



FISCAL SYSTEM VI. ISLAMIC REPUBLIC

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1. continuity and change in persia's public finances

Increasing role of the State. Public finances in Persia are intimately related to the significant role that the state has traditionally played in the Persian economy. The receipt of large revenues from oil exports and their expenditure for developing various sectors of the economy, improving infrastructure, and providing social services have made the government's fiscal policies a major determinant of the overall economic incentives, structure and level of economic activity. Moreover, as the government receives the proceeds from the export of petroleum—a national resource—the government plays an important distributive role. Thus a large portion of oil revenues is distributed to the population through the provision of employment by the government, direct or indirect subsidies and transfers, public development projects, low-cost credit, and other diverse mechanisms.

The revolution in 1979 increased the pivotal role of public finances in the Persian economy. Reflecting in part the populist nature of the Persian revolution, the public sector has received an expanded (constitutional) mandate in directing and managing the economic affairs of the country. (see



CONSTITUTION II) With intensified popular concerns about social equity, the state's responsibilities for addressing issues related to redistribution of income and wealth also increased. The public sector also gained control over new segments of the economy through the nationalization of a large number of private enterprises and of the entire banking system (Amuzegar, p. 85; Mazarei, 1996, pp. 290-92). These nationalizations were motivated not only by ideological considerations, but also by the practical concerns of running a number of highly indebted private companies whose proprietors had left Persia as a result of revolutionary upheavals. The control of much of the property expropriated during the revolution, however, was transferred not directly to the government, but to several semi-public foundations (*bonyāds*) that have been charged with undertaking some of the income redistribution functions under the Islamic Republic (see, e. g., **BONYĀD-E ŠAHĪD**). The post-revolutionary expansion of the role of the state in the economy was also reinforced by the exigencies of a war economy during the conflict with Iraq from 1980-88 (see **ECONOMY X**).

While the post-revolution period has been marked by an increase in the role of the state, in more recent years there has been a trend toward containing the size and functions of the government in the Persian economy. Following the end of the war with Iraq and with the growing burden of economic distortions and imbalances, the Persian authorities embarked on a program of economic liberalization and restructuring. This program was focused partly on reducing the role of the public sector in the economy, in part through privatization, and on eliminating the large imbalance in the public finances (see **ECONOMY X**).

Continuity in overall budgetary structure and process. Despite the important changes in the Persian economy and in the role of the state since 1979, the budgetary process has remained broadly unchanged. In recent years, however, the plan and budget processes have become increasingly important vehicles for the exercise of parliamentary influence over economic policies. These include some aspects of income distribution and investment priorities, especially for promoting the agricultural sector, as well as the setting of overall monetary and credit policy, and foreign exchange allocation for the entire economy.

Overall budgeting is undertaken through five-year development plans to establish medium-term objectives of the economy. Annual budgets, in turn, are determined in the context of the five-year development plans, which are both formulated by the Plan and Budget Organization (PBO; Sāzmān-e



barnāma wa būdja; see BARNĀMARĪZĪ) in consultation with the Ministry of Economy and Finance (Wezārat-e omūr-e eqtešādi wa dārā'i; see FINANCE MINISTRY), and other government agencies, and are approved by the parliament (Majles). Part of the responsibilities for the implementation of the annual budgets, especially with regard to the collection of non-oil revenues, and treasury functions are undertaken by the Ministry of Economy and Finance. There is also an inter-ministerial council that meets on a quarterly basis to review revenue developments, and modifies expenditures to the extent there are revenue shortfalls. Oversight of the implementation of development budgets lies largely in the domain of the PBO, which also undertakes broad reviews of compliance with the five-year plan and of the completion of development projects. It reviews particularly the operations of those enterprises that get into difficulties with regard to meeting their broad plan targets, or have a large impact on the budget in terms of budget and use of foreign exchange. In principle, there is also a process for post-auditing of annual budgets that is done by the auditing bureau (Divān-e Moḥāsebāt), which reports to the Majles (personal interview with Central Bank officials, 1998; Bānk-e Markazi-e Jomhūri-e Eslāmi-e Īrān).

Currently the public sector in Persia comprises the General Government (the Central Government and 25 provincial governments), and several hundred public financial and non-financial enterprises and agencies. The comprehensive annual budget document contains separate budgets for the General Government and for public enterprises and agencies. The Budget of the General Government includes transfers to and taxes and dividends received from the public enterprises. Some non-financial public enterprises, such as the National Iranian Oil Company, receive transfers from the budget to cover their capital expenditures. Starting in 1993, the operations of the Protection of Consumers and Producers Organization (PCPO; Sāzmān-e ḥemāyat az mašraf konandagān wa tawlid konandagān), which were previously extra-budgetary, have been consolidated into the budget. The budget excludes the operations of the city councils and municipalities, which—with a few exceptions—are financially independent. The budget does, however, include some transfers to the city councils and municipalities to cover the deficit. The budget also excludes a large number of enterprises and institutions that are owned and operated by the foundations, but does include some transfers made to them (International Monetary Fund, p. 18).

In the budget, revenues consist of oil and non-oil receipts. Non-oil receipts



consist of taxes (levied on income and wealth, production and consumption, and international trade) and non-tax earnings (mostly income from government monopolies, revenues from sales of goods and services by the government, earnings on foreign assets, and some privatization receipts). There are also some “special revenues,” which are earmarked for some “special expenditures,” relating mostly to the operations of the Social Security Organization (Sāzmān-e bimahā-ye ejtemā’i). Expenditures are divided into current and capital expenditures. Current outlays include general services, national defense, and economic services, as well as some subsidies undertaken through the PCPO. Capital expenditures generally cover development expenditures, such as on infrastructure (see [Table 1](#), [Table 2](#)).

2. fiscal performance and reform

It should be noted at the outset that information on the finances of the entire public sector is not readily available, and the discussion of the fiscal performance focuses on the finances of the Central Government. To examine developments in public finances, it is useful to divide the years since the revolution into two periods: first, from the revolution in 1979 until the end of the Iran-Iraq war in 1988, and second, the period of economic stabilization that started in 1988 to 1999.

The 1979-88 period. In the years following the revolution, the adverse impact of the war, an overall decline in oil export earnings, and sanctions by the United States resulted in prolonged and severe balance of payments difficulties and a general economic slowdown. In response, the government was forced to compress imports, put in place administrative controls on prices, and adopt a system of multiple exchange rates that contributed to massive distortions in relative prices (Behdad; Lautenschlager; Mazarei; and Pesaran). The fiscal stance was determined by the needs of the war, and by adjustments in overall expenditures on account of wide swings in oil revenues, especially in 1980 and 1986 (see [Economy X](#)).

With the start of the war with Iraq and the related decline in oil exports, the government’s finances deteriorated sharply. The fiscal deficit soared to 15 percent of gross domestic product (GDP) in 1980 (based on the Persian fiscal year, which begins March 20). There was some progress in fiscal consolidation in the following several years, but this retrenchment was interrupted by the sharp decline in international oil prices in 1986, when the deficit more than doubled to 9 percent of GDP. Overall, between 1979 and 1988, fiscal deficits



averaged 8 percent of GDP, compared with 2 percent in the five years prior to the revolution (1973-78) when oil revenues were exceptionally high. The deterioration in Persia's fiscal position during this period was broadly similar to that in other oil producers in the Middle East and North Africa region (Eken et al., p. 32). With the loss of access to international financial markets, the Persian authorities' predisposition against foreign borrowing, and in the absence of an active market in domestic government debt instruments, the large budget deficits were financed through borrowing from the domestic banking system, which led to sizable inflationary pressures.

There were important changes in the level and structure of revenues and expenditures from the revolution until 1988. Compared with 1973-78, total revenues declined sharply from 38 percent of GDP to an average annual level of 20 percent during 1979-88. Reflecting lower oil export earnings and the continued application of a highly appreciated official exchange rate for converting oil export earnings from the U.S. dollars into rials in the budget, oil revenues not only declined in relation to GDP, but also in relation to total government revenues. Also, the overall stagnation in economic activity, structural changes in the economy (including a shift in the composition of GDP toward the service sector that is more difficult to tax than other sectors of the economy), the numerous tax exemptions granted to agriculture and other activities, and an inelastic tax system resulted in a decline in the share of the tax revenues of the government. Moreover, government revenues were also constrained by pervasive controls on the prices of goods and services provided by the government, including foreign exchange. For example, the use of a highly appreciated official exchange rate for customs valuation purposes contributed to the fall in custom duties, an important component of tax revenue. Non-tax earnings, however, remained stable in relation to GDP. Compared with 1973-78, the level of expenditures fell by about one half to 20 percent of GDP, with capital expenditures bearing much of the brunt of adjustment (see Tables 1-4; [ECONOMY IX](#), Tables 8, 9 and 10). To attenuate the adverse impact of wartime shortages, the government undertook added responsibilities in the provision of explicitly subsidized basic goods, some under the umbrella of the PCPO, but also through implicit subsidies (explicit subsidies are those that are formally included in the budget; implicit subsidies are those effected through the provision by the government of goods and services at below market prices; personal interview with Central Bank officials, 1998).



The 1989-99 period. The cessation of the war with Iraq in 1988, the accumulation of notable distortions in prices and incentives, and aggravation of macroeconomic imbalances induced the Persian government to embark on a comprehensive restructuring and stabilization plan; the First Five Year Development Plan (First Plan) covering the years 1989-93. The primary objectives of the First Plan included the unification and reform of the foreign exchange system, and trade liberalization. It also included legal provisions for balancing the budget. The plan targeted increasing tax revenues, thereby lowering the reliance on oil export earnings. To lower the incentive for tax evasion and to help raise revenues, the income tax code was revised in 1992. While personal exemptions were increased, the maximum personal and corporate income tax rate was reduced from 75 percent to 54 percent, and the number of tax brackets were reduced. Starting in 1992, in part to improve the collection of revenues, the foundations and the hundreds of enterprises under their control were legally treated as private corporations. In practice, however, they have remained exempt from taxation (data on the scope of operations of the foundations is not readily available; Amuzegar [p. 100] reports an estimate of their budget in 1992 at 6,000 billion rials, about one half of the size of the General Government budget in that year). On the expenditure side, the plan aimed at reducing government outlays by encouraging the role of the private sector in the provision of goods and services. Steps were also taken to contain the growth of current expenditures and to stimulate economic growth by raising the level of budgetary capital outlays. Efforts were also directed at budgetary transparency, including incorporating the off-budgetary operations of the PCPO in the budget (see Sāzmān-e Barnāma, 1990, chap. 2; Wezārat-e Eršād-e Eslāmi, pp. 47-62).

In the first four years of the plan, fiscal retrenchment was successful and the deficit was lowered from more than 9 percent of GDP in 1988 to about 1 percent in 1992—mostly through curtailment of current expenditures. In 1993, with the sizable depreciation of the rial vis-à-vis the U.S. dollar and the utilization of the more depreciated rate for converting oil export earnings from dollars into rials in the budget, there was a massive increase in the size of budgetary revenues. Depreciation of the exchange rate and the ensuing price increases also led to a sharp rise in nominal budgetary expenditures and to sizable extra-budgetary “quasi-fiscal” foreign exchange losses (see below). These factors, together with lower-than-expected oil export earnings, contributed to a sharp deterioration in the government’s fiscal position in 1993 (Wezārat-e Eršād-e Eslāmi, pp. 63-87).



The above quasi-fiscal losses resulted from the sale of foreign exchange at the basic official rate for imports of some essential and military goods, and for debt service payments—mainly the liabilities of the state-owned commercial banks in the form of letters of credit—without making adequate provisions from the foreign exchange earned from oil exports to cover these expenditures. As a result of the insufficient budgetary allocation for these transfers, the Central Bank made the transfers to commercial banks and recorded such losses as credit extended to the government (International Monetary Fund, pp. 19, 47-48). These foreign exchange losses, which are classified under the current expenditures in [Table 3](#), amounted to 6.5 percent of GDP in 1993. These quasi-fiscal expenditures continued off-budget until 1995, when they were incorporated explicitly in the budget and provisions were for covering such expenditures. These provisions, however, have proved inadequate, thus leading to continued quasi-fiscal losses.. Including these losses, the budget deficit amounted to more than 7 percent of GDP ([Table 4](#)). As in the previous years, under the First Plan, net foreign financing of the budget was negligible and fiscal deficits were financed almost entirely through credit from the banking system, increasingly through interest-free borrowing from the Central Bank (personal interview with Central Bank officials, 1998).

With non-oil revenues declining to 9 percent of GDP, the objectives of the plan for raising tax revenues and lowering the dependence on oil revenues were not met. While the First Plan did not attain its goal of raising government revenues, there was some success, however, on the expenditure front. Total expenditures were cut to 23 percent of GDP from 28 percent during the 1979-88 period. Much of the adjustment was attained through cuts in current expenditures, facilitated partly by the end of the war with Iraq, which as noted above, underpinned the fiscal adjustment achieved during the plan. Explicit subsidies to consumers and producers through the PCPO averaged more than 1 percent of GDP. Implicit subsidies, however, were considerably larger; implicit subsidies on petroleum products alone were estimated at about 9 percent of GDP in 1994. The government's efforts to lower such subsidies through significant price increases were blocked in the Majles. Capital expenditures also declined relative to GDP (personal interview with Central Bank officials, 1998).

The Second Five-Year Development Plan (Second Plan), covering the period 1995-99, was approved by the Majles after a delay in March 1995. Its objectives in the area of fiscal policy are very much similar to those of the First Plan. The



Second Plan aims to establish a balance in public finances, particularly through tax reform, to eliminate exemptions (except for agriculture and related industries) and to improve tax administration. It also seeks to contain the level of explicit subsidies, and to lower implicit subsidies on the consumption of petroleum products by gradually raising the prices of such goods (Sāzmān-e barnāma wa būdja, I, 1993).

Thus far under the Second Plan, while important questions about the appropriate role of the state in the economy remain, the government has recorded some success in overcoming fiscal imbalances, and the fiscal deficit declined from more than 4 percent of GDP in 1994 to about 2 percent in 1996, which is accounted for by the continuing foreign exchange losses of the Central Bank. The government has also achieved some success in meeting its objective with regard to raising (non-oil) tax revenues, lowering current expenditures, and raising capital outlays. As in the previous years, these deficits have been financed through borrowing from the domestic banking system. More recently, the government has sought to enhance its ability to finance the deficit, as well as to assist with the development of the financial markets through the issuance of “participation papers” (awrāq-e mošārekāt), which will serve as treasury bonds (personal interview with Central Bank officials, 1998).

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