alcohol content).

- Fuel products (at specific rates, per liter).

- ***Advantages: simple to administer***

  - Revenue collection is easy; there is no need to worry about valuation since the levy is on "volumes" (i.e. excise tax per packet, per liter, etc.).

  - Can be achieved with existing tax administration resources (i.e. carries no additional burden for the tax authority).

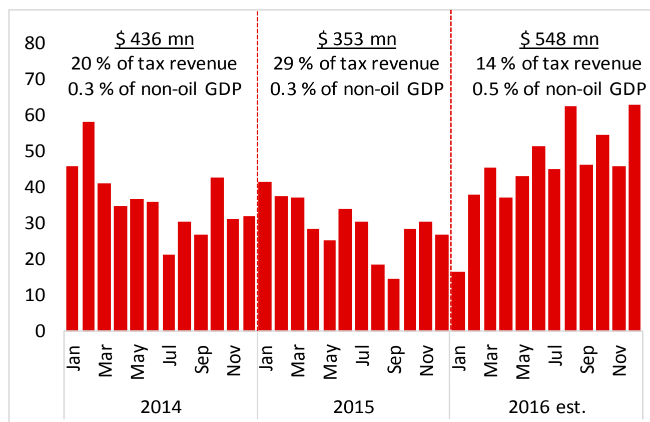
Customs Duties

Issues:

13. Custom duty collections are miniscule compared to the size of imports on which the economy depends to meet domestic demand. Iraq depends on many foreign goods for its consumption needs, and pays a hefty annual import bill (estimated at around $53 billion in 2016, equivalent to one-third of GDP). However, customs duties collected amounted to less than $600 million, entailing an effective tariff rate of just 1 percent.[7]

Iraq. Customs Revenue Developments, 2014–16

(US$ Million)



Source: Iraqi Authorities.

14. Several constraints explain such feeble performance: a complicated customs code with many exemptions, amidst a weak administration, and porous borders. Up to 2015, the structure of the customs code in force was simple, applying a unified tariff rate of 5 percent on most imports, which eased the administrative burden and simplified valuation of imported commodities. However, this code was replaced by one with many exemptions and a much more complex tariff structure (Customs Law of 2010, introduced in 2016) which levied multiple rates (10 rates in total, ranging generally from 0–80 percent by tariff lines) (Figure 3). This policy shift increased incentives for under-valuation and mis-classification of imports, smuggling and trade diversion, and corruption, especially given porous borders and weak information systems at the customs administration. The continued implementation of the pre-2010 Customs Law by the Kurdistan Regional Government (KRG) has complicated revenue collection by the Federal Government. This has contributed to continued weak revenue collection by the customs administration, despite the significant import bill.

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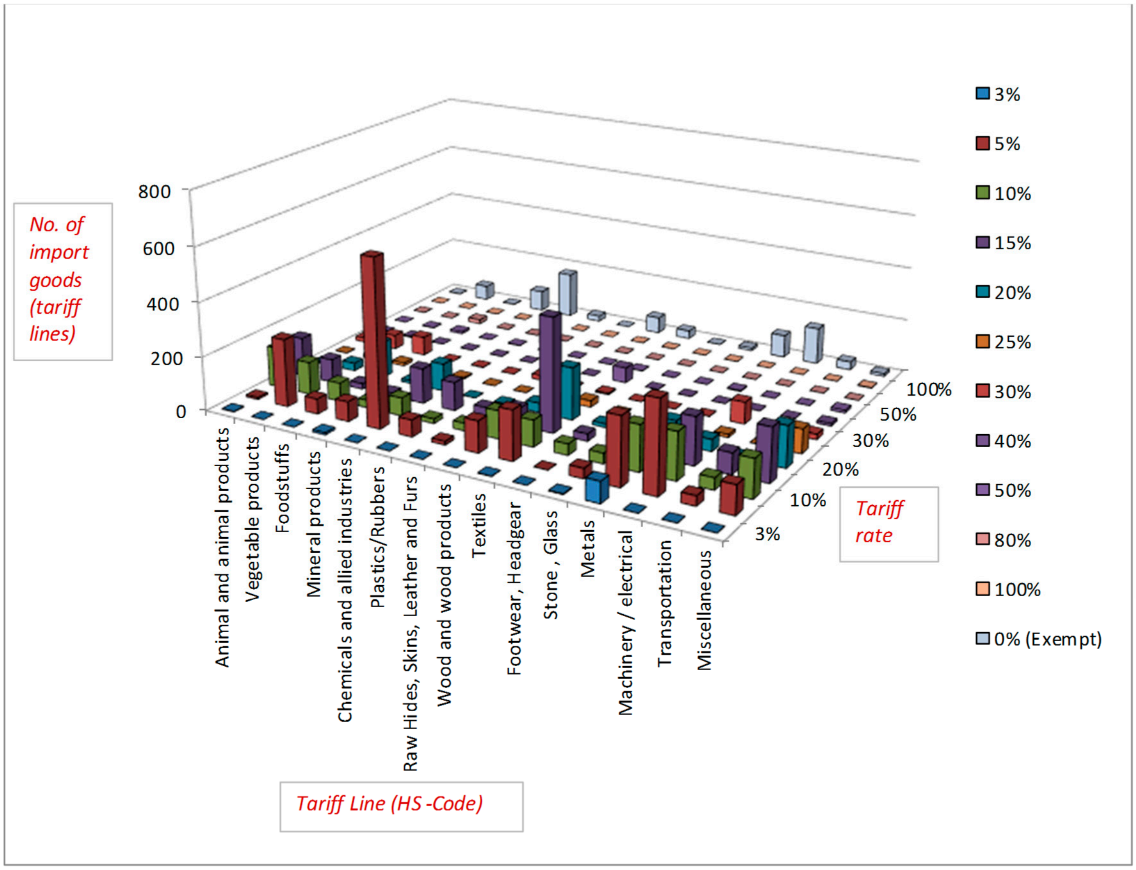
[7] The General Customs Commission oversees the de jure administration and collection of all import-related duties in Iraq as far as the Federal government is concerned. However, the Kurdistan Regional Government (KRG) also collects customs on behalf of the Federal government.

Figure 3. Customs Tariffs (HS Code) Broken Down by Tariff Line and Number of Import Goods Per Tariff Line



Source: Iraqi General Customs Commission.

Reform priorities:

- Reduce the number of tariff rates to between 2–4, with a moderate top rate (e.g. capped at 30 percent for final goods) and a zero/low rate on capital goods.
- Review the many exemptions in the customs law and limit ministerial power to change the rate structure or provide exemptions through decrees or other executive orders.
- Unify the rates between the federal government and the KRG.

D. Other Proposals to Raise Non-Oil Tax Revenue

- ***Improve management of the large taxpayer community*** within the tax administration. This can be achieved through expanding the small, existing Large Taxpayer Unit into a fully functional Large Taxpayer Office (LTO), which would:

- Ensure comprehensive responsibility over LTO affairs (e.g., administer all national-level taxes large taxpayers are due to pay or withhold, meeting appropriate criteria for improved administration).

- Carry out all taxation functions in respect of its taxpayers, and provide all the services they require in order to comply with their tax obligations.

- Organize the LTO along functional lines (such as for registration, tax assessment, and compliance management) rather than based on tax type.

- ***Implement computerized information systems both for taxes and customs to improve efficiency and effectiveness of revenue collection.*** This would enable to better gather and analyze information, proactively manage workload for resources, foster a cooperative engagement with and standardize the treatment of taxpayers, facilitate the uniform application of the tax law, and enable the formulation of scenario analysis and quantification of the potential impact of likely future reforms.

- ***Stop introducing new, incremental, or ad hoc taxes through the annual budget process once proper tax laws are in place.*** Any proposals should be designed and costed centrally and clearly defined in tax laws following budget approval, to have strong legal basis and clear implementation guidelines.

- ***Develop analytical capacity for tax reform within the Ministry of Finance*** to research carefully and study reform measure proposals adequately, through appropriate legal and technical expert advice. Undertaking hasty reforms in reaction to the emergence of fiscal difficulties has proved to be inefficient.

- ***Sequence reforms carefully.*** Reform proposals cannot all be implemented simultaneously. Combine difficult reforms with positive signals (e.g. implement new sales tax while simplifying the PIT).

- ***Communicate clearly*** through a comprehensive media campaign, about the need to increase non-oil tax revenue and the expected benefits of tax policy and administration reforms.

- ***Assess reform efforts along the way and adjust policies if—or as—needed***, in line with lessons learnt from actual implementation.

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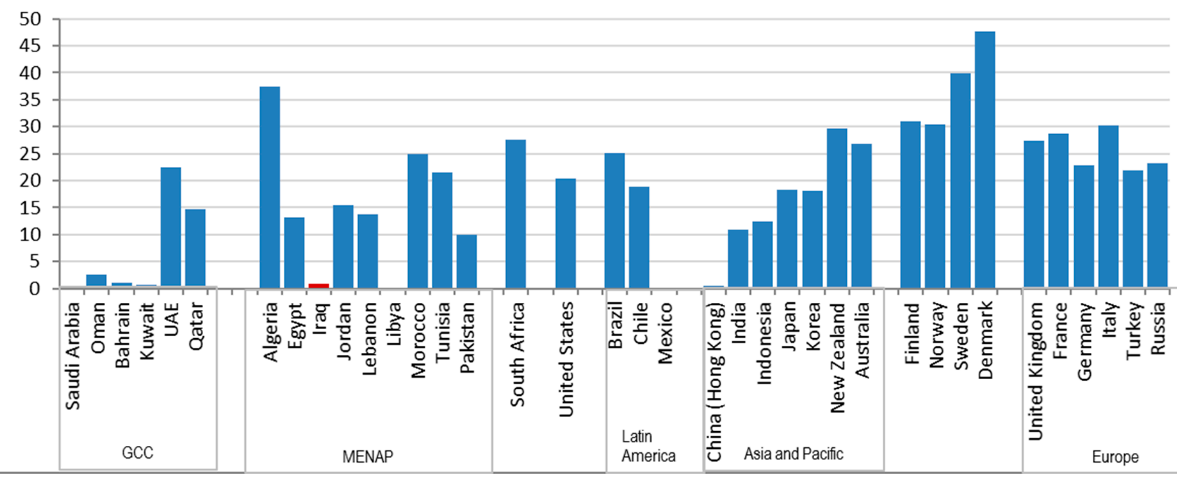
Annex I. Comparative Tax Indicators: A Cross-Country Exposition—Expanded Dataset

(Latest data year available)

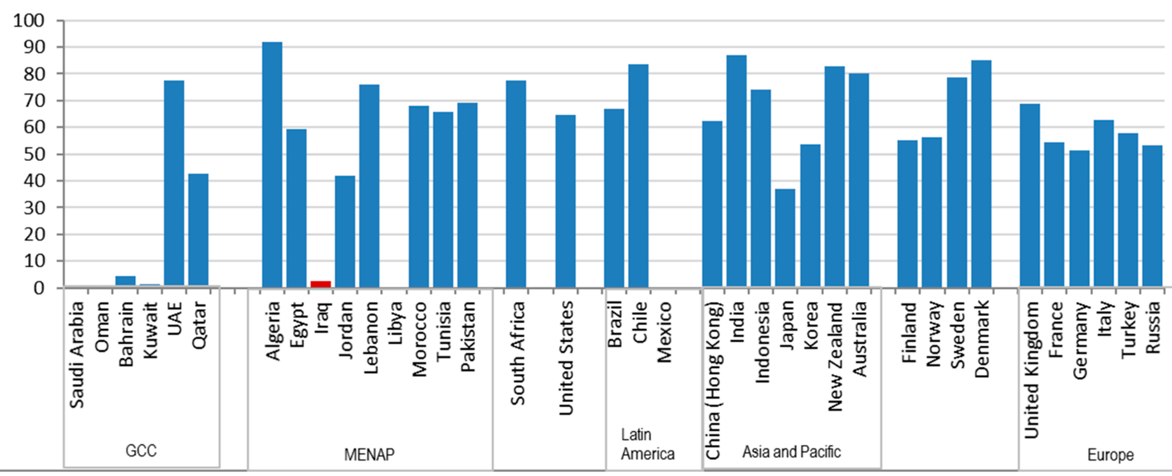
Tax Burden

(Tax revenue to GDP, percent)



Share of Tax Revenue in Total Revenue

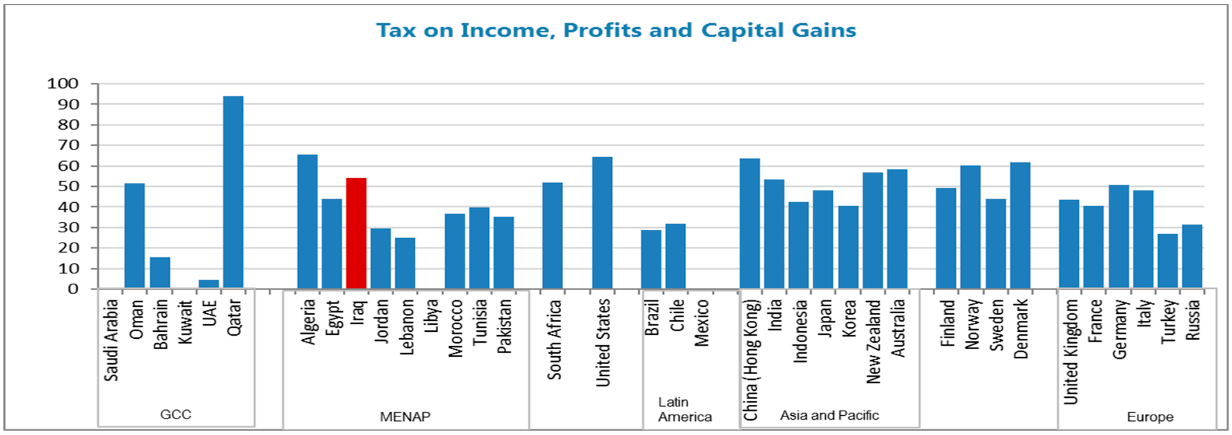
(Percent)

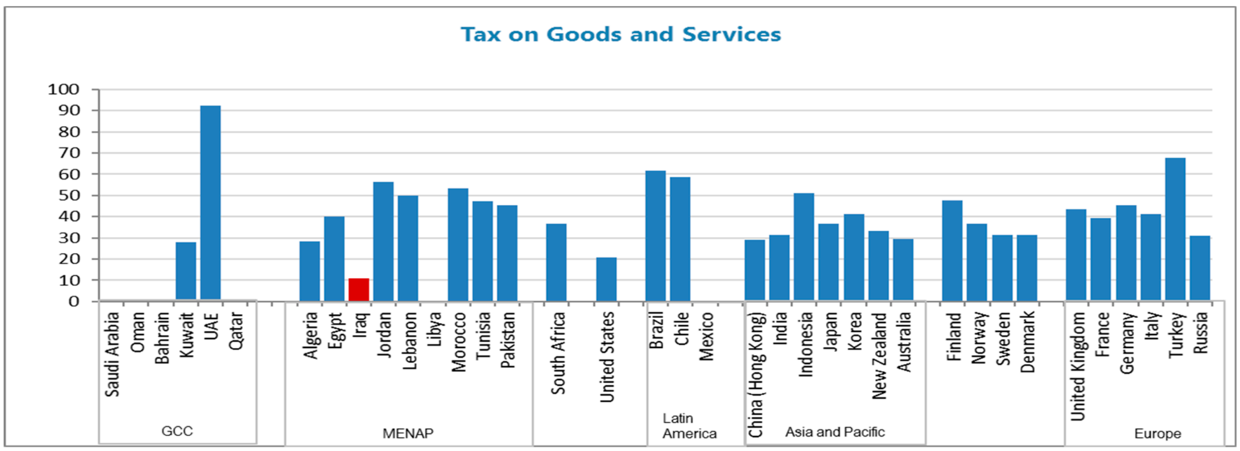


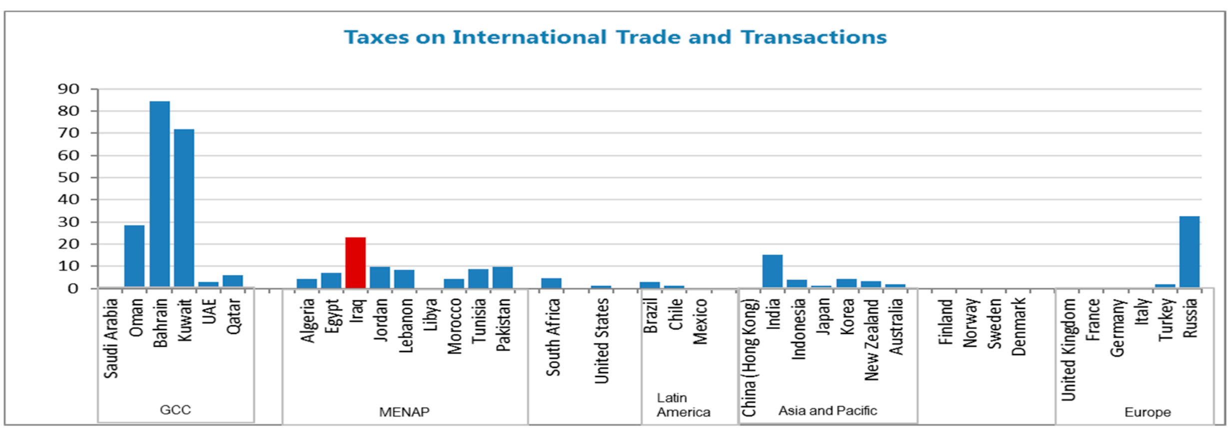
Source: Government Finance Statistics Yearbook, and World Economic Outlook Database—International Monetary Fund.

Composition of Tax Revenue by Tax Type

(share in total tax revenue, percent)





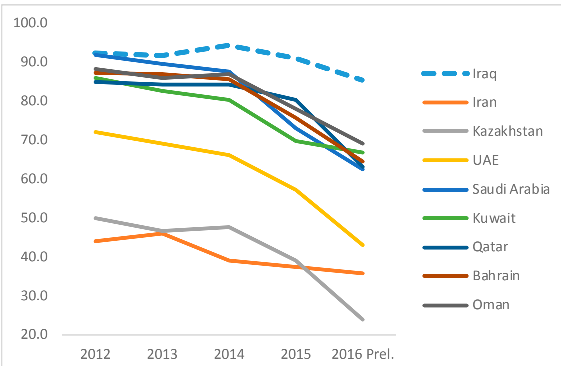


Source: Government Finance Statistics Yearbook, and World Economic Outlook Database—International Monetary Fund.

Annex II. Iraq's Dependence on Hydrocarbons, Relative to Other Oil Exporters in the Middle East

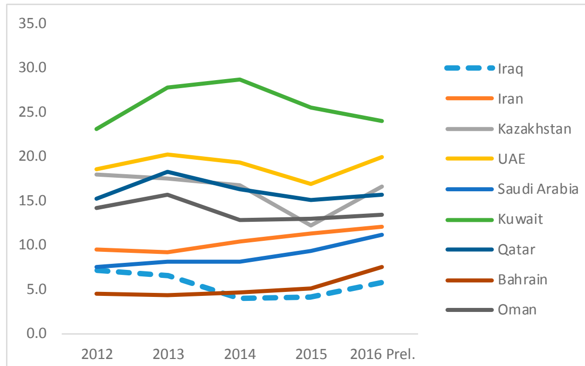
Oil and Non-Oil Revenue

Budget Oil Dependency, 2012-16
(Oil revenue in percent of total government revenue)



Source: Iraqi authorities, IMF WEO Database; and IMF staff calculations.

Non-oil Revenue, 2012-16
(Percent of the non-oil economy)



Source: Iraqi authorities, IMF WEO Database; and IMF staff calculations.