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Tax Policies and Regulations Enhancing Entrepreneurship in Iraq

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Al-Bayan Center Studies Series

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Tax Policies and Regulations Enhancing Entrepreneurship in Iraq

Dr. Ibrahim Adeeb Al-Jalabi*

Abstract:

- The rates at which individuals enter the field of entrepreneurship are negatively affected by administrative burdens and bureaucratic complexities, in addition to tax-related regulations and the complexities of the corporate income tax system.
- Iraq's tax policy remains influenced by socialist thought, as the tax laws in force are primarily derived from the Income Tax Law No. 113 of 1982 and its amendments. This law is the sole basis for calculating both individual and corporate taxes and lacks clear details regarding startups or entrepreneurial projects.
- The tax law grants tax exemptions limited to very specific activities related to certain agricultural projects or projects providing services to the state, such as the transportation of petroleum products. Other activities, such as commercial or professional businesses, are considered by the tax law as the most important forms of income sources.
- Certain taxes increase investment costs, such as the tax imposed on rentals, which is 10% of the property rental value according to the amended Property Tax Law No. 162 of 1959, raising the rental levels paid by startup owners.

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- The government needs to reduce the direct financial costs borne by private, especially entrepreneurial, projects by preparing a regulatory list aimed at promoting entrepreneurial projects.
- Exempting company profits from income tax for suitable periods to reduce the capital recovery period and increase the necessary resources for the project to meet its establishment requirements.
- Exempting assets purchased by private projects from ownership transfer fees if located within specified areas.
- Exempting private sector employees from income tax for a specified period or reducing it.
- Enacting laws requiring private sector institutions to contract with national companies for obtaining goods and services needed in their operations, especially those that cannot be produced locally.

Introduction:

Iraq has suffered and continues to suffer from the remnants of the socialist system that dominated its economic life since the 1950s. This system, pursued for half a century, implemented policies that severely damaged private enterprises and weakened economic incentives for private investment. With the continuation of the socialist approach, the culture of private work dwindled, and the general tendency among the majority of society became to seek employment in the public sector, making Iraq today the country with the highest rate of public sector employment.

In light of new orientations to activate the private sector's role in the economic life, many economic files are being presented that require reconsideration and correction to align with the new economic philosophy of the Iraqi state. Among these files are the tax policy and regulations in Iraq, which still rely on laws dating back to the socialist regimes. This paper aims to highlight various aspects of what the process of reforming the tax policy in Iraq requires, especially in terms of supporting private and entrepreneurial projects.

Entrepreneurs and Ways to Achieve Extraordinary Returns

Entrepreneurs are a major source of new businesses, generating the majority of net new job opportunities. Distinguished from their peers, entrepreneurs are characterized by their willingness to assume risks and earn economic profits through innovative methods of delivering a specific good or service. These innovative methods may include establishing a new business model, meeting consumer needs more effectively, or offering lower prices than their competitors. The risk is inseparable from entrepreneurship, as any venture aimed at achieving an economic profit is fraught with uncertainty. The capital income earned by an entrepreneur should include a normal return rate compensating for the waiting period for returns (the time gap between expenses and revenues) and an extraordinary return rate compensating for the risk and uncertainty of profit realization. Entrepreneurs aim to achieve economic profit by identifying and capitalizing on market price discrepancies.

An extraordinary return is achievable if the expected return rate from entrepreneurial activity, multiplied by the probability of realizing that return, is higher than the normal return rate. For example, if there is a 50% chance of earning a 10% return on investment, the expected return value is 5%. Therefore, as risks increase, the expected return decreases. If the expected return from the new (entrepreneurial) activity is less than the expected return from non-entrepreneurial activities, the entrepreneurial project will not be executed. In other words, extraordinary returns compensate the entrepreneur for the risks of engaging in a new activity. Under the expectation of a very ordinary return, a potential entrepreneur would have no economic reason to pursue a risky project. Extraordinary returns can be generated through the economic rent of entrepreneurial activities that can arise from barriers preventing competitor entry, such as patents, regulatory obstacles, or other forms of protection provided by governments to producers. These barriers delay the production of similar goods and services by potential other suppliers. Moreover, extraordinary profits may also result from access to rare or specialized resources, a good reputation in terms of quality, or success in risk-taking and innovation leading to a particularly attractive new design or product introduction, which takes time for competitors to catch up with.[1]

Some Concepts Related to Tax Policy and Entrepreneurship

The impact of tax policy on entrepreneurship varies depending on the type of tax, the quality of the accounting system, and the nature of tax exemptions. Before discussing the impact of tax policy on entrepreneurship, it's helpful to clarify some concepts related to tax policy and entrepreneurship, including:

I. Taxes Affecting Entrepreneurship

There are four main types of taxes that impact entrepreneurship[2]:

1) **Corporate Income Taxes:** Taxes that companies pay on their taxable income.

2) **Personal Income Taxes:** Taxes that must be paid on income earned by wage earners or self-employed individuals.

3) **Capital Gains Taxes:** Taxes that must be paid on profits from the sale of securities or real estate.

1. Garrett Watson & Nicole Kaeding, 2019, "Tax Policy and Entrepreneurship: A Framework for Analysis", FISCAL FACT No. 647, Tax Foundation, U.S.A., April, p.
2. Block, J. "Corporate income taxes and entrepreneurship," IZA World of Labor 2021: 257 doi: 10.15185/izawol. 257.v2

4) **Value-Added Taxes:** These are the taxes that must be paid on the profits an investor realizes when selling a capital asset at a price higher than its purchase price.

II. Tax Incentives Affecting Entrepreneurship:

Different types of tax incentives include tax exemptions, investment credits and bonuses, and tax credit accounts. Designing tax incentives requires identifying the types of qualified investments and the form of tax incentives to be adopted. Some of the most common tax incentives include[3]:

1) **Tax Exemptions (or Tax Holidays):** Tax exemptions are the most common form of tax incentives for investment in developing countries. Tax exemptions may take the form of a complete exemption from profit tax and sometimes from other taxes, or a reduced tax rate, or a combination of both. The exemption or reduction is granted for a limited period, ranging from one year to 20 years.

2) **Investment Allowances or Credits:** These are a percentage of the taxable income that investors are allowed to exclude, leading to a reduction in taxable income. Investment allowances or credits can apply to all forms of capital investment, or they may be limited to specific categories, such as technologically advanced machinery or equipment, or to capital investments in certain activities, such as research and development (R&D).

3) **Tax Credit Accounts:** This approach offers tax benefits to potential investors by allocating a specific amount of tax exemption to each qualified investor in the form of a tax credit account. For example, a potential exemption of $500,000 from corporate income

3. United Nations, “DESIGN AND ASSESSMENT OFTAX INCENTIVES IN DEVELOPING COUNTRIES,” 2018, SELECTED ISSUES AND A COUNTRY EXPERIENCE, New York.

tax obligations. Investors are required to file tax returns and maintain books and records like any other taxpayer. If an investor determines they have $60,000 in tax liabilities in the first year, they would pay no tax, but the amount in their tax credit account would be reduced to $440,000 for future tax years.

III. Entrepreneurship Metrics and Types

Studies on entrepreneurship use various metrics to reflect the extent of entrepreneurship, including[4]:

1) **Entrepreneurship Rates:** The number of entrepreneurs as a percentage of total employment; often calculated by the number of people working for themselves.

2) **Entrepreneurship Entry Rates:** The number of new companies or ventures entering a particular industry or market.

3) **Total Early-Stage Entrepreneurial Activity (TEA) Rate:** The Global Entrepreneurship Monitor (GEM) surveys adults aged 18-64 and defines the TEA rate as the sum of the nascent entrepreneurship rate and the new business ownership rate.

Types of Entrepreneurs[5]:

1) **Nascent Entrepreneurs:** Individuals involved in starting a business venture.

2) **New Business Owners:** Owners and managers of businesses less than 3.5 years old.

3) **Opportunity Entrepreneurs:** Entrepreneurs who start their businesses because they see a profitable business opportunity.

4. Block, J. Op. cit
5. Ibid.

4) **Necessity Entrepreneurs:** Entrepreneurs who start their businesses out of necessity.

5) **Innovative Entrepreneurs:** Entrepreneurs who have new goods or services for customers.

6) **Imitative Entrepreneurs:** Entrepreneurs with goods or services that are identical or very similar to what is already available in the market.

7) **Low-Growth Entrepreneurs:** Entrepreneurs with low growth potentials/ambitions.

8) **High-Growth Entrepreneurs:** Entrepreneurs with high growth potential/ambitions.

9) **Formal Entrepreneurship:** Entrepreneurs who have registered a business.

10) **Informal Entrepreneurship:** Entrepreneurs who have not registered a business.

11) **Low-Tech Entrepreneurship:** Entrepreneurship in low-technology sectors.

12) **High-Tech Entrepreneurship:** Entrepreneurship in high-technology sectors.

13) **Social Entrepreneurship:** Entrepreneurs primarily motivated by solving social problems.

14) **Profit-Oriented Entrepreneurship:** Entrepreneurs primarily motivated by making a profit.

The Impact of Tax Policy on Entrepreneurship:

Tax policy is a significant factor affecting entrepreneurship. High actual income tax rates on companies increase the tax burden on registered companies, thereby reducing the profits from entrepreneurship.[6] Additionally, the number of startups, as well as the number of employees in each startup, decreases with higher government taxes.[7] Entrepreneurship entry rates may also be negatively affected by administrative burdens related to taxes and the complexities of the corporate income tax system. These represent fixed operating costs that do not depend on the company's profit level or the entrepreneurs, and high-income taxes pose a barrier to small companies where the labor to capital ratio is high, leading to lower levels of employment in emerging entrepreneurial projects. High levels of corporate income taxes reduce the gains from successful innovation, thus having a deterrent and demotivating effect, especially for risk-taking entrepreneurs with innovative ideas.[8] In addition to reducing the total number of inventors nationally, high income taxes also affect where they choose to live, as studies indicate that top scientists and inventors migrate to locations with lower taxes.[9]

6. Bell, Alexander M., Raj Chetty, Xavier Jaravel, Neviana Petkova, and John Van Reenen, "Do Tax Cuts Produce More Einsteins? The Impacts of Financial Incentives vs. Exposure to Innovation on the Supply of Inventors," 2019, NBER Working Paper #25493.
7. Giroud, Xavier and Joshua Rauh, "State Taxation and the Reallocation of Business Activity: Evidence from Establishment-Level Data," 2015, NBER Working Paper #21534.
8. Block, J. Op. cit
9. Moretti, Enrico and Daniel J. Wilson, "The Effect of State Taxes on the Geographical Location of Top Earners: Evidence from Star Scientists," 2017, American Economic Review, Vol. 107(7), pp. 1858–1903; and Akcigit, Ufuk.

Tax Policy and Private Investment in Iraq:

The Iraqi government has sought to encourage private investment in Iraq through several laws, notably the Investment Law No. 13 of 2006 and Law No. 50 of 2015, which included a number of tax and non-customs fee exemptions for ten years from the commercial operation start date of each project phase.[10] This also includes exemptions for certain assets from customs duties, such as assets imported for the investment project during the project's construction phases before commercial operation begins, and assets imported necessary for the expansion, development, or modernization of the project to increase its design capacity. Income derived from agricultural activities has also been exempted from taxes.[11] However, these exemptions are restricted to projects licensed by the National Investment Commission, primarily focusing on large-scale projects like residential development, agricultural projects, or any other projects requiring land for permanent facilities. Projects not requiring a license from the Investment Authority are generally subject to a corporate tax rate of 15% of the company's net profit before distribution to shareholders.[12]

The tax policy in Iraq is still influenced by the socialist thinking that prevailed until 2003. The current tax laws in Iraq are primarily derived from the Income Tax Law No. 113 of 1982 and its amendments. This law, the only one adopted for calculating both individual and corporate taxes, lacks clear details regarding startups or entrepreneurial projects. The current law's role in stimulating entrepreneurial projects in Iraq can be assessed as follows:

10. Republic of Iraq, Federal Government. (2015). Law No. 50 of 2015, the second amendment to the Investment Law No. 13 of 2006, Articles 10 and 11. Iraqi Gazette, (4393). Retrieved February 7, 2024, from https://iraqld.e-sjc-services.iq/LoadLawBook.aspx?page=2&SC=130320168831297&BookID=32739

11. Republic of Iraq, Federal Government. (2006). Investment Law No. 13 of 2006, Article 17. Iraqi Gazette, (4031). Retrieved February 7, 2024, from https://iraqld.e-sjc-services.iq/LoadArticle.aspx?SC=040120086854504

12. General Authority for Taxes. (2011). Corporate Tax Guide. Retrieved February 7, 2024, from https://tax.mof.gov.iq/دليل-ضريبة-الشركات/

1) Exemptions included in the Income Tax Law are very limited, mainly concerning certain agricultural projects or projects related to providing services to the state, such as transporting oil derivatives. Meanwhile, other activities like commercial, industrial, or professional businesses are considered major income sources according to the tax law, with no significant exemptions mentioned for the income these activities generate, even for a limited period.

2) The law does not distinguish between profits distributed to shareholders and profits reinvested; income tax is imposed on profits before their distribution to shareholders, which negatively impacts investment, as not all profits turn into consumable income; a significant portion goes towards capital expansion and the resultant increase in employment opportunities and gross domestic product.

3) The law does not differentiate between old companies and startups, which generally need support and encouragement to establish new investment assets that contribute to employment.

4) Some taxes can increase investment costs, like the tax imposed on rentals, which amounts to 10% of the property rental value according to the amended Real Estate Tax Law No. 162 of 1959, raising the rental levels for emerging and entrepreneurial project owners.[13]

5) Certain fees also contribute to increasing production costs and reducing profits for startups and entrepreneurial projects, notably customs duties on importing production machinery or raw materials.

13. Republic of Iraq. (1959). Real Estate Tax Law No. (162) of 1959 and its amendments. General Authority for Taxes. Retrieved February 8, 2024, from https://tax.mof.gov.iq/-قانون-ضريبة-العقار-رقم-162-لسنة-1959-وتعديلاته/

6) Weak national product protection through increased taxes and fees can be beneficial for entrepreneurial projects, especially customs duties on imported finished goods.

High tax evasion rates and the weakness of tax accounting and auditing systems significantly undermine the effectiveness of tax policy and its role in stimulating entrepreneurial projects.

Tax Reforms and Ways to Enhance Entrepreneurial Projects

Identifying tax reforms requires, above all, defining the objectives of tax policy and redefining the functional role of taxation. In this context, we can distinguish between more than one approach. The traditional neutral approach limits the role of taxes to funding the public expenditures necessary for the government to fulfill its duties in maintaining security, order, and providing essential public services to society. The interventionist (Keynesian) approach prioritizes employment, while tax policy in developing countries aims to stimulate the private sector and activate automatic economic development mechanisms. Here, tax reforms cannot be effective unless they come within a comprehensive package of reform programs and policies related to economic matters, such as property laws, tax laws, customs duties, social security systems, employment policies, social welfare policies, company registration procedures, and financial and banking reforms.

With the goal of activating automatic economic development mechanisms based on the private sector, a number of priorities must be pursued, including:

1. Mobilizing idle material and human resources and incorporating them into various areas of private investment.
2. Increasing the productivity of material and human resources

through the use of the latest available technologies and training the workforce on them.

3. Increasing the proportion of productive labor returns compared to the rentier returns obtained by landowners and capitalists.

4. Increasing returns to skilled labor compared to unskilled labor.

5. Stimulating innovation and entrepreneurship through rewarding rewards and reducing the impact of financial risks.

In light of these priorities, general rules for tax reform that stimulates private investment and entrepreneurial projects can be established, such as:

1. Reducing the direct financial costs borne by private, and particularly entrepreneurial, projects.

2. Increasing the costs of idle resources and minimizing rentier returns as much as possible.

3. Protecting private investors with a focus on entrepreneurial projects that use modern technologies and employ skilled labor.

Based on these rules, a set of tax policies and incentives can be adopted, such as:

1. Legislating customs exemptions for modern machinery imported by private projects and the necessary raw materials for production that have no national alternative.

2. Exempting retained profits for expansion purposes from income tax to encourage the expansion of private projects.

3. Targeting frozen assets by imposing taxes on the market value of these assets, including unoccupied real estate by its owners, cash

circulating outside the banking system, or unexploited agricultural properties.

4. Exempting national stocks and bonds income from taxes to secure financing sources for private investments.

5. Exempting employees in the private sector from income tax for a specified period or reducing it.

Besides these measures, the five priorities for achieving the goal of spontaneous private sector development can be achieved. The role of tax policy in entrepreneurship is effective if it is within comprehensive programs to support and stimulate entrepreneurship, whether through technical, financial, managerial, and economic development programs or through financing programs via bank loans or even guaranteeing these loans. One of the most important forms of support for private investment and entrepreneurial projects that a country like Iraq can legislate is laws obliging private sector institutions to contract with national companies to obtain the goods and services they need in their work and to prevent importing or contracting with any foreign company unless it is impossible to obtain the required good or service from a national source.

Support and stimulation for national private entrepreneurial projects is a goal that requires the cooperation of all government institutions working to achieve it, starting from legislative authorities that should enact the necessary laws to support private entrepreneurial projects. Ministries in various specializations should all work to provide facilities for the private sector and entrepreneurial projects, and even educational and religious institutions can play a pivotal role in the economic transformation based on almost total reliance on the state to reliance on a market economy and stimulating private projects. Advanced societies begin by teaching their children work and financial management skills from kindergarten, and prestigious universities fund part of their expenses from their research services provided to the private sector. Thus, if a country's direction is towards a real transformation from a planned economy to a market economy, state institutions must transform from controllers and directors of the private sector to its servants. The satisfaction of the private sector should be one of the basic criteria for evaluating the performance of the government, its ministers, directors, and employees. An employee can be replaced or dismissed if they neglect, mistreat the private sector, or hinder its work.