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FISCAL SYSTEM V. PAHLAVI PERIOD

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The first attempts at setting up a modern fiscal system in Persian began after the Constitutional Revolution (q.v.; see, e..g, Jaz´ayerī; Shuster). Though the first national budget was prepared and presented to the Second Majles in 1910, it was not before the 1920s that along with the setting up of a centralized administration an effective fiscal system also gradually emerged. An important distinction between the modern fiscal system which emerged during the Pahlavi period and the ancient system which prevailed until the early 20th century was that the earlier system was largely based on land revenue administration conducted by local and regional administrators and governors, while the new system was largely based on indirect taxes and oil revenues administered by centrally controlled ministries and specialized national agencies. The 1921-79 period witnessed a growing involvement of the state in the economy as signified by the increasing share of the public sector in the national income. The development of the fiscal system and policy from the inception of the Pahlavi era played an important developmental role in the economy. In addition to its developmental role, two other aspects of the fiscal system, namely, its implications for income distribution and its impact on economic stability (demand management), also need to be considered. This article will deal with these three aspects of the fiscal policy in turn.

THE PERIOD 1921-1941

In the early 1920s the fiscal system was in total disorder (Millspaugh, pp. 20-37). In 1922, the Majles appointed an American mission headed by A. C. Millspaugh with extensive powers to administer the finances of the government. The mission stayed in Persia for five years, during which time, with considerable help from the army, it managed to rationalize the archaic taxation system and centralize the finances of the state. During the 1920s the government was mainly involved in the strengthening of the civil administration and the army, and in investment in infrastructure, e.g., education, communications, roads, railways, and ports. During that period the current and capital expenditures of the central government were grouped together under the general budget. According to the published accounts about 40 percent of the total expenditure in the general budget during the late 1920s was devoted to the Ministry of War (Bharier, p. 65). The general budget, however, gives a misleading pictures of both the structure of government expenditure and its total. Throughout Reżā Shah's reign a large part of indirect taxes (e.g., the tax on sugar and tea instituted in 1925) as well as the oil revenues were kept in special accounts mainly devoted to railroad construction and to the purchase of armaments (Šarafī, p. 14, Bharier, p. 64). According to Bharier (p. 64) by the mid-1930s, following the trade monopoly act (Qānūn-e enḥeṣār-e tejārat-e ḵārejī) in February 1931, the government assumed a more interventionist stance in the economy. On the budgetary side this was reflected in a growing share of government expenditure being devoted to development expenditures and in particular a large scale involvement of the state in setting up import substituting light industries such as textiles and sugar. Government expenditure is estimated to have increased in real terms by 11 percent per annum between 1928 and 1937 (Karshenas, p. 71). According to Moghadam (pp. 158-69), during the latter half of the 1930s, 48 percent of total government expenditure was on development projects. This was composed of 23 percent on railways, 6 percent on roads, and 19 percent on industry and mining.

On the revenue side, customs revenues and other internal indirect taxes formed the main share of government revenue. With the attainment of tariff economy in 1928, tariff rates and customs revenues increased from about 100 mn rials in the late 1920s to 362 mn rials in 1937 (Karshenas, 1990, p. 74). Customs revenues as a ratio of dutiable imports increased from about 10 percent during the 1920-25 period to 30 percent in 1929 and close to 100 percent in the late 1930s (Bharier, table 4, p. 71). Under the provision of the trade monopoly law of 1931, the government also set up various trading companies with exclusive rights of wholesale marketing of major mass-consumed or export products such as sugar and tea, opium, tobacco, cereals, dried fruit, cotton piece goods, silk and cocoon, carpets, cotton, wool, and skin, etc. (U.K. Department of Overseas Trade, 1935). Though not all the companies were directly owned by the state, their operations were tightly controlled by the government and, with profit rates as high as 40 to 50 percent of their turnover, they played an important part in financing government expenditure (Wilber, p. 130). Over 70 percent of central government revenues during the Reżā Shah period (1926-41) consisted of indirect taxation (inclusive of customs revenues). Oil revenues formed a relatively small share of total government revenue (between 10 to 16 percent) during this period. Direct taxes were on average about 10 percent of total global government revenues (Karshenas, p. 74, table 3.2).

The developmental impact of the fiscal system during Reżā Shah’s reign was considerable. The government budget played an important role in financing fixed investment in the economy during the 1930s. About 60 percent of government investment was in roads and railways, which contributed to the integration of the national economy. By the end of the 1930s, the average duration of a journey fell to about one tenth of what it had been to before World War I, and the cost of transport was cut by some three quarters (Issawi, p. 375). It is estimated that by 1941 total industrial investment had reached a book value of about ć58 million sterling, of which ₤28 million had been contributed by the government (Karshenas, 1990, p. 75). On the other hand, it has been argued that the heavy taxation of agriculture probably had a negative impact on agricultural growth (Moghadam, 1956, p. 17). This, however, should be set against the positive impact of greater security and improved means of transport which must have improved the marketability of agricultural produce.

In view of the considerable increase in government expenditure in this period, it is notable that the fiscal policies of the government did not lead to financial instability and undue inflationary pressures. The rate of inflation (wholesale price index) was about 9 percent per annum during the 1930s, which was quite moderate in view of the large increases in indirect taxation. The reason for the financial stability during this period was that government expenditure was by and large financed by taxation and budget deficits remained quite moderate. On the income distribution side, considering that a major part of indirect taxation fell on mass-consumed commodities such as tea, sugar, and kerosene, the fiscal policy of the government must have caused considerable economic hardship for the low-income groups. A progressive income tax, with a spread of 0.5 percent to a maximum of 4 percent, was introduced in 1930, but it mainly applied to the public sector wage and salary earners and its revenue-raising impact was quite low. From 1921 to 1933 a 7 percent flat rate of tax on rents and income from land was in force, but collection was poor, as witnessed by the 10 percent contribution of direct taxes to total government revenues in relation to agricultural product and urban real estate rents which comprised the major share of national income in that period (Agah, p. 137). In 1933 this tax was replaced by a 3 percent tax on agricultural produce. The inability of the government to impose land taxes or other types of direct taxes on landlords in this period reinforced the income inqualizing aspects of fiscal policy (Karshenas, pp. 64-87).

THE PERIOD 1941-54

This period witnessed considerable political instability and inaugurated the end of etatist economic policies of the inter-war period. During the 1940s the main preoccupation of the government was with political matters, and the issues related to long-term economic development received less attention. Though discussions and deliberations on development planning started immediately after the war, it was not before 1949 that the Plan Organization was established and the first Seven-Year Development Plan was initiated (see BARNĀMA-RĪZĪ). The plan was a collection of investment projects, comprising a total expenditure of 21 billion rials ($ 650 m), to be financed partly by oil revenues and other domestic resources (68 percent) and partly by a loan from the World Bank (32 percent). With the oil nationalization dispute and the World Bank's refusal to grant the agreed loans, by 1954 only 20 percent of the total planned expenditure was undertaken (Motamen, p. 99). During the oil nationalization dispute the trade monopoly law of 1931 was once more invoked to bolster government revenues, but unlike the interwar period the private sector undertook the larger share of investment in his period, and the exchange rate rather than direct government controls were the main instruments of adjustment (Motamen, passim; Clawson and Sassanpour, passim). During the 1941-53 period, a few attempts at reforming the direct taxation system were made, but, apart from introducing more complicated structures, they failed to improve the effectiveness of direct taxation (for more details see Bharier, pp. 74-78).

THE PERIOD 1954-79

After 1954 there was a significant change in the structure of fiscal system and the role of fiscal policy in economic development in Persia. An important aspect of this change was the substantial increase in the share of oil revenues in total government revenue following the 50-50 profit-sharing agreement with the oil companies and rapid increase in oil revenues in subsequent periods. The share of oil revenues which had remained at 15 to 16 percent of total government revenues throughout the period 1928-51, increased to 45 percent in 1955-57, 51 percent in 1965-67, and more than 75 percent in 1975-77 (Karshenas, p. 82, table 3.4). While in the interwar period the main function of the fiscal system was the mobilization of funds from a predominantly agrarian economy, in the post-1954 period the main task of the fiscal system was the distribution of a relatively large amount of already centralized funds in the form of oil revenues. This affected all other aspects of the fiscal system. One consequence was the low tax effort by the government and the low buoyancy of taxes relative to the GNP. Domestic taxes which formed the non-oil component of government revenues remained at or below 10 percent of the GNP throughout the period. In particular, direct taxation fluctuating between 1 to 2 percent of the GNP remained very low. The main burden of direct taxation fell on wages and salaries, while corporations benefiting from various tax holidays and exemptions carried a lower burden of taxation. In the mid-1960s for example, the effective rate of tax on incomes derived from property and from corporations was about 1.5 percent, as against 7-8 percent on wages and salaries (Kaldor). This pictures does not seem to have changed dramatically over the period (Karshenas, p. 191). Indirect taxes furnished between 80 to 90 percent of tax revenue in this period, and as a ratio of GNP remained stable at around 6-8 percent mark. The government's tariff policy as well as its interventions in domestic trade in this period was mainly aimed at protection or subsidization of particular lines of activity or with a view to balance payment adjustments, rather than the revenue raising objectives of the interwar period. Customs revenues as a ratio of dutiable imports declined to about 30 percent in the mid-1950s, and remained roughly at that rate for the rest of the period (Bharier, p. 71).

The central role of the fiscal system in the development of the Persian economy in this period is best reflected on the expenditure side of the budget.

This is signified by the fact that the ratio of government absorption (investment plus consumption expenditure) in non-oil GDP rose from about 20 percent in the late 1950s and the early 1960s, to 38 percent in 1970, and 58 percent in 1977. Share of government investment in GDP increased from about 7 percent in the late 1950s, to 12.5 percent in 1971-72, and 18 percent in 1975-77. Government investment took place within the framework of the Second Seven-Year Plan (1956-62), and three five-year plans during the 1963-77 period. During the 1950s, the structure of government investment was not very different from the interwar period, with investment in physical infrastructure and in light manufacturing industries being prominent. During the next three five-year plans, however, there was a significant change in the structure of government investment, with a larger share going to the industrial sector and within that, to heavy industry (Karshenas, 1990, pp. 111, 169, 188). Along with government investment, current or consumption expenditure of the government also grew rapidly in the post-1954 period, with important changes in the composition of expenditure. The share of education declined from 21 percent in 1963 to 15 percent in 1970, and 12 percent in 1976, while the share of health expenditure remained roughly at 4 percent during this period. The share of general administrative expenditures declined from 36 percent in 1963 to 20 percent in 1977, but military expenditure increased its share from 28 percent to 48 percent between these two years. Considering that this was a period of rapid growth in the overall government spending, this highlights the massive military expenditure undertaken by the government in this period. A large part of the government’s industrial investment also was allocated to factories producing armaments and military equipment.

Unlike the experience of the interwar period, the fiscal policy of the government in this period caused a great deal of economic instability. Despite the existence of medium-term planning at the formal level, actual government investment was closely correlated with the proceeds from the oil sector even at the short-term annual level (Karshenas, pp. 171-72). The destabilizing effect of the government’s fiscal policies in this period, however, went far beyond that implied by the fluctuations in oil revenues. The government paid little attention to the monetary implications of its fiscal policies and their multiplier effects on private sector economic activity, which magnified the effect of fluctuations in oil export revenues on the economy. One example was the highly inflationary credit boom of the latter half of the 1950s and the subsequent recession of the early 1960s. A more prominent example was the oil price boom of the 1970s which led to a fivefold increase with high rates of inflation and substantial wastage of economic resources (Shafa-eddin, pp. 52-77, Pesaran, pp. 15-50, Razavi and Vakil, pp. 61-98).

As to the income distribution effect of the fiscal system, though the objective of a more equal distribution of income was mentioned in various government plans and budget documents, no specific policy measures were formulated with income distribution as their aim. The general income tax law of 1967 incorporated a progressive tax system with a spread from 10 to 55 percent on marginal incomes (Bharier, pp. 74-78). However, with income taxes being no more than 0.5 to 1 percent of the GNP, and the low incidence of property and corporate taxes, the impact of the progressive income tax income on income distribution remained marginal. According to estimates by Farhad Mehran (1975) the incidence of the overall government taxation (both direct and indirect) on various income groups in 1971 was more or less uniform. Government expenditure is expected to have exerted a more important impact than taxation on income distribution, due to its much larger size over this period. According to estimates by Mehran (1977), the incidence of benefits from government expenditure on social and physical infrastructure (education, health, social welfare, transport and communications), was much more progressive than government taxes. An interesting aspect of Mehran's estimates is that despite the larger share of government expenditure being financed by oil revenues, the net incidence of tax/expenditure policies of the government in 1971 was on average negative. This is not surprising in view of the fact that more than 60 percent of government current expenditure in this period was spent on general administration and the military. This could be one reason for the high rates of tax avoidance and low tax yields during this period.

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