Journal of Emerging Trends in Economics and Management Sciences (JETEMS) 8(1):6-16
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jetems.scholarlinkresearch.com

The Challenges of Developing an Effective Income Tax System that Can Bring Additional Source of Income to Kurdistan Region of Iraq

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Abstract
This research aims at investigating the factors that has hindered the development of income tax system of KRI (Kurdistan Region of Iraq). The main factors selected to focus on are: Institutionalization, Political Stability, and Economic Stability. This study was motivated by the question, "What are the obstacles that the current income tax system and tax officials facing in terms of socio-cultural, socio-politics, and socio-economics?" This study focuses on finding the effect of those three variables on the development of income tax system of the region. With no previous studies about such important topic, and with the lack of institutionalization, political, and economic stability and their impact on the development of an effective tax system, this study is to find the characteristics of an effective tax system with stating what the obstacles that face the development and implementation of an effective tax system in a developing state. The result show that both variables of institutionalization and political stability have a great impact on the development of the income tax system. However, the third variable of economic stability has been the opposite of the expectations as it did not contribute to the development of the income tax system in the past decade during which the economy was stable and booming.

Keywords: income tax, institutionalization, political stability, economic stability

INTRODUCTION

With all the financial problems that the Kurdistan Region of Iraq (KRI) is currently facing, KRI lacks an effective income tax system that can help the government to bring some money back to the government. The government spends on salaries, infrastructure, and other expenses huge share of the money without returning or reclaiming any of the money that is spent in the mentioned sectors. As the KRI was focused on Business attraction strategy that the KRG was in the position of attracting foreign investors to come and invest in the Region to participate in the development of the Region. With all that simplicity of the tax regime of the region that applies flat rates of taxation on Corporate Income Tax (CIT) and Personal Income Tax (PIT), but the implementation of the tax rules and policies by the tax officials in the region is not that simple. Different obstacles that taxpayers and tax officials face on daily basis are based on different decrees and exemption provided by the government, but not accepted by the Tax Authorities (TA).

KRI is currently facing one of its hardest times in terms of economic crisis based on the speech given by Khailani (2015), and it lacks a tax-oriented system that can help the regional government supports its payments to the needed sectors.

Research Questions

- What are the characteristics of an effective tax system?
- How to develop and implement an income tax system in favor of creating an additional source of income for the region?
- What are the obstacles that the current income tax system and tax officials facing in terms of socio-cultural, socio-politics, and socio-economics?
- Why the KRI has failed to develop an institutionalized tax oriented system?

Aims of the Study

- Finding the characteristics of an effective income tax system.
- Pointing out the current issues and obstacles of implementation of the income tax system in KRI.
- The factors that has hindered the development of an effective income tax system in the region.

LITERATURE REVIEW

Some Determinants of an Effective Income Tax System:

- ***Certainty (Institutionalization):***

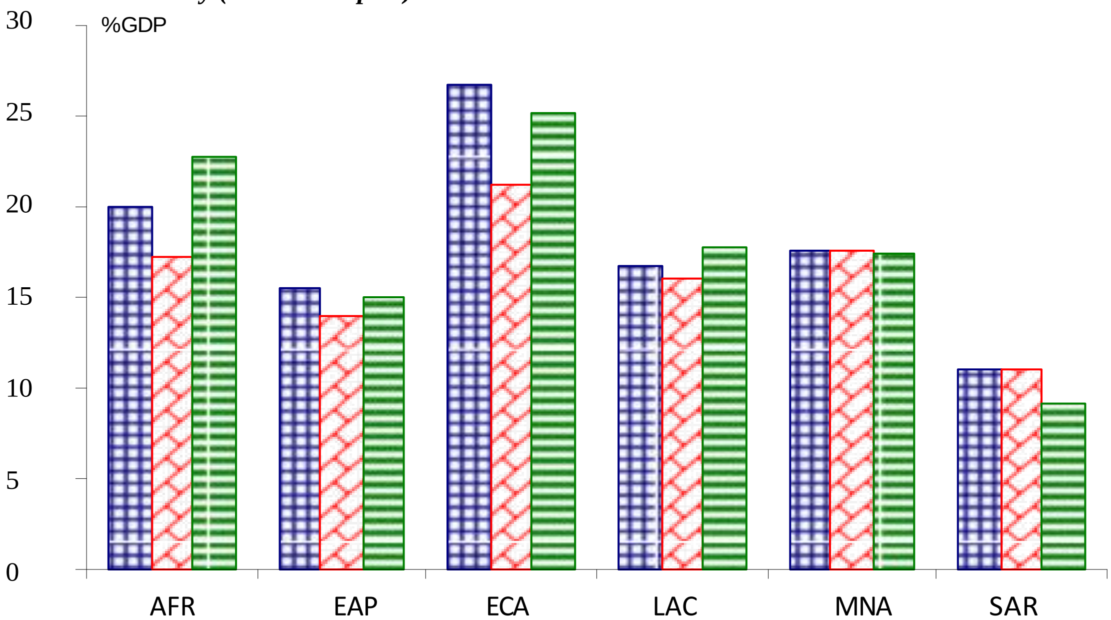
An important characteristic of a good tax policy is the certainty or institutionalization of the policy. In other words, how clear and certain the policy is for the taxpayers. The policy to be certain should be clear, simple, and specific in order to ensure that the policy is fully clear for the taxpayers. The tax policy should indicate the time, place, and amount of the tax with clear instructions and guidance for the tax payers to make the process easier and certain that the tax payer will pay the required amount at the right time, at the right place, with the right amount. This characteristic helps the policy to be easily implied and administered as it is linked with the simplicity of the tax policies, rules, and regulation. The simpler the rules, the higher the certainty for tax payers (AICPA, 2001).

- ***Neutrality (Political Impact):***

The tax policies should be kept neutral, and they should not affect any business or personal decision whether to discourage or encourage one action or another in order to keep the core purpose of taxation which is to collect revenue for the government to cover its expenditure not to encourage or discourage any business or personal decisions (KYCPA, 2001).

The Impact of the Economy on the Implementation of Tax

Different pattern of tax collection and tax effort can be applied in different countries in different regions over the course of different times based on what is the best tax regime for the country. Mostly similar tax regimes and patterns are applied in the countries that are located in similar regions, and even the percentage of the tax revenue that contributes to the Gross Domestic Product (GDP) of the countries in similar region as can be seen in the below chart:



Source: IMFGFS; WDI. Presented in World Bank Policy Working Papers by Le et, al., 2014).

Tax effort can be measure or decided based on the tax gap, which is the difference between the actual tax due and the tax collected. The bigger the gap, the lesser the effort because less amounts will be collected than the amounts due. The smaller the gap, the greater the effort because the closer the amounts collected to the actual tax due (Morss & Lotz, 1967).

The rate of tax implementation can be decided based on the ratio of the tax collection that contributes to the GDP of the country, and thus, the tax collection level to be determined. Countries can be grouped together based tax effort and tax collection level, and the similarities can be found based on the level of income of those countries as can be seen the below table:

Table (2): List of Countries accordingto Tax Efforts and Tax CollectionsLevel

	LOW tax	**HIGH tax effort**	
LOW Tax-collection	**Developing Countries** Albania Dominican Nicaragua Korea, Rep, Argentina Azerbaijan, Guatemala Paraguay, Bahrain, India Peru, Bangladesh Indonesia, Philippines Botswana, Iran Sierra Leone, Cameroon Kazakhstan, SriLanka, Chile Lebanon, Sudan China, Madagascar Thailand, Colombia Malaysia, Venezuela, Congo,DR Mexico, Yemen Congo, Rep	**Developing Countries** Bolivia Cote D'Ivoire Ethiopia, Ghana, Kenya, Pakistan Senegal, Syria, Turkey, Uganda, Vietnam, Zambia	**Developed Countries**
HIGH Tax- collection	**Developed Countries**Australia Canada Germany, Ireland, Luxembourg, Switzerland	**Developing Countries** Algeria Belarus Brazil Bulgaria Croatia Rep Hungary Jamaica Jordan Mongolia Namibia PNG Poland Russian Fed SlovakRepCzech SouthAfrica Egypt Tunisia Uruguay Yugoslavia Zimbabwe,	**Developed Countries** Austria Belgium Cyprus Denmark Finland France Greece Italy, Morocco, Netherlands NewZealand Norway Portugal Slovenia Spain Sweden UK

Table (2) Source: World Bank Policy Working Papers by (Le et, al., 2014).

Taxation in Developing Countries and Challenges

One of the fundamentals for a successful country development comes from the establishment of an effective tax system and this has been proved across countries around the world. However, for developing countries it is more challenging because of their taxable capacity and the tax reliefs that are given which leads to lack of efficiency and effectiveness in the collection process (Le and et, al. 2014).

Too much reliance on the oil revenues in the oil countries has impact on the level of taxation as all the attention are on the revenue of oil and income from taxation is not put under consideration, and this has been the case in oil countries such as Iran, Bahrain, Kuwait, Qatar, and Algeria (Purshian et al., 2013).

For the developing countries that can depend on natural resources, it is not easy to give the advice of focusing on tax effort rather than oil to develop and generate revenues because it is easy for them to depend on the resources that can bring them revenue without putting much effort in it. Plus, without raising the voice of the people against themselves who are in power (Torgler et al., 2008).

Developing countries need to pay more attention to PIT as it can be the major source of revenue even more than CIT. Developing countries can enlarge the tax base to improve the overall tax revenues and support the equity and fairness principle as the earnings will be subject to tax to create some equity (Bird, 2009).

The Role of Taxation in the Economy

Besides being a source that can help the economy of a country grow faster by establishing tax systems that are in favor of development of the economy such as reduction in tax rates to give incentives and increase investment in the country. The influence that politics has on tax systems, at the same time tax structures and policies do have impact on the politics. Reforms in the tax system is being used in political campaigns in developed countries (Engen & Skinner, 1996).

Taxation does have impact on the economic growth because taxation can change the decisions made based on how the taxation has been applied. The reduction in taxes can help to increase the investment and increase the rate of growing; however, any increase in the tax rates can raise serious questions regarding how it will affect the growth rate of the economy (Myles, 2000). Decrease in tax rates can increase the GDP and this has been proven in many countries (Alesina & Ardagna, 2010). Tax rates have a great impact on the growth rate of the small firms as they see tax rates to be a huge obstacle on their growth (Klapper et. al., 2008). There is a positive relationship between tax and GDP, and a negative relationship between tax and corruption (Pourshian et. al., 2013).

Tax in Iraq and Kurdistan Region (KRI)

Tax system in Iraq was first developed in 1927 under the law of "Income Tax" law numbered "52"; however, until the year of 1958 no direct taxes were applied until the period of Saddam's regime. During the period of Saddam's regime, the taxes were decreased and even removed except the real estate and some other basic payments for regulations in public offices. Saddam's regime was focused on communism, so there was no direct taxation or anything like that, and the government controlled everything. After Saddam's regime, in 2004 the law 49 was published and started to charge companies at rate of 15% from the profit of companies, and 35% for oil companies. There is only PIT and CIT applied, and there is no sales tax or other taxes related in Iraq (Head Committee of Rebuilding Iraq Strategically, p. 9-33).

All auditing firms that are operating in the region have published in their tax guide handbooks and identified that the tax rates applicable in the regions which are:

- 15% flat rate of CIT for all companies, except oil production companies which are exempted from CIT according to the investment law of the region and PSCs between oil companies and MoNR.
- 5% flat rate of PIT.
- There is no VAT applicable in the region.

Source (EY, PwC, Delloitte, KPMG, and Triller, 2015).

With all the developments in the economy of the region until now which is one of the hardest eras of the KRG due to the economic crisis, no advancements can be seen in the income tax system of the region, nor any serious actions toward developing a tax system that can generate some revenue for the region. As tax can be one of sources that can lead to economic growth if the tax system is effective and well implemented, the tax system in KRI needs serious adjustments to make it effective and well implemented. Based on the characteristics of the effective tax systems in the world as shown in the literature review, socio-politics in KRI seems to have a huge impact on the development and application of the income tax system in the region. In socio-politics, this research will be focused on the impact of institutionalization, political stability, and economic stability in the region on the income tax system of the region.

Hypothesis

Hypothesis of this research based on the assumptions and literature review is:

Even though Socio- economic and political situation in the region are the factors that have hindered the development of income tax of the region, they can be positively used to help the KRG in developing an income tax system, which can contribute a lot to the economy of the region.

The research will focus on Institutionalization, Economic, and Politics.

- Lack of institutionalization of income tax system in KRI has hindered the development of income tax system, but it can be used to help in developing the system.
- Political stability can help the region to develop the income tax to be more efficient in terms of bringing revenues to the region.
- Economic stability in the region can help the region to develop the income tax to be more efficient in terms of bringing revenues to the region.

METHODOLOGY

As the main title of the research is income tax in the Kurdistan Region, the individuals focused or targeted are the ones who deal with income taxes in the region.

Individuals	Position	Number	Method
Government Officials	General Manager of Income Taxation	1	In-depth Interviews
	The manager of PIT	1	
	Manager of the CIT	1	
	Estimator	1	
	Auditor	1	
Private Sector	Tax Compliance Delloitte	1	In-depth Interviews
	Tax Compliance PwC	1	
	Tax Compliance EY	2	
	Iraqi CPA	1	
	Financial Manager of an oil Company	1	

Chart (3)

Social Artifacts
Social artifacts are chosen based on how much they are related to our topic and how much they can contribute to the research. Therefore, the documents are the official documents from the government side, or the documents from the companies working in tax related services.

MEASUREMENT
Nominal Definition of "Institutionalization"
Institutionalization is defined in many dictionaries, and all agree that the institutionalization is to establish or to make something to be institution that can be a culture, norm, or custom that is accepted and followed by everyone involved (Collins-Dictionary, Mariam-Webster, and Oxford-Dictionaries).

Nominal Definition of "Political Stability"
Ake (1975) defines political stability as it includes behavior and structure which in the behavior side the people are affected and involved in obeying or disobeying the rules and laws, and the political structure is how the power is divided in order to best be used in favor of the individuals of the society.

Nominal Definition of "Economic Stability"
Business Dictionary defines economic stability as, "Economic stability is a condition in which the financial system of a nation displays only minor fluctuations in output growth and exhibits consistently low rates of inflation rate. Economic stability is seen as a desirable state for a developed country that is often encouraged by the policies and actions of its central bank."

Conceptualization of (Dependent Variable) "Tax System":
Nominal Definition of Tax System:
Many scholars and authors have defined tax system, and almost all agree on which that the tax system is the system of imposing charges and collecting revenues from citizens and corporations to cover its expenses. "Is the system by which governments impose charges on citizens and corporate entities to finance its expenditure" (Business Dictionary). In addition, some authors and scholars disagree while they define tax systems. For example, Samuel (2011) defines tax system as the system that the government use to impose fees or levy on the profit of its businesses and individuals. On the other hand, James and Nobes (1998) refuse the ideas that define the tax system as the system of imposing levy or fee on the individuals or corporations, but they define it as the transformation of money from the profit of the private sector to cover the expenses of the public sector.

Variable		Source	Analysis	Type
Independent Variable	Institutionalization, Political Stability, Economic Stability.	Primary and Secondary	content analysis	Unobtrusive research
			Analyzing existing documents.	Unobtrusive research
			In-depth Interviews	Field Research
Dependent Variable	Tax System	Primary and Secondary	Analysis of existing data and documents	Unobtrusive research
			Content analysis.	Unobtrusive research
			In-depth Interviews	Field Research
			Survey	Questionnaires

Chart (4)

FINDINGS
Interviews

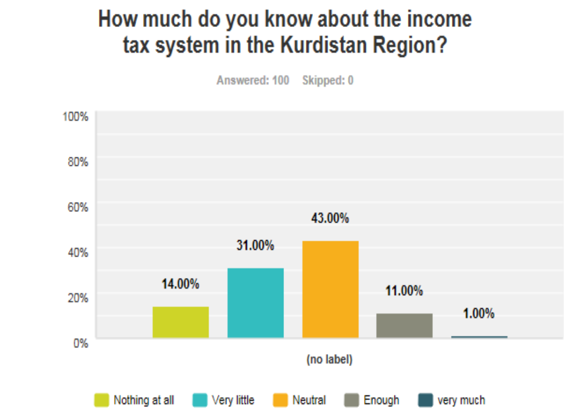
Individuals	Position	Names	Respondent
Government Officials	General Manager of Income Taxation	Anonymous	Rejected to answer
	The manager of PIT	Anonymous	Respondent#2
	Manager of the CIT	Anonymous	Rejected to answer
	Tax Official	Anonymous	Respondent #4
	Tax Official	Anonymous	Respondent #5
Private Sector	Tax Compliance of a big four audit firm	Anonymous	Rejected to answer
	Tax Compliance PwC	Anonymous	Respondent #7
	Tax Compliance EY	Anonymous	Respondent #8
	Iraq CPA	Anonymous	Respondent #9
	Financial Manager of an oil Company	Anonymous	Respondent #10

Chart (5) Individuals Interviewed

Income System of KRI

To show how much the citizens of the region know about the income tax system of the region, the survey takers were asked about the income tax system of KRI in the third and fourth question of the survey.

The below figure (6) shows the responses to the third question of the survey regarding the income tax system of the region.



	Nothing at all (1)	Very little (2)	Neutral (3)	Enough (4)	very much (5)	Total	Weighted Average
(no label)	14.00% 14	31.00% 31	43.00% 43	11.00% 11	1.00% 1	100	2.54

Figure (7)

The below are the basic statistics of the responses of the third question of the survey:

Minimum	**Maximum**	**Median**	**Mean**	**SD**
1	5	3	2.54	0.9

The frequency and the percentage of the responses are shown in the table (8)

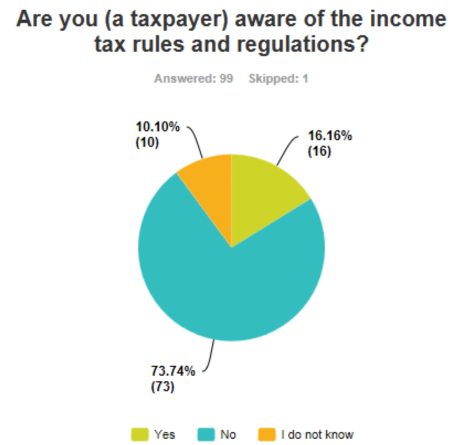
How much do you know about the income tax system in the Kurdistan Region

Table 8: requency and the percentage of the responses are shown in the table (8)

F		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Nothing at al	14	14.0	14.0	14.0
	Very little	31	31.0	31.0	45.0
	Neutral	44	44.0	44.0	89.0
	Enough	11	11.0	11.0	100.0
	Total	100	100.0	100.0	

Institutionalization of the Income Tax System of the Region

The survey takers were asked about whether they know about the tax rules and regulation, and their responses are shown the figure (9).



	Yes (1)	No (2)	I do not know (3)	Total	Weighted Average
(no label)	16.16% 16	73.74% 73	10.10% 10	99	1.94

Figure 9: Tax rules and regulation, and their responses are shown the figure

The below are the basic statistics of the above responses:

Minimum	**Maximum**	**Median**	**Mean**	**SD**
1	3	2	1.04	0.51

Table 10: The frequency and the percentage are shown in the table (10).

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	8	8.0	8.1	8.1
	Disagree	42	42.0	42.4	50.5
	Neutral	29	29.0	29.3	79.8
	Agree	17	17.0	17.2	97.0
	Strongly agree	3	3.0	3.0	100.0
	Total	99	99.0	100.0	
Missing	System	1	1.0		
Total		100	100.0		

Kurdistan Region has a transparent Income Tax System

Political Stability

The opinion of the survey takers were taken by asking them whether the politics in KRI has a great impact on the income tax system of the region or not.

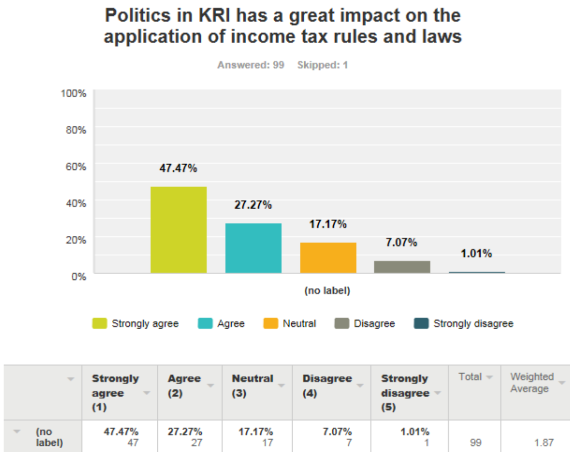


Figure (11) shows the responses

Figure 11: Politics in KRI has a great impact on the income tax system of the region or not

Below are the basic statistics of the above responses:

Minimum	Maximum	Median	Mean	SD
1	5	2	1.87	1

The frequency and the percentage of the responses are shown in the table (12).

Table (12). Politics in KRI has a great impact on the application of income tax rules and laws

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	1	1.0	1.0	1.0
	Disagree	7	7.0	7.1	8.1
	Neutral	18	18.0	18.2	26.3
	Agree	27	27.0	27.3	53.5
	Strongly agree	46	46.0	46.5	100.0
	Total	99	99.0	100.0	
Missing	System	1	1.0		
Total		100	100.0		

Economic Stability

To indicate the impact of the economy on the income tax system of the region, survey takers were asked about the periods of economy in the KRI. The first period from 2003-2013, which is considered as prosperous years of economy for KRI. The second period of after 2014, which is considered by era of crisis for KRG based on the speech of Khailani in KCC-2015.

Below are the basic statistics of the above responses:

Minimum	Maximum	Median	Mean	SD
1	5	3	3.26	1.05

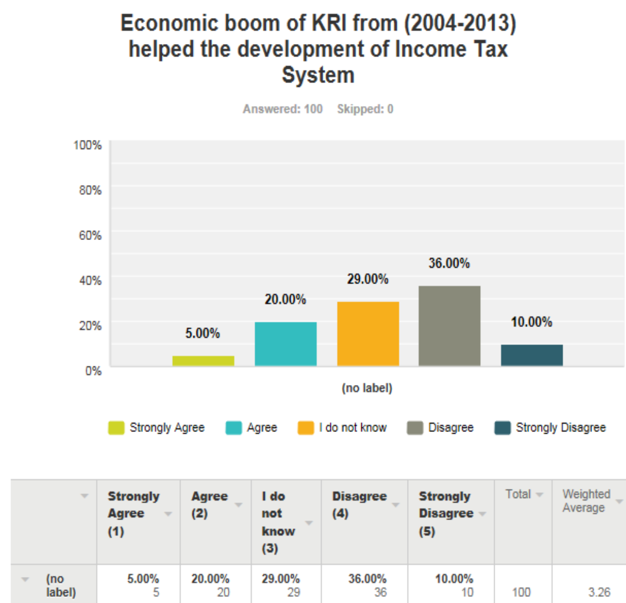


Figure (13)

The frequency and the percentage of responses are shown in the table (14)

Table 14: Economic boom of KRI from (2004-2013) helped the development of Income Tax System

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	10	10.0	10.0	10.0
	Disagree	36	36.0	36.0	46.0
	Neutral	29	29.0	29.0	75.0
	Agree	20	20.0	20.0	95.0
	Strongly agree	5	5.0	5.0	100.0
	Total	100	100.0	100.0	

DISCUSSION AND ANALYSIS

Income Tax System of the KRI

Based on the survey that was conducted, 14% of the population of the survey do not know anything about the tax of the region. 31% of the population know very little about the tax system with 43% of the population staying neutral on the question, 11% of the population stated that they know enough about the tax system, and only 1% of the population know very much about the system. If we analyze these results, we will see that a large number of the citizens of which 32% have bachelor degree, 30% with masters degree, 15% with diploma, 12% high school, and 11% have PHD. From the random citizens of the region, it can be concluded from these responses that large number of population do not know much about the income tax system of the region if nothing at all.

Institutionalization of the Income Tax System:

The respondent number #4 said,

> *"The current income tax system is institutionalized and is fully implemented according the tax rules and regulations across the region."*

According to the above answer, the Kurdistan Region of Iraq does have an institutionalized income tax system that is supported by the law

The respondent number #7 said,

> *"The current system with the adjustments is well implemented and institutionalized around the region, but each office in each city is affected by the different political and ideologies implemented in the city. So, yes, it is institutionalized system, but differences may appear in the process in different cities of the region."*

Political Stability

One auditor in the TA said:

> *"People can easily get away from the tax due to different reasons. This is because of the power they have or anything like that. I do not want to mention names or give more details in this regard, but exemptions are given easily"*

Respondent #8 said,

> *"In this country,political stability is the most important thing because it affects the stability of other factors that can change the situation economically. Political stability can help the development of the income tax system."*

Economic Stability

The respondent #7 was asked, "How did the income tax system grow during the last decade as the region was having some kind of boom in its economy?" He replied,

> *"During last decade, the economy of the region was booming, but the tax system was under the influence of decrees and decisions made by the government as the government was planning to attract businesses and develop private sector. All the developments were made at the cost of the tax system. During that time, Board of Investment published its own set of rules and exemptions from taxation. The Ministry of Natural Resources (MoNR) signed contracts with oil companies called Product Sharing Contracts (PSCs) which gives them full exemption from all taxes."*

ANALYSIS

In the process of data analysis by SPSS, it was found out that the population of the survey are not that familiar with the subject as they could not contribute much information to the survey. As the Regression Model of the survey is as the below equation and coefficient table (15):

Y = 1.792 + 0.323 Institutionalization – 198 Political Stability + 0.219 Economic Stability

Table (15): Analysis Interpretation

Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	1.792	.574		3.121	.002		
	Institutionalization	.323	.180	.181	1.800	.075	.909	1.100
	Political Stability	-.198-	.129	-.152-	-1.535-	.128	.944	1.059
	Economic Stability	.219	.097	.234	2.263	**.026**	.862	1.160

Based on the above analysis, it is interpreted that the population cannot be depended on for both Institutionalization and political stability as they do not have a significant coefficient to the dependent variable which is income tax. The table (16) shows the correlation between each independent variable (Institutionalization, Political Stability, and Economic Stability) and dependent variable (income tax).

Table 16: correlation between each independent variable (Institutionalization, Political Stability, and Economic Stability) and dependent variable (income tax).

Correlations

			Income tax	Income tax	Institutionalization	Political Stability	Economic Stability
Spearman's rho	Inc. tax	Correlation Coefficient	1.000	.292**	.260**	-.046-	.204*
		Sig. (2-tailed)	.	.003	.009	.651	.042
		N	100	100	100	100	100
	Inc. tax	Correlation Coefficient	.292**	1.000	-.056-	-.147-	-.142-
		Sig. (2-tailed)	.003	.	.582	.145	.160
		N	100	100	100	100	100
	Institutionalization	Correlation Coefficient	.260**	-.056-	1.000	.023	.263**
		Sig. (2-tailed)	.009	.582	.	.820	.008
		N	100	100	100	100	100
	Political Stability	Correlation Coefficient	-.046-	-.147-	.023	1.000	.212*
		Sig. (2-tailed)	.651	.145	.820	.	.035
		N	100	100	100	100	100
	Economic Stability	Correlation Coefficient	.204*	-.142-	.263**	.212*	1.000
		Sig. (2-tailed)	.042	.160	.008	.035	.
		N	100	100	100	100	100

**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

The correlation coefficient between Institutionalization and income tax is significant as the correlation coefficient is 0.260 which means as the institutionalization increases, income tax system will be more effective and efficient. The correlation coefficient between political stability and income tax is not significant which means the responses cannot be depended on. The correlation coefficient between economic stability and income tax is significant which means with the increase in economic stability, the efficiency in the income tax will increase. Based on this analysis it can be said that the population are not much familiar with the income tax system of the KRI which itself a great point that confirms the income tax system of the region is not open to all the population.

Thus, the followings are confirmed:

- Institutionalization: The current income tax system lacks institutionalization, and the increase in the

level of institutionalization is expected to increase the development level of the income tax system. The first hypothesis is confirmed.
- Political stability: the responses of the survey cannot be depended on as the correlation is negative relation. However, based on the frequency of the responses and the interviews conducted, there is huge interference of politics in the implementation of the income tax system of the region. The second hypothesis is confirmed.
- Economic stability: Even though the survey results confirm that there is a significant correlation coefficient between economic stability and development of income tax system of the region based on the responses of the survey takers. However, the interviews and experience of past decade has proven that the economic stability did not contribute to the development of the income tax system of the region. The third hypothesis is rejected.

Limitation of the Study

Even though this study reached its aim, there were some limitation that are unavoidable. First, unavailability of the exact data from the public offices which made it hard to give exact information from the government authorities. Second, the population of the survey was not big enough to cover a large number of people to be able to give a more precise information. Finally, not having well educated respondents regarding the tax related question was an obstacle to receive precise responses from the attendance of the survey.

CONCLUSION AND RECOMMENDATIONS

Institutionalization:
- The income tax system of Kurdistan region is not institutionalized.
- Lack of institutionalization has caused the system not to be transparent and clear for all the taxpayers and tax collectors.

Political Stability:
- Political stability is vital for the stability in other sectors of economy which increase revenue.
- Political stability has a great influence in implementing and collecting taxes.

Economic Stability:
- Unlike what was presented in the literature review that the countries with higher incomes are having better tax systems, KRI during its prosperous years did not develop its income tax system to create additional resource of revenue besides the oil.
- Economic stability in KRI did not help development of an effective income tax system.

Recommendations

Institutionalization:
- Income tax system of the region to be institutionalized around the region.
- Computerizing all tax filing processes.
- Implementation of laws and rules strictly.

Political Stability:
- Through legal powers, politics can be stabilized.
- Laws, rules, and regulations must be above everyone.

Economic Stability:
- Economic stability to be used in favor of income tax stem not against it.
- During the stabilized periods of economy, actions to be taken to develop the income tax system.

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