USAID-Funded Economic Governance II Project

A PLAN FOR THE OVERHAUL OF THE IRAQI TAX SYSTEM

PREPARED FOR:

TAX POLICY UNIT, MINISTRY OF FINANCE, GOVERNMENT OF IRAQ

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A DRAFT PLAN FOR THE OVERHAUL OF THE IRAQI TAX SYSTEM

INTRODUCTION

This document has been developed by the Tax Policy Unit within the Economic Department of the Ministry of Finance of the Government of Iraq, in consultation with advisors from BearingPoint working under the USAID funded Economic Governance II Project. It sets out a plan for the overhaul of the Iraqi Tax System in the Medium Term (three to five years).

The Iraqi Tax System includes the Tax and Customs Laws, as well as the administration of taxes through the General Commission for Taxes (GCT) and of Customs levies and duties through the General Commission for Customs (GCC), each of which is a Directorate of the Ministry of Finance. In addition, it includes the Tax Policy Unit, responsible for the development of the overall tax revenue strategy for the Government of Iraq, and the design and drafting of tax legislation.

The plan has been developed to address the need for the Government of Iraq to diversify its sources of revenue beyond those obtained from the sale of crude oil and petroleum products on international markets. Tax and Customs revenues currently represent barely 5% of Iraqi government revenues.

The objective is to increase the yield of tax revenue from an evolving Iraqi economy in a manner that facilitates and encourages economic development, while at the same time protecting Iraqi taxpayers and families, especially the poor, from adverse social impacts.

Tax reforms have to be achieved through changes to the tax laws, both those that determine the taxes and those that govern their application, collection, review, audit and enforcement, and also through improvements in tax administration. Similar considerations apply to Customs reforms, although changes to Customs Law are not included in this plan.

The plan includes a program for the overhaul and modernization of the Iraqi tax legal system, and outlines a progressive schedule for tax legislation development over the next three to four years. The plan also includes the reforms in progress in the GCT and intended for the GCC.

This is a working plan, subject to improvement and revision over time, in particular through the inclusion of further details on how the plan is to be implemented. It is also an action plan, providing guidance and direction on the phased development of tax legislation.

The plan initially outlines current work in progress, including Tax and Customs Commissions administrative reforms as well as current legislative development actions, both underway and planed for the near-term future. It then outlines areas which are expected to be among the priorities for action during the coming year, including desirable legislative reforms and the need to develop specific regimes to accommodate other reforms in economic governance. Finally, it addresses the strategic broadening of the revenue base through the development and introduction of new taxes, including a sales tax at the border, with possible extension to a broad-based sales tax on goods and materials manufactured and produced in Iraq, or a VAT.

To provide guidance for the further design and development of these regimes, some relevant technical material has been included in an extensive Appendix to this document.

Detailed steps for the development and approval of the plan

Development of a first draft of the plan with the assistance of BearingPoint advisors – already achieved.

Further development and refinement of this draft plan consultation between the TPU and advisors - completed.

Presentation of this draft plan by TPU for discussion and review by:

- The Iraqi tax community including academics and business leaders
- Other Iraqi government agencies, including the GCT (and GCC)
- IMF representatives, prior to the next SBA review meetings
- The Minister of Finance

Further review and refinement of the plan, taking account of feedback, further reviews as considered appropriate, approval by Minister, approval by COM, and adoption by the GoI.

Priorities for action and the implementation of the plan to overhaul the tax system

Addressing the IMF SBA conditions and its expectations for broadening of the tax base and improvement of tax revenue collection and administration.

Identifying deficiencies of existing tax laws and planning and implementing remedial actions in the short and medium term.

Improving Customs and tax administration effectiveness in collecting current revenues and developing their capacity to administer a wider range of duties, taxes and levies in future.

Researching issues, designing new tax regimes, planning for the introduction of new taxes, including a broad based sales tax or a VAT as recommended by the IMF under the SBA, and new tax regimes within existing taxes (such as reviewing the taxation of capital gains, rents, dividends and interest payments, and the deductibility of interest expenses in thinly capitalized entities, under the Income Tax Law).

Identifying the economic, security and social conditions that are required to be attained prior to the introduction of any new taxes, monitoring progress towards the achievement of those conditions, and adjusting the tax policy work program or work plan accordingly.

Developing new specific and general tax regimes while remaining responsive to changing internal and external priorities, the revenue needs of the federal and regional governments.

Preparing policy proposals outlining the case for changes, explaining the need for these changes, reviewing the arguments for and against the changes, and making recommendations for changes to laws, regulations, instructions, processes and procedures.

Developing and drafting tax legislation and regulations, to give effect to policy decisions.

Timetable and support for the development and approval of this plan

- Initial draft by BearingPoint advisors – July 2006
- Review and revision within TPU in consultation with advisors – August 2006
- Restructured draft by advisors with emphasis on implementation – September 2006
- Review and revision within TPU in consultation with advisors – October 2006
- Presentation to members of tax community, GCT (and GCC) – November 2006
- Revision and finalization, delivery to Minister of Finance – December 2006
- Minister to forward to COM to seek their approval – December 2006
- COM approval and referral to House of Deputies – December 2006
- Approval by House of Deputies and adoption by GoI – December 2006
- Presentation to the IMF for review against the SBA – December 2006

Support measures proposed

Conferences

Financial support for the conference November 21-22 2006:
"Tax Reform: A Mainstay for Building the Iraqi Economy"

Presentation during the conference of an overview of this
"Draft Plan for Overhaul of the Iraqi Tax System"

Review of the Plan by a select group of invited participants

Regional meetings

Consultation meeting with IMF representatives, if required, at a regional centre

Advisor support

Tax Policy Advisor, substantially full time

Local Staff Tax Legal Adviser, full time

TIMETABLE AND ACTIONS FOR THE IMPLEMENTATION OF THIS PLAN

Phase 1 – Actions in progress

A. Introduction of Mobile Phone Tax Law – in progress, implementation expected in 2006

Description

The proposed Mobile Phone Tax (MPT) Law has been initially drafted and recently redrafted by a working group involving members of the TPU, representatives of the GCT and a BearingPoint local advisor.

The revised draft has been forwarded to the Minister of Finance for approval before being sent to the State Consultative Council at the Ministry of Justice, where it will be reviewed by three teams, with each requiring representation by at least one person from the drafting committee.

Following that, the draft law will be submitted to the Council of Ministers, and then sent for debate and approval in the House of Deputies, which will again require support from representatives of the drafting committee.

After approval by House of Deputies and the Presidential Council the Law needs to be signed by the President and published in the Gazette.

Regulations and Instructions have been drafted and will also need to pass through an approval process before they can be adopted and the Law put into effect.

Effort and support required

TPU supported by BearingPoint local legal advisor to continue involvement in promoting and defending the law during the review and legislative processes.

TPU and GCT to be involved in progressing and implementing the Regulations.

Support of BearingPoint advisors working with the GCT will be required to develop their capacity to administer the tax. Instructions have already been written but will need revision if the law changes.

Procedures need to be agreed and established for the responsible division of the MoF to administer and advise the list of exempt organizations to the GCT.

Training required

Local training of GCT staff on the MPT Law, Regulations and Instructions. Likely to involve only headquarters staff, with the tax eventually administered by the Large Taxpayer Unit, which has yet to be formed. While there will be few taxpayers, the administration of exemptions for specific users will require significant resources.

B. Reorganization and capacity development for the Tax Commission – in progress to 2007

Description

The reorganization plan for the General Commission for Taxes was approved by the Minister of Finance on 26 February 2006.

The reorganization involves restructuring of the Headquarters and Branch Offices along functional lines, rather than along tax related departmental lines. The pilot phase of the reorganization commenced in May 2006 and involves the headquarters and two branches, Karada and Khadimiya.

The main functional lines will be:

- Taxpayer Services
- Collections
- Audit
- Investigations

These will functions be supported by teams in both headquarters and in branch offices.

Additional headquarters based functions will include:

- Branch Operations, including
    - Large Taxpayer Unit, with its own taxpayer services, collections, audit and investigations teams
    - Revenue Analysis and Reporting
- Information Technology
- Corporate services, including
    - Training
    - Human Resources
    - Financial Management
- Legal Affairs, including
    - Legislative Affairs
    - Appeals (also in branches)

The reorganization is being managed by a Steering Committee, with the planning and implementation coordinated through Working Groups, all supported by BearingPoint.

Concurrent with the reorganization, a major computerization of taxpayer records is being implemented, under which all returns and payments will eventually be entered and managed on-line, both at headquarters and in the branches. The pilot phase involves the headquarters and the same two branches as the reorganization plan.

Effort and support required

This is a major reorganization exercise which when fully implemented is expected to provide for the enhanced administrative and revenue collection capability of the GCT.

The initiation phase under the guidance of a short-term BearingPoint advisor occurred during June and July 2006. The Steering Committee that reports to the DG and the Working Groups organized according to the four main functional lines will be responsible for continuing the detailed design and job descriptions for the new positions and the work flows associated with each position. Ongoing support for the reorganization will be provided by BearingPoint Tax Administration advisors.

The computerization project is in progress for many taxes with other taxes to be added progressively. Taxpayer registration data is included and recent historical returns and payments data will be added over the next few months. The computerized system will assist in improving workflow patterns under the new functional organization.

Study tours planned

The Working Groups will be sent on a study tour to a country or countries that have compatible forms of tax administration, most likely Jordan and / or Lebanon.

The Steering Committee will be sent on a study tour to another country where a major tax reform project has been implemented, most likely Hungary.

These study tours are expected to be completed and the results reported and incorporated into the design and implementation of the reorganization during 2006.

Other training required

To be detailed, as part of the GCT reorganization and computerization plan.

C. Review and consolidation of existing tax laws – in progress to end 2006 and during 2007

- *New Income Tax Law and Tax Administration Law*
- *Effective treatment of Property Taxes – Rentals, Transfers, Vacant Land*
- *Review of current first-class and deluxe hotel and restaurant Sales Tax*

Description

Work commenced earlier in 2006 on the process for the redesign of the Tax Laws of Iraq, including the consolidation of relevant Iraqi tax laws and CPA Orders into a single Income Tax Law, and the possible separation of administrative provisions into a Tax Administration Law. In February, input from the wider tax community was sought through a conference "Tax Reform in Iraq" supported by BearingPoint / USAID. The need for reform was widely acknowledged, although participants expressed their concern that this should be done for the benefit of the Iraqi people, and not be driven by the prescriptions of foreign advisors.

Work on the review and reform of existing tax laws was interrupted to enable the Mobile Phone Tax Law to be drafted, along with an initial draft of accompanying Regulations. Further work has been required on the Mobile Phone Tax legislation, and members of the TPU have been involved in foreign meetings and study tours.

A greater depth of consultation was achieved through the recent conference "Tax Reform: A Mainstay for Building the Iraqi Economy" that took place on 21-22 November. This conference brought together government, parliamentary, academic and business participants to consider the issues of tax policy, tax legislation and tax administrations, and the economic effects of taxes. This conference also provided an opportunity for the presentation of a draft version of this plan to a smaller group of participants who were invited to review and comment on the plan.

With the need to focus time and effort on developing the plan for the overhaul of the tax system, to present a final version of the plan to the Minister of Finance and Council of Ministers, to implement the Mobile Phone Tax, to address emerging fiscal federalism issues, and to participate in training and study tours that support the aims and objectives of the TPU and the tax policy work program, there will not be time to complete extensive revision and rewriting of the Tax Laws before the end of 2006.

The bulk of this work should be rescheduled for 2007, ideally for completion after the TPU have gained the benefit of an initial study tour, with the delay also affording an opportunity to incorporate some provisions for devolution of taxes that may emerge from fiscal federalism discussions and decisions. If there is a compelling need for legislative progress in the short term, it may be possible to produce a consolidation of the existing income tax and real estate laws, incorporating any essential changes to tax law that have been identified by the TPU or the GCT. However, even that is unlikely to be possible before the end of the first quarter of 2007.

Given the factors outlined, and the likely overlap of preparatory work on defining the scope for introduction of other taxes, the timeframe for this activity should be extended through the first eight months of 2007.

Specific actions required

The Ministry of Finance through the TPU, in consultation with relevant other parties, will be required to develop and introduce tax legislation to achieve the following:

1. The review, revision, rejection or adoption and consolidation of existing tax laws, including the following:

    - Income Tax Law number 133 of 1982 (as amended by CPA Orders 37, 49 and 84);

    - Real Estate Tax Law number 162 of 1959) as subsequently amended by CPA Order 49);

    - Real Estate Transfer Tax Resolution 120 of 2002, which repealed parts of Income Tax Law number 113 of 1982, and of other resolutions;

    - The Vacant Land Tax Law number 26 of 1962; and

    - The Hotel Sales Tax Resolution number 36 of 1997, applicable to "Deluxe and First-Class Hotels and Restaurants".

2. The improvement of administrative provisions within the wider body of tax law, with consideration to be given to the development and introduction of a separate Tax Administration Law, which would, among other objectives:

    - Set out the rights, duties and obligations of taxpayers and of tax administrators;

    - Describe the procedures to be employed for the registration of taxpayers and the assessment and collection of taxes, levies and duties, as applicable for each type of tax; and

    - Define the rights of the tax administration to use powers for inspection of records, conducting audits, and enforcement of taxpayer registration and the collection of taxes as assessed, the processes for review and appeal in the case of disputes, the application of penalties and interest charges on overdue tax payments, and the use of fines and other measures for enforcement of tax obligations.

3. The reflection in tax legislation of any devolution of federal fiscal powers to regional and governorate levels, including agreement on responsibilities for:

    - Determining the taxes to be applied at each level of government, and setting the rates of taxes or ranges within which the tax rates will be set;

    - The administration of the registration of taxpayers, the assessment and collection of taxes, fees and levies, enforcement of the same; and

    - The distribution of each type of revenue collected to federal, regional or governorate bodies on an exclusive or shared basis.

Support measures needed

Conferences

Support for further conferences to consult with the Iraqi tax community at several stages in the legislative development program, such as when aspects of the proposed new legislative structure are nearing completion, with draft legislation available for review and discussion.

Study tours (the order of these can be interchanged)

One week study tour for TPU members to a country or countries with an established federal system and some decentralized fiscal responsibilities, and ideally also with a VAT, primarily focused on understanding the devolution of fiscal powers, and which levels of government have responsibilities for tax legislation, tax base and tax rate setting, administration of revenue collection, and any revenue sharing arrangements.

Candidates: Federal Republic of Germany, Canada, Australia

Two week tour to a fiscally federal country, including central and regional governments and their tax policy and tax legal drafting departments, ideally to a country also with a VAT / GST, more broadly focused on the responsibilities of central and regional governments in regard to revenue legislation, revenue collection, revenue administration, any revenue sharing arrangements, and any equalization arrangements applied on the expenditure side of the budget.

Candidates: Canada, Australia

Training courses

Tax law design and drafting, one week or more, outside Iraq

Fiscal and economic impacts of tax law changes, one week, outside Iraq

Alternatively, a two week course or two one week courses each covering a combination of the above subject areas may be more effective.

Development and advisor support

Tax Policy Advisor, substantially full-time

Tax Law Drafting Specialist Advisor, full-time for six months

Local Staff Tax Legal Adviser, full time

Phase 2 – New Initiatives

A. Development of improved tax regimes for business and investment – 2007 onwards

Description

There is a need for an ongoing program of improvements and enhancements to the Income Tax Law, following the consolidation and restructuring of existing tax laws, as proposed for the initial phase of legislative reform. Some of these will be driven by the need to improve the technical quality and effectiveness of the revised laws. Others will be driven by demands from the domestic and international community for new tax regimes to cover general and specific investment and development needs.

Without limiting the range and coverage of tax measures that may be required, the following is a list of possible improvement and extensions to the tax law:

Technical improvements to the Income Tax Law:

- If not already adopted in Phase 1, the creation of a new separate Tax Administration Law, which will cover administrative and enforcement rules that would otherwise need to be repeated in any new Sales Tax, VAT and other laws, as well as in each of the existing tax laws, or their regulations;

- Development of a gross income and allowable deductions approach to determining net taxable income, with depreciation as part of the allowable deductions, avoiding the need for the reversal of accounting depreciation;

- Amendment of the Income Tax Law to include real estate rental income (as presently assessed under the Real Estate Law) and possibly interest income along with salary and wage income and business income in the Income Tax Law, with a common set of allowances and deductions for all such income;

- Development of a regime for the taxing of fringe benefits and benefits-in-kind that are provided to employees in lieu of salary and wages;

- Development of a capital gains tax regime, which may include or exclude real estate as a special case;

- Review of the taxation of corporate distributions to shareholders and owners;

- Development of a comprehensive international tax regime including rules on transfer pricing, for both goods and services, taxation of dividends, royalties;

- Develop a regime for taxation of corporate reorganizations and relocations;

- Development of a regime to allow for the negotiation of international tax treaties with other sovereign nations, including rights to first taxation, and the exchange of information about taxpayers that have activities in both countries.

Likely demands for new and improved tax regimes:

- Creation of general incentives for investment, for domestic and international investors, including the supremacy of tax law for governing tax concessions;

- Development of specialized tax regimes for petroleum exploration and production, and for minerals exploration and mining.

Note that it would be preferable for all tax measures and concessions to be included in the Tax Laws, rather than allowing other laws to provide for tax holidays and other tax concessions or special tax regimes independently. Ideally, the tax law should contain a clause establishing its supremacy and exclusivity in determining taxes.

Specific actions required

The Ministry of Finance through the TPU will be required to create and introduce relevant legislation to continue the process of improvement of the Income Tax Law of Iraq, and to facilitate the establishment of specialized tax regimes or to give effect to regimes specified in other laws of Iraq that have tax implications.

Support measures needed

Study tours

To be decided

Conferences

To be decided

Training courses

To be decided

Development and advisor support

To be decided

B. Consideration of possible new taxes, duties, excises and levies – 2007 onwards

Description

As part of the overhaul of the tax system, it is necessary to consider the potential for the introduction of additional taxes that will complement existing taxes, and which might also provide greater flexibility for collecting revenue at different levels of government.

Two areas of taxation would appear to be especially relevant in this context:

1. Payroll taxes

Payroll taxes are levied on the total salary and wage payments made by employers. They have a similar base to the social contributions that are applied to salary and wage income, but the taxes do not need to be attributed to individual taxpayers.

Because the revenue base is easily identified, payroll taxes are relatively easy to assess and collect from employers, either nationally or within geographic regions.

Payroll taxes can be used to provide revenue at national, regional or governorate level, although with the wage and salary withholding tax already providing revenue at the national level, it should be unnecessary to impose an additional tax at that level.

Even though the revenue may be intended for lower levels of government, it would be expedient for the enabling legislation to be introduced at national level, to achieve consistency of tax treatment throughout the country. The legislation could set an upper limit to the rate of tax, leaving regions and governorates to set the actual rates. If the tax rates are not capped, it is possible that some regions or governorates could set unrealistically high rates in an effort to generate revenue, leading to fiscal instability.

2. Excise taxes

Excise taxes or excise duties are levied on specific goods that are imported into or manufactured within a country. In the case of Iraq, that would require the application and collection of taxes on goods as they crossed the border, or as they left the place where they were manufactured or produced in their final form.

Excise taxes are ideally applied and collected at the national level, as the places of import and manufacture of excisable goods are not uniformly distributed around the country. To do otherwise would be to promote inter-regional rivalry and competition for the production of excisable goods, along with attempts to restrict the movement of such goods from other regions.

Excises may be levied on a per unit basis (specific rate) or on a value related basis (ad valorem). In practice, both methods are commonly adopted, with some goods (such as motor vehicles) being assessed on a value basis, and some (such as petroleum fuels) on a quantity basis. Excisable goods are usually listed in schedules.

Excises are generally applied to goods for which demand is not strongly influenced by price (goods that have a so-called inelastic demand curve) as these can yield high revenues without significantly impacting on the level of consumption.

Excises may be applied for purposes other than the raising of revenue, such as the discouragement of the consumption of certain goods (such as alcohol and tobacco), although such policies may have an excessive impact upon poorer families.

Excises are also sometimes used as a tax on luxury goods that are preferred by wealthier people, but are not essential for everyday consumption.

The potential for applying excise in Iraq covers a number of types of goods:

- Motor vehicles, on a certified value related basis, as they are imported;
- Petroleum fuels, on a quantity basis, as they are imported or released by refineries for distribution (but not while price subsidies are still in place);
- Tobacco and tobacco products, including cigarettes and cigars, on a per weight or per number basis;
- Alcohol and alcoholic drinks, on a volume basis by alcohol content, if not prohibited by other laws and traditions;
- Perfumes and fragrances, on a value related basis.

Specific actions required

The Ministry of Finance through the TPU will be required to create and introduce relevant legislation to establish new tax regimes that may be required to facilitate the enhancement of revenue collected at national, regional and governorate levels, and to negotiate with representatives of regional and governorate administrations on the design and implementation of the taxes applicable at sub-national levels.

Support measures needed

Study tours

To be decided

Conferences

To be decided

Training courses

To be decided

Development and advisor support

To be decided

Phase 3 – Development, design and introduction of a broad-based Sales Tax or VAT

The introduction of a new broad-based sales tax and particularly a VAT will be a major undertaking for the GoI which must not be done hastily. There is plenty of evidence to indicate that the successful introduction of a VAT requires a planning and pre-implementation period of at least two years, in any country. While a sales tax applied exclusively at the border may not require such extensive planning, the issue of border security and the integrity of revenue collection at the border must be resolved before such a tax can be considered. Several other important indicators must be satisfied before broad-based sales tax and particularly a VAT can be considered.

The essential conditions for a full-fledged sales tax or VAT include:

- Effective control and measurement of the flow of goods at the borders;

- A tax administration authority able to administer an intensive, transaction based tax, with monthly returns, assessments and payments, at low cost;

- Taxpayers with experience in transaction based accounting, able to complete monthly returns based upon accurate and reliable records of purchases and sales that will withstand scrutiny by the tax administration; and

- For a VAT, taxpayers able to produce and provide detailed tax invoices (or equivalent records) for every transaction with another registered taxpayer, and for final sales, creating a largely self-policing and verifiable audit trail.

Before a border sales tax or VAT can be introduced it will be essential that there is effective measurement and control of the movement of goods at the Iraqi borders, for both imports and exports. The best indication of this being achieved for imports will be when the revenue from the Customs Duty that is intended to replace the current Reconstruction Levy is judged to be close to the expected yield based upon the actual value of imports (using import data matched with export data obtained from Iraq's trading partners). There will be little benefit from introducing any new tax to be applied at the border unless and until the existing Levy or Duty is being collected. Because the expected consumption-based type of VAT is levied on imports but is refundable for exports, the outwards flow of goods needs to be equally well controlled and measured. Significant training of GCT and GCC staff, along with publicity about the changes, and provision of advice and support to liable taxpayers, will be required during a period of several months leading up to the introduction of these new taxes.

In some ways the direct introduction of a VAT would be rather less complex than its introduction following the application of a broad-based sales tax. That is because there would be fewer stages needed in the design and development of legislation and regulations, meaning that a longer period could be spent on the design of the VAT legislation and regulations, on the training of tax administration and other staff in the proper application and enforcement of the VAT, and on designing and providing information for businesses that will be required to enable them to collect the VAT in the course of their regular sales activity, to account for the VAT received and paid, and to pay the net difference to the revenue agency on a regular basis.

<u>Option A – staged introduction – implementation over 2008 - 2010</u>

Step A1 – Introduction of a broad-based sales tax, initially at the border – early 2008

The Ministry of Finance through the TPU will be required to create and introduce relevant legislation to apply sales tax on imported goods and materials, recognizing the intention to extend this tax subsequently to cover a broader range of goods and materials that are produced and manufactured domestically.

Assuming that the conditions outlined above are met, especially the effective control of import movement of goods and materials, and the collection of taxes and tariffs at the borders, it will be necessary to verify that the imposition of a discriminatory sales tax in addition to the proposed Customs duty tariffs will be acceptable to the WTO.

The design of this legislation need not be complex. There will be a need to determine the agency responsible for the collection of the sales tax, the rate or rates of sales tax, and to identify categories of goods and materials which may qualify for exemption. It will also be necessary to decide whether a single rate or multiple rates of tax should apply, and to decide which categories of goods and materials should be subject to each rate, if there is more than one. The classification of goods and materials subject to each rate or to be made exempt from sales tax should follow the Tariff Code classifications within the Customs Law. The base value for the application of sales tax should be the duty-paid value of imports.

The law will need to specify which administrative body is to be made responsible for the collection of the sales-tax. In the present environment, it may not be practicable to set up an additional agency in border areas. The Customs Commission already has difficulty in enforcing the collection of the Reconstruction Levy, and without some greater support for their role and function at border posts, it is difficult to see that the collection of Customs Duty or Sales Taxes will be any more effective. In fact, with the higher potential impost of a combined Customs Duty and Sales Tax, there will be a greater incentive for the importers of goods and materials to evade these taxes.

As the sales tax will be applied at a single stage in any supply chain for goods and materials, it should not be necessary to consider the need for refunds of sales tax, except possibly for goods that are subsequently re-exported in unchanged form, and for goods and materials which are wholly incorporated into other products that are subsequently exported. The latter provision may be needed to maintain the competitive advantage for Iraqi export industries. An exemption for imported capital goods that are to be used exclusively in the production of exports may also be needed.

The introduction of a border sales tax on a wide range of goods and materials would have a one-off impact on the expenditure levels of all Iraqi households, most probably with a proportionally greater impact on poorer families. Some compensatory adjustment in social safety-net payments may be required. The cost of this would reduce the net fiscal gain from the additional tax revenue.

Support measures needed – step A1

Study tours

To be decided

Conferences

To be decided

Training courses

To be decided

Development and advisor support

To be decided

Step A2 – Extension of the sales tax to local manufacture and production - 2008 / 2009

The Ministry of Finance through the TPU will be required to create and introduce relevant legislation to extend the sales tax to cover a broad range of goods and materials produced and manufactured domestically.

Extension of a sales tax to cover the local manufacture and production of goods and materials will be inherently more complex than the establishment of a sales tax at the border. Apart from the need to determine rules that will define the manufacturing and production activities to which the sales-tax will and will not apply, and processes for registration, policing and enforcement, there are significant tax design issues.

These will require careful study and analysis to determine the most appropriate solutions in the Iraqi context. In some ways, the task of designing a broad-based sales-tax is more complex than that of designing a Value-Added Tax (VAT).

One important tax design issue is the potential impact of cascading taxes. If a sales tax is imposed on imported and locally-produced goods and materials that are subsequently used in the manufacture of other goods for sale, then those final goods would have a double impost of sales tax, the first included in the price of the goods and materials used by the manufacturer, and the second applied by the manufacturer. It may be that only some of the inputs used by the manufacturer have been subject to sales tax – certainly, the cost of wages and salaries paid to the employees of the manufacturer are not subject to a sales tax – so the effective sales tax is less than a doubling of the basic sales tax. Nevertheless, the compounding of sales tax in this way is undesirable, especially if goods and materials need to pass through several different manufacturing stages before they completed and ready for sale.

There are a number of different ways in which this cascading problem may be addressed, and the effect reduced. These include the exemption of sales taxes on goods and materials imported and produced for use in manufacturing (difficult to police), and the refund of some or all sales tax included in the price of the goods and materials used by producers and manufacturers subject to sales tax (easier to control). The exemption of certain industries or of certain goods and materials produced within those industries from sales tax may also be considered. The latter approach would require regulations with an extensive set of schedules of exempted materials.

The need to address these and other tax design issues means that the development of this legislation will take longer that for the introduction of the sales tax at the border.

Note that it might be easier, from a legislative and administrative point of view, to proceed to the development and introduction of a VAT without first introducing a broad-based sales tax. Alternatively, if it is decided that any decision on introducing a VAT should be deferred, then it would be desirable to proceed to develop and introduce a broad-based sales tax.

The introduction of a broad-based sales tax on a wide range of goods would have a one-off impact on the expenditure levels of all Iraqi households, most probably with a proportionally greater impact on poorer families. Some compensatory adjustment in social safety-net payments may be required. The cost of this would reduce the net fiscal gain from the additional tax revenue.

Support measures needed – step A2

Study tours

To be decided

Conferences

To be decided

Training courses

To be decided

Development and advisor support

To be decided

Step A3 – Conversion of a broad-based sales tax into a VAT – 2009 / 2010

The Ministry of Finance through the TPU will be required to create and introduce relevant legislation for a VAT regime to apply to all goods and services consumed in Iraq, assuming that the form of VAT follows the internationally favored "destination principle". The alternative would be to apply VAT on all goods, materials and services produced in Iraq, according to the "origin principle", but this would have strong disadvantages for Iraq's competitive position in international trade. The latter approach would require VAT to be applied to exports of crude oil, for example. There need be no differences in the treatment of domestic transactions under these two forms of VAT, but only in the treatment of imports and exports.

There are several options for the design of a VAT and the actual design and detailed rules will have to be tailored to match business practices in Iraq. Even so, the introduction of a VAT will affect a great many enterprises, including most companies, and some professional practitioners, sole traders and other unincorporated businesses. One important decision will be that of a threshold for compulsory VAT registration. The introduction of a VAT will require some improvement in record-keeping and the wider use of formal invoices. In general, the introduction of a VAT will also provide an opportunity to improve the collection of other taxes, especially income tax, as the VAT accounting records tend to provide a useful basis for the scrutiny of business income. Another issue to decide is whether voluntary registration should be allowed.

Adopting a "consumption type" VAT according to the "destination principle" will require the law to impose VAT on all imports, refund VAT on exports, and most probably require a system involving "output" tax invoicing and "input" tax crediting within the domestic supply chain for all goods, materials and services. Much of this detail can be developed from standard examples of VAT laws applied elsewhere. Again, this will need to be tailored to suit the Iraqi context.

As part of the design of the VAT, decisions will be needed on whether to adopt a single rate or multiple rates for the VAT, and whether the VAT will be applied across all goods, materials and services, or whether there will be exclusions. In VAT law this will require development of legislative treatment for "zero-rated" and "exempt" goods, materials and services. Any concessions and exemptions will need to be carefully defined and limited, against the need to maintain as broad a tax base as possible, so as to achieve the greatest revenue yield at an acceptable rate or rates for the VAT. These are important questions which have widespread economic and social implications. The introduction of a VAT in place of a broad-based sales tax might have a positive or negative impact on the expenditure levels of all households in Iraq. The differential impact on poorer households would need to be analyzed.

One advantage of introducing a VAT as compared to a broad-based sales tax is that the potential for a cascading of taxes is reduced, if not entirely eliminated, as if the majority of goods and services are subject to the VAT, then a credit for purchases is available for registered VAT taxpayers to offset against VAT liability on their sales.

It will be necessary to include transitional measures to allow for the crediting or refund of sales tax already paid by businesses, upon the introduction of the VAT.

[The terms in quotations above have a special meaning in VAT parlance and their correct interpretation in Iraqi Arabic will need to be determined and agreed. Developing clear and precise expressions for all technical terms and using them consistently is an essential part of the design of VAT legislation.]

Support measures needed – step A3

Study tours

To be decided

Conferences

To be decided

Training courses

To be decided

Development and advisor support

To be decided

Option B – Direct introduction of a broad-based VAT – implemented in 2009 or later

Introduction

In some ways the direct introduction of a VAT would be less complex than its introduction following the application of a border sales tax or of a broad-based sales tax. The introduction of a VAT following the application of a border only sales tax, without proceeding to a broad-based sales tax, would follow the path outlined in the previous section, omitting step A2.

Given the current difficulties in measuring the flows of goods at the border, and collecting levies, duties and taxes on imported and exported goods, the direct progression towards the introduction of a VAT might provide an effective source of revenue even if it could not be properly enforced on all imports across the border.

The reason for this apparent inconsistency is that a well-designed VAT would collect the full VAT revenue from all but the smallest scale importers at the next stage of the transaction chain, when they sell the imported goods, whether to intermediaries or to final consumers. This assumes that it would be possible to identify and enforce VAT registration for all significant importers. If no VAT has been paid at the border, the credit for input tax payments would be zero, so the VAT would be payable on the full value of the sales. If VAT has been paid at the border, and credited to the importer's VAT account, then a credit would be allowed against the VAT due on sales proceeds. The only situation in which VAT is evaded is where goods are imported by persons who are not registered for VAT. As a standard practice, these people should be required to pay the VAT, in addition to other taxes, at the time of importing goods.

Design and Implementation

The Ministry of Finance through the TPU will be required to create and introduce relevant legislation for a VAT regime to apply to all goods and services consumed in Iraq, assuming that the form of VAT follows the internationally favored "destination principle". The alternative would be to apply VAT on all goods, materials and services produced in Iraq, according to the "origin principle", but this would have strong disadvantages for Iraq's competitive position in international trade. The latter approach would require VAT to be applied to exports of crude oil, for example. There need be no differences in the treatment of domestic transactions under these two forms of VAT, but only in the treatment of imports and exports.

There are several options for the design of a VAT and the actual design and detailed rules will have to be tailored to match business practices in Iraq. Even so, the introduction of a VAT will affect a great many enterprises, including most companies, and some professional practitioners, sole traders and other unincorporated businesses. One important decision will be that of a threshold for compulsory VAT registration. The introduction of a VAT will require some improvement in record-keeping and the wider use of formal invoices. In general, the introduction of a VAT will also provide an opportunity to improve the collection of other taxes, especially income tax, as the VAT accounting records tend to provide a useful basis for the scrutiny of business income. Another issue to decide is whether voluntary registration should be allowed.

Adopting a “consumption type” VAT according to the “destination principle” will require the law to impose VAT on all imports, refund VAT on exports, and most probably require a system involving “output” tax invoicing and “input” tax crediting within the domestic supply chain for all goods, materials and services. Much of this detail can be developed from standard examples of VAT laws applied elsewhere. All of this will need to be tailored to suit the Iraqi context.

As part of the design of the VAT, decisions will be needed on whether to adopt a single rate or multiple rates for the VAT, and whether the VAT will be applied across all goods, materials and services, or whether there will be exclusions. In VAT law this will require development of legislative treatment for “zero-rated” and “exempt” goods, materials and services. Any concessions and exemptions will need to be carefully defined and limited, against the need to maintain as broad a tax base as possible, so as to achieve the greatest revenue yield at an acceptable rate or rates for the VAT. These are important questions which have widespread economic and social implications.

The introduction of a VAT tends to have a one-off impact on the expenditure levels of all Iraqi households, often with a proportionally greater impact on poorer families. Some compensatory adjustment in social safety-net payments may be required. The cost of this would reduce the net fiscal gain from the additional tax revenue.

Under this direct implementation option, it will not be necessary to include transitional measures to allow for the crediting or refund of sales tax already paid by businesses, upon the introduction of the VAT.

[The terms in quotations above have a special meaning in VAT parlance and their correct interpretation in Iraqi Arabic will need to be determined and agreed. Developing clear and precise expressions for all technical terms and using them consistently is an essential part of the design of VAT legislation.]

Support measures needed – Option B

Study tours

To be decided

Conferences

To be decided

Training courses

To be decided

Development and advisor support

To be decided

APPENDIX – TECHNICAL FACTORS TO BE CONSIDERED

Objectives and Basic Principles of Taxation

As previously stated, the overarching objective is to increase the yield of tax revenue from an evolving Iraqi economy in a manner that facilitates and encourages economic development, while at the same time protecting Iraqi families, especially the poor, from adverse social impacts. Tax reforms have to be achieved through changes to the tax laws, both those that determine the taxes and those that govern their application, collection, review, audit and enforcement, and also through improvements in tax administration.

The standard principles of tax system design need to be applied:

Equity – the basic principle of fairness in revenue system design and administration.

- Horizontal equity - treating taxpayers in equivalent circumstances in a similar manner, no matter what their source of income or wealth.

- Vertical equity – differentiating between taxpayers according to their relative income and wealth, also according to their family circumstances, and applying higher amounts of tax to those in better circumstances, relative to the taxes applied to those in lesser circumstances.

These two principles of equity are often reflected in a tax system that provides allowances and exemptions for those with limited incomes and means, and which applies successively higher rates for selected taxes to those in better circumstances (so-called progressive tax systems). An overall progressive tax system may include some progressive taxes, some flat taxes and some mildly regressive taxes (such as taxes on types of expenditure favored by the poor).

Efficiency – revenue should be raised at least cost to the economy and taxpayers

A well designed tax system will raise the necessary revenue in a manner that minimizes harmful distortions to the economy.

This principle is often ignored in practice, where governments seek to favor some sectors of the economy at the expense of others, in the mistaken belief that market forces will be inadequate to achieve balanced economic growth.

Economic arguments can be employed to demonstrate that the broader the base and the lower the rate of a particular tax, or combination of taxes, the lower is the economic distortion caused. Economic principles can also show that applying higher rates of tax where supply and demand are more inelastic can raise more revenue with less economic distortion.

Simplicity – taxes and tax law must be understandable by those affected by them.

Taxpayers need to understand the tax law and their obligations accordingly, when and how to pay taxes that are due, how to calculate taxes under self assessment and the consequences of their failure to comply with the tax law.

Costs of collection – both administrative and compliance costs should be minimized

Taxes should be designed so that the administrative procedures are simple and easily enforceable, with minimal duplication of effort.

The costs to taxpayers, in time and money, in finding out about their liability to pay taxes, determining the tax to be paid (for self assessment) and presenting the information required by the tax authorities must be minimized.

Revenue Yield of Taxes

All existing taxes and a range of potential new taxes need to be considered for their potential to yield tax revenue from the Iraqi economy, in the medium and longer term. The potential revenue yield for any tax depends upon several factors:

- The tax base – the total economic value or value-added base over which the tax can be applied;
- The tax rate – the percentage of the base that is appropriated by the tax in each period or instance; and
- The behavioral response – the anticipated or assumed change in behavior by taxpayers who adjust their behavior or rearrange their affairs to reduce their specific or overall tax liability.

The simple calculation for the yield of a tax is economic base times the rate of the tax applied to that base. If the tax rate scale is graduated, then the base has to be segmented accordingly before the calculation can be performed.

The behavioral factor is always important. Even in a pure market economy, the supply and demand for various goods and services will change in response to the introduction of taxes. The tax yield depends on the elasticity of both supply and demand curves for the goods or services taxed. With low elasticity in both curves (i.e. with neither supply nor demand being price sensitive) there will minimal adjustment in market clearing prices and quantities, little reduction in economic activity, and the tax yield will be close to the base times rate maximum. High rates of tax can be applied without inducing economic distortion

With higher elasticity in either or both curves, the quantity supplied and demanded will adjust downwards significantly, and economic activity will contract more markedly. As well as a reduction in tax revenue, there will be an overall further loss to the economy, known as deadweight loss, with consumers and producers bearing the consequences of this, as well as the tax burden.   Even moderate rates of tax have the potential to introduce economic distortions, especially if some economic sectors are taxed and others are left untaxed.

Analysis of this type in respect of each and every tax needs to be included as part of the tax system design and development process. In choosing the tax mix, it is also important to identify which taxes are complements and which taxes are competing with one another.

Tax Design Issues

Each and every tax needs careful design to be effective, efficient, in economic terms, as well as from the perspective of the administration and the taxpayer. Some existing and proposed taxes may be hybrids of more than one type of tax. In general, it is better to include income related taxes within the income tax regime and to limit the rate of specific transaction based taxes, while assigning the latter to lower levels of government.

For example, the current Real Estate Transfer Tax may be viewed as a form of transaction tax, but it has elements of a tax on income (the accumulated value-added representing a capital gain) and a tax on the transfer of wealth (as the initial cost of the property is not deducted from the selling price). The exemption for low value property and the progressive tax rate scale applied to the balance of the assessed value are common to both income and wealth transfer taxes. The use of an administratively assessed value rather than a reported transaction price means that this tax should not be classified as a sales tax. This practice also reduces price transparency, and replaces an opportunity for evasion through fraudulent price reporting with another through exerting influence over the administrative valuation.

In most developed countries, property transfer taxes are based upon actual prices paid, with a progressively increasing rate scale, allowing for a tax free threshold. This is reflected in Iraq. However, the setting of tax rates, collection of revenues and administration of such taxes are usually devolved to the equivalent of regional or governorate levels in most federal countries. This is based upon the fact that property is immovable, so having different rates in different regions does not create significant economic distortion. However, federal property is exempt.

Categories of Taxes to be Considered

There are three categories of taxes that will need to be considered in this exercise:

1. Existing taxes, subject to modifications.

2. New taxes as proposed for consideration as part of an undertaking for the GoI within the current SBA with the IMF.

3. Other taxes that may deserve attention.

The Tax Yield Potential Matrix

The table below illustrates the actual and potential contribution of various categories of taxes, levies and duties to overall tax revenue. It includes estimates of revenue for 2005 and on a relative scale the potential for revenue yield in future years. In this context, “high” means above 20% of total revenue, “medium” between 10% and 20% of revenue, “low” between 5% and 10% and “minimal” between 1% and 5%, and “negligible” less than 1%. These ratings are subjective and open to debate. The comparison base is the total tax and Customs revenue received by the central government during 2005, estimated at 340 billion ID. Some additional revenue was retained by the governorates and by the Kurdish regional government.

Type of Tax	**Current Revenue (2005 year)**	**Potential Revenue (Relative basis)**	**Comments**
Existing Taxes	Million ID		
Income Tax – Corporate	24,617	Medium to High	Few significant taxpayers at present, but good potential for growth if SOEs become taxable, as and when new industries emerge, and from future private sector involvement in the energy sector.
Income Tax – Business and Professions	23,351	Medium	Enforcement relatively difficult at present. Presumptive taxes have a role to play but growth of services sector will require full income tax.
Income Tax – Individual (Withholding)	78,509	High	Possible growth from improved withholding from salaries and wages in the private sector to match current revenue from public sector.
Real Estate Rental Tax	9,029	Low	Prefer to include this as an element of income tax subject to same rate scale and personal allowances and based on actual rental income if and when that can be ascertained.
Real Estate Transfer Tax	40,416	Medium to High*	Currently a significant contributor to revenue but in longer term may be more suitable for application at the regional or governorate level.
Vacant Land Tax	848	Negligible	Needs to be abolished or included in a general land or property tax.
Sales Tax – Deluxe Hotels and Restaurants	74	Minimal to Low	More revenue if current exemptions are removed and GCT have powers of entry and inspection of books.
Reconstruction Levy	Estimates range from around 165,000 to 285,000	High but tending towards medium unless control of goods at borders is improved	Currently applied at 5% but with a wide range of exempted goods. Some governorates apply a matching levy for their own revenues. Not enforceable in

			current conditions.
Customs Duty		High if enforced	As agreed by GoI under EPCA to replace the reconstruction levy, with a broader base, having fewer exemptions, and at a rate of 10%
New Taxes			
IMF proposal			
Sales Tax (at border)		High	Requires effective control of flow of goods and collection of revenues at the borders.
Sales Tax (broad based)		High	Requires in addition to the above an effective measure of the value of domestic goods at the point of taxation (wholesale or retail) and some credit for border taxes paid.
Value Added Tax		High	Requires effective control of flow of goods and collection of revenues at the borders, along with capacity for administration of transaction based taxes and strong compliance incentives. Liable firms need to have good transaction accounting systems, including full invoicing.
Other examples			
Payroll Taxes		Low to Medium	Levied at a flat rate on the total payroll, separate to income tax and social security levies. Used in many countries at regional and local levels in lieu of a local income tax, as it is easier to administer. The maximum rate should be set by central government.
Excises		Low to Medium	Generally applied to discretionary goods with inelastic demand to minimize economic distortion. The greatest potential yield is from an excise on petroleum fuels, although subsidies must be eliminated first. In other countries alcoholic beverages, tobacco, perfume and luxury goods are subject to excise.

Natural Resource Taxes and Levies		Medium to High	For future petroleum exploration and production projects, the government may not have ownership of any or all of the resulting hydrocarbons produced. A royalty or tax on production could provide a first tranche of revenue to the government, as any income tax on operating profits will be delayed until deductible up-front costs have been fully recovered.
Environmental Taxes and Levies		Low	Limited potential at present, but could be used for example as an incentive to reduce gas flaring and wastage by the oil sector in future.
Infrastructure Development and Maintenance Fees and Charges		Low	Potential at regional, governorate and local levels, to pay for improved infrastructure (toll roads) or for provision of essential services (water, sewerage, waste disposal). Often included in property taxes.
Other User Charges and Levies		Low	Generally follow a cost-recovery model for non-essential services. The use of road tolls to pay for new highways that save time and fuel is an example. Other examples are fees for using sporting facilities, and rental charges for borrowing fiction books from public libraries.

Classification of Taxes

Without limiting generality, a wide range of taxes can be described in a standard taxonomy. Following and adapting the scheme of the IMF publication “Tax Law Design and Drafting” (Two volumes, 1996 and 1998, Editor: Victor Thuronyi) we can classify the recognized classes of taxes together with some of their associated specialized tax regimes as follows:

Taxes on Income

- Individual Income Tax
  - Withholding Tax on Salaries and Wages
  - Taxation of Unincorporated Enterprises
  - Presumptive taxation
- Corporate Income Tax
  - Taxation of Corporate Reorganizations
  - Taxation of Enterprises and their Owners
- Taxation of Capital Gains
- Taxation of Investment Funds
- Tax Incentives for Investment
- Depreciation, Amortization and Depletion
- International Aspects of Income Tax

Payroll Taxes

Social Security Contributions

Taxes on Land and Buildings

- Taxes on Land – Agricultural, Municipal, Vacant Land
- Taxes on Buildings and Property Ownership and Rentals
- Taxes on Buildings and Property Transfers

Taxes on Wealth

- Periodic Taxes on Wealth
- Taxes on Wealth Transfers

Taxes on Financial Transactions and Instruments

- Check and Stamp Duties
- Taxes on Financial Transfers

Sales Taxes and Turnover Taxes

- Sales Taxes on Specific Goods or Services
- Broad-based Sales Taxes
    - Border Sales Taxes
    - Wholesale Sales Taxes
    - Retail Sales Taxes

Value Added Taxes

- VAT Exempt and Zero-rated Goods and Services
- VAT Treatment of Financial Services
- VAT Treatment of Immovable Property

Customs Duties and Levies on Imports and Exports

- Customs Duties and Levies on Imported Goods and Services
    - Tariff Codes, Setting of Rates for Duties and Levies
- Customs Duties and Levies on Exported Goods and Services
    - Tariff Codes, Setting of Rates for Duties and Levies

Excises

- Definition of Goods Subject to Excises
- Ad Valorem and Specific Rates of Excise

Resource Royalties, Levies and Taxes

Fees and Charges for Services (User Charges)

- Levies and charges for the development and maintenance of infrastructure
- Fees and charges for provision of essential services
- Fees an charges for use of discretionary services

The taxes can also be classified according to the IMF's Government Financial Statistics (GFS) Manual. However, that classification system is designed for government financial accounting, and does not cover the associated tax regimes which also need to be considered. The same comments apply to the OECD standard list of taxes used for revenue reporting.

At a more fundamental level, all taxes can be classified as direct taxes (where the revenue is based upon income, wealth or other attributes of the taxpayer) and indirect (where the revenue is based upon flows or stocks of money or goods that are not the income or wealth of the taxpayer from whom the payment is collected). This classification alone is too broad for the effective review and assignment of taxes. Nonetheless, it is important to recognize that a balance between taxes on income and taxes on consumption can lead to a more effective tax system, raising more revenue than either category of tax could achieve alone, with less economic distortion and a lower overall impact upon economic growth and development.

Fiscal Decentralization

Iraq has already evolved from its former unitary system for the funding and provision of public services into a partly decentralized system, where local governments have some revenue raising powers. Further to this, the Kurdish region comprising the three northern governorates of Iraq has asserted a degree of independence and autonomy in management of its financial affairs. That region has its own Parliament and government financial institutions.

Section five of the Iraqi Constitution provides for establishment of further regions, and for regions and governorates not incorporated into a region to receive an equitable share of national revenues sufficient to meet their obligations, and to manage their financial affairs. It also provides for powers exercised by the federal government to be delegated to regions and governorates (and vice versa) with the consent of both governments, subject to the law. These are sufficient to facilitate the devolution of some rights of fiscal management to regions and governorates. Some would argue that the rights of the regions rank above those of the central government. The system that evolves in practice will involve changes to the present system.

To a greater or lesser extent, many countries have fiscal responsibility shared between central and lower level governments, representing regions, sub-regions and municipalities or local administrative authorities. The form that fiscal decentralization assumes varies significantly from country to country, depending upon their constitution and sub-national organization.

In Iraq, it is anticipated that regional governments and governorate councils will achieve a substantial measure of fiscal independence, including the right to levy or assume control of certain taxes within their territorial limits. There are some principles of fiscal federalism that have been distilled from experience in many countries, and these are summarized in the next section.

The working assumption under which the plan for the overhaul of the Iraqi tax system has been developed is that the central or federal government will continue to legislate for major taxes, duties, excises and levies that will apply nationally (with the exception of the Kurdish region), in consultation with the regions once these are formed and have the necessary fiscal capacity, and that regions and governorates will have increasing powers to determine rates of some taxes, collect some taxes, retain or share revenues with the centre, and administer taxes. Taxes, levies, fees and charges currently collected under the Municipalities Law will continue to be collected by local administrative authorities. The central government may continue to legislate for such taxes, or alternatively this function may be transferred to the regions. These taxes and charges are not further considered in the mainstream plan for the reform of taxes.

Some specific guidance on the assignment of taxes, including responsibility for deciding on tax bases, tax rates, tax revenues and tax administration, are presented in tabular form in the final section.

Principles of Fiscal Federalism

Some useful principles to guide the devolution of fiscal powers are as follows:

Diversity

The federal system should provide scope for variety and differences in fiscal arrangements in different regions, governorates and localities. Regions, governorates and communities that differ in their preferences for local public services should not be forced into a common pattern.

Equivalence or matching

The geographical coverage of different public services varies considerably. Some, such as defense, or electricity generation, are nation-wide, while others, such as education or health-care can be organized on a regional or governorate basis. Some, such as refuse collection, libraries and sporting facilities, can be provided at local level. Each type of service should ideally be decided upon and funded at the lowest level at which it can be organized most effectively.

Locational neutrality

Regional fiscal differences may influence the choice of location for industries and businesses, even where people choose to live. Some degree of difference is acceptable, but large differences in taxes between different regions, governorates or administrative districts are to be avoided.

Centralized redistribution

The redistributive function of fiscal policy (progressive taxation combined with transfer payments or benefits) should be performed at the federal level, as otherwise the principles of equity in treatment of taxpayers may be violated.

Centralized stabilization

Fiscal balances should be used as instruments of macroeconomic policy at the national level. Sub-regional and lower level governments generally lack the means to pursue such policies.

Minimum provision of essential public services

The national government should ensure, through grants to and transfers among regions and lower level administrative bodies if necessary, that every citizen receives at least a minimum level of essential services such as security, health, welfare and education.

Equalization of fiscal position

Even with effective centralized redistribution, there may be significant differences in needs and circumstances among people in certain regions, such that objectives cannot be met within the available regional finances. The central government should oversee some means of fiscal redistribution among regions so that at least minimum levels of services can be provided.

Assignment of Taxes

Central Government

Generally, central governments should have essentially unrestricted ability to levy and administer taxes, as well as to set user fees. In part, this arises from the relatively large revenue needs of central governments: in addition to funding their own expenditures, they typically, for a variety of reasons discussed below, fund lower level governments. Moreover, since central tax bases and rates are homogeneous throughout the country, central taxes avoid tax-induced distortions to the geographical allocation of labor and capital, and are therefore relatively attractive from the perspective of economic efficiency or neutrality. A strong case can also be made for central administration, coupled with tax base sharing with local governments, in the case of certain taxes (such as the personal and corporate income taxes, and possibly VAT). This eliminates administrative duplication, significantly simplifies taxpayer compliance and enforcement, and permits achievement of economies of scale. An exception to the general rule of unlimited central government authority to tax generally applies in the case of the property tax. This tax is almost always preserved as an exclusive tax for sub-central governments, although in smaller countries, the central government may even have a role to play here in establishing the principles that apply for base setting.

Regional and Governorate Taxes

The general principle that should apply for regional governments and governorates, except in the case of consumption-based sales and excise taxes, is that they should be limited to tax sharing on centrally-defined and administered taxes. In each region and governorate, for each shared tax, regional or governorate collections would be levied at a single fixed rate, based either on central tax collections or on the central base. Such an approach can be applied for personal income taxes but also in the case of corporate income taxes, and if appropriate in particular settings, for natural resource taxes and a sales tax or VAT. Principal motivations for this are simplicity in tax administration and ease of taxpayer compliance. It may be appropriate in circumstances in which regional governments and governorates are relatively unsophisticated in tax matters, to limit the fixed regional and governorate tax rates to relatively narrow bands, particularly for taxes on business. This reduces the likelihood of geographical distortions to business activity. Of course, as with all levels of government, regional governments and governorates should be free to levy taxes and charges to fund the provision of essential services for which they are responsible, to the extent that these are not funded by transfer payments from higher levels of government, as well as cost-based user fees for discretionary services.

Local Taxes

Own source revenues for local governments and municipalities often take the form of property taxes, selective sales taxes, business license taxes and fees and user charges for services provided by local governments. As in the case of regional governments and governorates, local governments should only participate in shared central taxes on the terms outlined above for regional governments and governorates. However, it is not usually appropriate for local governments to share directly in central and regional government taxes in this manner.

Revenue Assignment Options

The following table summarizes the basic principles outlined above. For each tax, it considers four different dimensions of revenue assignment: (1) the determination of the base; (2) the setting of rates; (3) the allocation of the revenues collected; and (4) administration. These are not necessarily the same, in part because tax bases can be shared among different levels of government and, in part, because tax simplicity and administrative and economic efficiency argue for standardization of procedures wherever feasible.

GENERAL PRINCIPLES OF REVENUE ASSIGNMENT				
Key: **C: Central government** **R: Region** **G: Governorate** **L: Local or municipal government** **A: Administrative body**	**Tax Assignment Options** **Assignment of Responsibility for:**			
Tax	**Base**	**Rate**	**Revenue**	**Administration**
1. Personal income tax	C	C, (R*), (G*)	C, (R*), (G*)	C, (R*), (G*)
2. Corporate income tax	C	C, (R*), (G*)	C, (R*), (G*)	C, (R*), (G*)
3. VAT (consumption basis)	C	C, (R*), (G*)	C, (R*), (G*)	C, (R*), (G*)
4. Sales tax applied at the border	C, (R)	C, (R*), (G*)	C, (R*), (G*)	C, (R*), (G*)
5. Consumer sales tax or consumption-based excise or luxury goods or services tax	C, R, (G), (L)	C, R, (G), (L)	C, R, (G), (L)	C, R, (G), (L)
6. Customs duties and levies	C	C, (R*), (G*)	C, (R*), (G*)	C, (R*), (G*)
7. Natural resource taxes	C, (R)	C, (R), (G*)	C, (R), (G*)	C, (R), (G*)
8. Environmental and pollution taxes	C, (R)	C, (R), (G*), (L*)	C, (R), (G*), (L*)	C, (R), (G*), (L*)
9. Social security and general payroll taxes	C, (R)	C, (R), (G*)	C, (R), (G*)	C, (R), (G*)
10. Property ownership annual taxes	C, R, G, (L)	(R), G, L	(R), G, L	(R), G, L
11. Local, governorate and regional fees, levies and charges including user charges	(C), (R), G, L	(C), (R), G, L	(R), G, L, A	(R), G, L, A
Notes: (1) An asterisk indicates that a regional, governorate or local tax rate that would be a fixed percentage of the central tax collections or the central base. (2) A bracket represents a weaker recommendation.				