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With the advent of the Islamic Republic Iran the role of Govt. became all encompassing. The constitution specified that the Govt. should design its budgets to ensure political and economic independence and more equitable distribution of Income. In this context the taxes in Iran are not be levied just for the sake of raising revenue for the Govt. but rather they should be designed to enhance and improve the distribution of income to the maximum social advantages.

The post resolution phase of Iran (1979-2000) started with high inflation caught in the clutches of fluctuating ups and downs in the world oil market leading to risk and volatility.

During 1981-2005 an average 47.2% of the governments income was directly earned from oil export. Thus government’s rely on oil is 55% tax revenue is 26% of resources. Taxes comprise of nearly 6% of the GDP. The country has high income tax rate and moderate corporate tax rate. The top income tax rate is 35 percent and flat corporate tax rate is 25 percent.

The most important driver of Iranian economy is oil, and Iran has benefited from the high price of oil since 2002; the last time Iran experienced a current account deficit was 1998. Since then, its annual current account surpluses have ranged between a meager $860 million in 2003 and a record $20.65 billion in 2006. Iran's oil revenues rose to $81 billion in 2007 and are projected to exceed $100 billion in 2008. These revenues have led to a sharp increase in public spending.

It is in this context the present research work aims at studying the dynamics and dimension of Iran’s tax policy during the post Revolution of planned economic development i.e. 1979-2005.
In view of the strategic role of the Central Govt. of Iran, the macroeconomic financial policies through taxes, affect economic growth. So it is necessary to study to how does the central Govt. of Iran manages its oil export revenue performances through taxation policy and to what extent the tax revenues create impact on savings, investment, GDP growth during the post-Revolution period 1979-2005. Such type of study is essential because economic development efforts of the Govt. of Iran are constrained by the external factors / shocks from volatile world oil market, U.S. and European economic sanctions which create difficulties in attracting Foreign Direct Investment (FDI). The internal factors such as opposition of the radical religious leaders, dominance of state owned financial institutions, political instability, corruption and the most important is the ever increasing rate of inflation throughout the planned development efforts of the Govt. of Iran.

The overall effects of taxes are measured as the ratio between taxes and GDP. This index demonstrates the efforts of the taxation system and tax collection with respect to value added created in the country.

**Trends in tax revenues and expenditures (Chapter 2)**

The share of government income from taxation section and oil & gas section between years 1972 to 2000. The ratio of tax revenues between 1972 and 1979 (the year of Shah's fall) was first reducing and then found an increasing trend. The least amount of tax income compared with oil and gas income was earned in 1975. The increased share of oil in government revenues was due to the increased price of oil in global market. The reason for increased tax revenues in 1987 and years after was not a sudden considerable increase of tax revenues but the decrease of government revenues from exported oil and gas to $1/4x$ of the former year which in itself goes back to the oil crisis of Iran in those years. The reducing trend of government share from oil and gas revenues and increase of tax revenues started in 1997 and has been gradually improving ever since. The low share of tax revenues in Iran can be revealed through a comparison with developed countries. As an example, the share of taxation in G.N.P. of Sweden is near 50%, in United States 30% and in Japan 27%. In Iran, however, only 30% of the planned tax can
be received and most of the tax evasion is by the companies and guild units. It is interesting that the Iranian guilds and trade unions organize demonstrations in objection to paying tax. The cause can be attributed to the lack of an organized system and the incorrect information acquired by taxation departments along the extensive corruption and bribery in this government organization.

A comparison of the details of tax revenues between years 1977 and 1999 reveals some of the specifications of the Islamic government in view of tax reception as compared with the time of Shah. In the categorizing of the share of different sections of companies tax, imports tax, income tax, consumption & sale tax and property tax no considerable change occurs in the government general budget. The serious reduction of tax revenues in these two junctures, before and after the Islamic government goes back to the companies' tax and property tax. Only in two areas, i.e. imports tax and consumption & sale tax we witness an increased share in general budget which is in itself a reflection of the more expanded activity of service sector and mediator jobs during the Islamic Republic as compared with the Shah's time.

**Deficit Budget**

Both before and after the Revolution, the Iranian government has been nearly always facing budget deficit. The share of the budget deficit in comparison with all government costs increased in the immediate years following the fall of Shah and reduced for a short duration by adopting controlling policies. However, increased again and reached its maximum in 1989. The reducing trend of budget deficit which started in 1990 continued until 1996 and is still continuing due to increased payments in development sector. There seems no hope of a considerable change in this trend in the near future.(308)

**Impact of fiscal variables on growth (Chapter 3)**

The growth models were studied to understand the relationship between the growth and fiscal policy variables. These models included the effect of the composition of government expenditures on growth, the effect of the size of the government, and the effect of taxation. The hypothesized relationships were tested
in the context of our empirical models for Egypt, Iran, Morocco, and Tunis. The results were, to a large extent, consistent with a number of cross-section studies for developing and developed country samples. In particular it was shown that, controlling for the effect of investment and economic instability, government consumption is negatively related to growth.

Both private and government investment were correlated with growth. Public investment, especially those in strategic sectors, is positively correlated with growth. Our empirical tests, however, indicate that public spending in education is not positively correlated with growth. Public expenditure (as a share of GDP) seems to be negatively correlated with growth in non-oil exporting MENA countries (in our sample), but in only one case the coefficient of G/Y was statistically significant.

Contrary to a number of published studies, the share of current government revenue in GDP was positively correlated with growth. Since the share of non-tax revenue in total government revenue is fairly significant in a number of MENA countries, particularly in the oil-exporting nations, this variable may not reflect the impact of taxes on growth. As an alternative, the ratio of taxes to total government revenue, an indication of the share of distortionary taxes in government revenue was included in the regressions and they were found to be negatively and significantly correlated with growth.

Policy implications emanating from the empirical findings are fairly straightforward: significant trade-offs are involved with different fiscal policy packages. Lower consumption expenditures and more government spending in sectors that enter private production functions as inputs, and positively influence their productivity, e.g. transportation, communication, electricity, and water, is pro growth. Obviously, the same can be extended to government investment in social institutions that create an environment conducive to growth--though we were not able to specifically test for this. Government consumption expenditure is clearly a drag on growth. Improved public administration and higher standards of efficiency in government operations can release resources for more productive use in both the public and private sectors. Such a measure also contributes to fiscal discipline
and inflation control-the evidence provided here indicated a negative correlation between inflation and growth.

Given that the share of taxes in GDP and in total government revenue in MENA countries is significantly lower than Middle to high income countries, the presence of governments larger than the average for developing countries can be justified by the models reviewed in this paper. However, in the long-run, this situation will not be tenable, particularly in populated nations, since the requirement of a higher share of taxes in GDP will reduce the net positive contribution of the government to growth.

**Composition of the tax revenue (Chapter 4)**

Composition of tax revenues shows that prior to 1975, indirect taxes always constituted a large portion of tax revenues. Following improvement of the economic activities and higher dependency on oil revenues, composition of tax revenues tended toward income generating sources. As a result the share of direct taxes rose from 22% in 1959 to 56% in 1975. During these years the taxation system underwent transformation. Ratification of the Direct Taxation Law in 1966 and making it more regular caused policy direction to tend toward collection of direct taxes. Following the (1979) Revolution and the war (that started in 1980) tax revenues fluctuated. Along with the negative growth of effective economic variables in the tax base, such as imports, gross domestic products, and oil revenues, the tax revenues went down too. Fundamental actions carried out at the beginning of the Revolution such as requisitioning and nationalization of big industries left a great impact on the taxation system so much so that even after the lapse of two decades, its effects are still noticeable in the taxation system, particularly in company taxes. In any case after amendment of the Direct Taxation Law in 1987, and positive changes in some macro economic variables, the share of indirect taxes came down and the share of direct taxes went up, so that the share of direct and indirect taxes changed from 59% and 41% to 60% and 40% respectively.
The General sketch of the tax system shows that composition of taxes is not desirable. Consequently other companies must bear the burden of taxes, and those engaged in occupations pay lower taxes despite the fact that they face lower activity risk and earn higher profits.

During the period under investigation the main portion of tax revenues was secured from indirect taxes, but in recent years, direct taxation constituted more than 50% of tax revenues.

Potentially there is an extensively capacity in the taxation structure of the country, which is realizable through reform in the taxation system and in the sectors related thereto.

**Share of corporate tax:**

The share of corporate tax in total revenue has traditionally been higher compared to the share of personal income tax in Iran. The primary reason for taxing corporations is to raise money. In the absence of an accounting/information system that can be used for measuring the income of tax units accurately and comprehensively, and with ‘mixed’ tax systems, taxation of corporations becomes more practical. The mixed tax system combines features of a global and a scheduler system. The formal applies a uniform rate to income from all taxes and the later tax the principal sources of income flow at different rates. The major advantage of taxing corporations is that taxation of retained earnings at source can reduce the cost of identification and collection for tax administrators. The disadvantage is that corporate tax discourages the supply of capital, a factor relatively scarce in developing countries.

In recent decades Iran, raised more corporate taxes that individual income taxes due to difficulties in the identification of individual tax bases. The basic corporate tax rate was 54 per cent plus 10 per cent tax on companies. Additional non-tax charges had raised the effective tax to higher levels, making capital very costly, thus raising incentives for extensive tax evasion. Due to the high rate of corporate taxes, low investment rates and the need for a higher private investment rate in the economy to boost economic growth, the corporate tax structure was significantly
modified and simplified in the first year of the Third Plan. The new corporate tax law fixes the tax rate on non-public corporations at 2.5 per cent and on public corporations at 22.5 per cent.

**The Flat Rate Tax System**

In accordance with Article 111, the taxable income of foreign contractors in Iran, active in areas such as construction, technical installations, transportation, designing plans for buildings and installations, topographical surveying, drawing, supervision and technical calculations, is a flat rate of 12 percent of their annual receipts in all instances.

**The Effects Of Taxation On Investment (Chapter 5)**

Empirical evidence obtained from both firm-level data covering a sample of 14 European OECD countries and industry-level data covering 21 industries in 16 OECD countries suggest that investment is adversely affected by corporate taxation through the user cost of capital.

The empirical results, both at firm and industry level, assessing the effect of taxes on investment are obtained by introducing the tax adjusted user cost in a standard investment equation with adjustment costs of capital. The tax effects on investment are not separable from the effects of the other components included in the user cost. The firm and the industry level investment equations are based on different non-linear specifications. At the firm level, a non-log specification including a quadratic term of the lagged investment-to-capital ratio capturing a non-linear adjustment of investment is used. The industry level equation is specified in log terms and the adjustment of investment is captured by the lagged investment-to-capital ratio.

The investment-to-capital ratio is negatively affected by increases in corporate taxation. The long-run user cost elasticity is estimated to vary between -0.4 and -1, depending on the empirical specification. A simulation experiment indicates that a cut in the statutory corporate tax rate from 35% to 30% would increase the long-
run investment-to capital ratio by 1.0% and 2.6%, depending on the specification. These are lower and upper bound estimates at the industry level and the firm-level estimate lies within this interval. The estimated effect of this tax reduction is equivalent to an increase in the average investment-to-value-added ratio by 0.2 to 0.5 percentage points.

The corporate tax rate enters non-linearly into the user cost formula and as a result the magnitude of the effect of a change in the tax depends on the level of corporate taxes. Countries with a higher corporate tax rate experience a somewhat larger negative effect from the same increase in the tax than countries with a lower tax rate.

The effect of a five percentage point increase in the net present value of the depreciation allowance (of both machinery and structures) is estimated to increase the investment rate by 0.9% to 2.5%, depending on the empirical specification. Since the depreciation allowances are deductible from firms’ tax liability at the rate of the corporate tax, the magnitude of the impact of a change in capital depreciation allowances also depends on the level of corporate tax rate.

**Effects of taxation on GDP**

Empirical findings on the aggregate effects of the tax structure on GDP

The empirical findings at the macro level on the effect of the tax structure on long-run GDP were obtained by introducing a set of tax structure indicators into a panel regression of GDP per capita covering 21 OECD countries over the period 1970 to 2005. Differences across countries in the overall tax burden are accounted for by including the level of the tax-to-GDP ratio. The setup also considers the government budget constraint and takes into account that more use of a given tax instrument reduces the amount of revenues that need to be raised from other taxes. This allows drawing conclusions on the impact of a revenue-neutral shift from one tax instrument to another on long-run GDP.

Estimates of the effect on GDP per capita of changing the tax mix while keeping the overall tax-to-GDP ratio constant indicate that a shift of 1% of tax revenues
from income taxes to consumption and property taxes would increase GDP per capita by between a quarter of a percentage point and one percentage point in the long run depending on the empirical specification.

**The Effects Of Tax Reforms On Employment**

Prof. Angela Birk, of University of Hamburg and Jochen Michaelis of University of Kassel (HWWA Discussion Paper 2002) have studies ‘Employment and Growth Effects of Tax Reforms…’). They have shown that:

a cut in the payroll tax financed by an increase in the wage tax lowers both equilibrium employment and the equilibrium growth rate. That a higher energy tax combined with a cut in payroll taxes enhances employment but mitigates economic growth.

**Sustainability Of Fiscal Process (Chapter 6)**

Iran is export led growth oriented developing country in the Middle-East. The government of Iran has to adopt its fiscal policy measures facing the problems such as fluctuations in oil prices in the international market, inflation and unemployment. The government expenditure and revenues have to be reconciled and adjusted for maximum social advantage leading to sustainability in view of the unprecedented external shocks and economic declines in Iran during post Revolution period particularly from 1995 till 2005, it is worthwhile to study the sustainability of fiscal process in Iran.

Since spending and revenues are not multi co integrated the fiscal process in Iran is unsustainable in a stochastic environment. The government spending and to analyse the sustainability of fiscal process of Iran revenues do not move together over long run even in an non-scholastic environment these fiscal variables can deviate.
Furthermore, spending and revenues move together, without causing each other, as the country sells oil to finance its expenditure in excess of its tax revenues. These two facts explain seemingly a co-integrating relationship between revenues and spending.

Furthermore, deficits and debt accumulation are the norm in the country’s fiscal processes and the policy response is inappropriate given the budget situation. The evidence suggests that the government spending and revenues in Iran are independent. Furthermore, if these two fiscal variables move together, they do not cause each other.

The government of Iran sets on average relatively low tax rates during recessions and increases tax rates during the expansion to respond to deficit. Furthermore, the government does not desire to equalize tax rates during war/unusual-time and peace/normal-time periods. It actually reduces tax rates during war time. It was found that the Iranian fiscal policy, as far as oil and gas income is concerned, is a responsible policy in the sense that some, if not all, of the energy income is used for investment and the reduction of debt, but is not a fully responsible fiscal policy.

**Effect Of Fiscal Process On Inventories (Chapter 6)**

Iran is the most affected country in the world, which has to pay the highest cost of inventories through exports as well as imports of commodities and capital goods.

When Iranian economy suffer losses due to volatility of oil prices, it is expected that the state owned enterprises and the govt. development project should function as buffer stock to compensable the losses. Under such circumstances, fiscal or monetary authorities provider subsidies to the going projects of public welfare. This ultimately leads to large inventory costs.

According to the national accounts of Iran, during the period 1988-2000 the cost of inventories averaged at the highest level of 7.3% of GDP if calculated at current prices. Ideally it should be zero on average for sufficiently large period. In developing countries the cost of inventories generally is between one to two
percent due to inefficiencies and statistical errors. The inventories cost figure of 7.3% GDP is greater reels GDP’s growth rate (4-3%) during long period of 1988-2003. It is a serious matter. Amongst many courses, three factors of fiscal processes get importance for explaining high cost of inventories: One, is high dependence in the oil revenues, Second, periodical softening and hardening of the budget constraints of the public enterprises. Thirdly Govt. restrictions on private purchase of goods and services.

The variation in the change in inventories in Iran could be explained by the tendency of risk-averse gents to over-accumulate inventories as a result of significant variations of the cost of capital and supply-shocks expectations in an economy dependent on the oil revenues and imports of capital/intermediary goods. This occurs in the context of underdeveloped financial markets and soft budget constraints of the public enterprises, the features which are not captured in the standard models of inventories accumulation assuming perfectly competitive markets. There is also evidence to suggest that high average change in inventories could be explained by capital flight hidden in the imports statistics, by wasting some of the over accumulated inventories under the soft budget constraint, and by statistical errors and omissions due to high PPI/CPI inflation differentials.

The mixed tax system combines features of a global and a scheduler system. The format applies a uniform rate to income from all and the latter taxes the principal sources of income flow at different rates.

Oil revenues are in the nature of an economic rent, because the participation of domestic factors in the production of crude oil and the return to them by way of factor payment is a tiny proportion of the annual oil revenues which are directly received by the state. Virtually like manna from haven. They are not just an important source of income but make up a very high proportion of the countries foreign exchange earnings. They thus become the independent variable of the economic system. And in countries such as Iran where the power of the state tends to be absolute an arbitrary, they would enhance and reinforce that tendency, and afford the state the independent means by which to extend its bureaucracy, military networks and means of coercion as well as pursue its goals of economic
development. In the case of agricultural, oil countries like Iran the strategy of development would tend to be biased against agriculture. Specially as there seems to be no need for each contribution of foreign exchange, earnings. Petrodollars can be used to import food and other agricultural necessities and luxuries.

Of the extent that the oil revenues make the state independent of the domestic means of production and the social classes. The latter became independent on the state for employment, direct hand outs and privileges borrowed capital for investment, as well as general welfare schemes ranging from education and health to food subsidies. Therefore, as the fount of economic and political power, state expenditure affects the fortunes of various social classes in a lager, agricultural oil economy where oil revenues per head of the population are not large enough to ensure a reasonable living standards for all members of the society, this type of relationship gives rise to a new, patriotic system of social stratification: the state has to be selective in affording even the minimum standard of comfort to individual members of the society, and those who benefit significantly from it constitute only a small percentage.

In this context the tax revenues mainly coming from oil exports impact the over all development of the over all development of the comity.

In 1976 before the Revolution, government expenditure was 37 percent of GDP while its revenue was about 39 percent. However after the Revolution even though the government was at war, its total expenditure, including that earmarked for war purposes, constituted a much smaller percentage of real GDP then that during the pre-Revolutionary years. Real government expenditure is a percentage of real GDP decreased to a low of 16 percent in 1991-92 and then rose to a high of 23% in 1994-95.ratios of government revenues in real GDP followed the same pattern during the same period. This decline is mainly due to the decrease in oil revenue, which was both international and incidental. Oil revenue decreased due to the ravages of the eight year Iran-Iraq and its ramifications, and second to the national policy of economic independents and self-sufficiency. Before the Revolution, Iran was exporting up words of five millions barrels of oil a day. The war destroyed the country’s ability to extract and ship oil at a level near this magnitude. In the mean
time, Iranian policy maker were determined to limit oil and gas exports to expand non-oil exports in ordered to pay for imports. While oil exports were effectively limited, there was no corresponding increase in non-oil exports. Expansion of non-oil exports has not materialized yet. In actuality such exports decline to about 2 percent of total imports. As a result, total government revenue and expenditure declined. Although the direction of this trend seems to have shifted upwards in 1993, revenue and expenditure as a percentage of GDP remain much lower than the 1976 levels. It seems unbelievable that the government has been running a growing surplus rising to as much as 2 percent of the GDP in the first half of the 1990’s, despite the high rate of unemployment, both open and misguided and the obvious need for growth and development.

To be brief we can say that the period 1960-20 the Iranian economy grew at an average rate of 4.5% which is reasonably good in comparison with other MENA countries. However this performance shows a high degree of variability. Rapid growth in 1960 and early 1970 was followed by a period of negative growth during 1979 Revolution and Iran-Iraq war period (1979-1988). Growth rebounded following the post war reconstruction and subsequent economic reforms.

However the fiscal and monetary policy stimulus at the height of the oil price cycle increased inflationary pressures and intensified the economy’s volatility to fluctuation in oil price. Channeling larger oil revenues to finance higher government spending together with accommodating monetary policy, has led to the rapid credit and double digit inflation This posed a serious challenge for macro economic and fiscal management.

The share of corporate tax in GDP in Iran is low compared to industrial countries and other regions of the world economy.

Over the last four years, measures like reduction in the corporate tax, a very substantial reduction in the cost of import registration deposit, and a lower nominal exchange rate brought about by higher oil revenue have reduces the cost of acquiring capital goods. Consequently, the ratio of private investment in machinery and equipment (at constant 1997 prices) to non oil GDP has risen
significantly which compares to a risen cost of capital in the 1993 – 1997 period during which the private investment rate fell to historically low levels.

It is particularly after 2000 government of Iran adopted structural reforms focusing on energy price reform, capital market flows and the preparation of Value Added Tax (VAT). The unweighted income tax was reduced to 23% in 2003-2004 from 27 % in 2Q03-2004 and the import ban on automobiles was replaced with high tariffs as it was felt that the fiscal policy adjustments should not jeopardize growth and employment objectives.

The financial system in Iran is still weak and inadequate. However the government of Iran had adopted some banking reforms such as regulations on licensing net open operations, from 1999-2004. This is not enough because these measures do not reduce the risk and uncertainty element in the financial market. The IMF has suggested the following banking supervision reforms:

1. Enlarging the range of sanction of banks
2. Defining the role of external auditors
3. Bringing all deposit taking institutions under central bank supervision.

Under such circumstances the fiscal reforms must be for reducing dependence on oil revenue for which implementation of the VAT is need of the hour. It is recommended that implicit and explicit subsidies should be phased out. The stringency fiscal reforms should include public expenditure program and cash management. Expansionary fiscal and monitory policies have maintained inflation relatively high at round 13%. It is therefore needed that fiscal policy of Iranian government, is aiming at building fiscal savings to cushion against unexpected down turn in oil prices. So establishing sustainability in fiscal policy is the great need.

Challenge before government of Iran is that the fiscal adjustment could be achieved mainly by cutting and targeting subsidies, reducing other current outlays and containing the growth of capital expenditure. Government spending on subsidies has continued to increase on the basis of higher oil revenue and non oil deficit is expected to remain high.