Chapter-IV

Structure of Government Expenditures

Introduction:

In the previous chapter, the structure of non-oil revenues and fiscal policy was analyzed and the problem of fiscal deficits and government borrowing was noted. The oil boom in the early 1970s that had eliminated the financial constraints on development in Iran was also discussed. This chapter examines the trend in government expenditures (current and capital) during two periods: a) 1970-79 and b) 1980-89. Between these two periods there were substantial changes in government expenditures. In the second period the capital expenditure to GDP ratio declined substantially. In terms of composition, the share of government expenditure in different sections of the infrastructural sector was subject to significant fluctuations during the two decades under investigation, and a major part of government expenditures particularly in the 1980s, consisted of different type of subsidies. This chapter also investigates the trends in the ratio of government expenditure to GDP which was impressive by international standards during the mid 1970s.

Public Expenditures and Economic Growth:

A number of studies have focused on the importance of public investment in the process of economic growth. Loaya and Vilanuera (1993) show that the level of investment by the public sector has a positive impact on growth. Public spending has also been seen as the most effective policy instrument for achieving distributive objectives (Gillis, 1989).
However, a rise in overall government expenditure cannot, in itself, be considered a good thing. For deciding how far an increase in government expenditure is justifiable, one must examine the heads under which expenditure has been incurred. Other related aspects which also need to be taken into consideration are the priorities laid down for expenditure, allocation of financial resources to various sectors, observance of various canons of public expenditure, and the amount of benefit accruing to society from the government expenditure concerned.

**Components of the Expenditure:**

Iran’s public expenditure is divided into regular and special outlays. Regular expenditure consists of standard government expenses (including law and order, welfare, and development). These are divided into current (ordinary) expenses of running the state’s basic functions, and capital (development) allocations for investment in public development projects. Current expenditures include general government services; defense; social services (e.g. health and education); and economic services (e.g. agriculture, water resources, energy, manufacturing, transport and communications).

The development budget is also divided into these four categories. Special expenditures are financed by special levies, and always equal to special revenues. Subsidies are part of regular expenses. In what follows, we discuss the performance of government expenditures during different periods and their contribution to overall economic growth.
Government Expenditures and Economic Growth:

The availability of oil revenues had increased the capacity of the state to increase its expenditures and thus the state assumed a much more significant role in setting the pace and structure of growth in the economy.

Chart 4.1: Ratio of Iran's total government expenditures/GDP (factor cost)

Source: Central Bank of Iran, Annual and Economic Reports, various years.

It can be argued that while overall government expenditures grew during the 1970s. Over the period 1971-80, government expenditures/GDP ratio showed an average annual rate of growth 5.1 percent. The corresponding figure for the 1981-90 was 7.2\(^8\). The nature of those expenditures changed, with the share of development expenditures, which was vital

\(^8\) Figures are calculated based on graph 4.1
for improving the country's infrastructure, decreasing considerably in the 1980s. The average growth of government expenditures during 1971-1980 was about 38.12 per cent, whereas it stood at 11.77 percent during 1981-1990 (Table A.1). The government development expenditures in comparison with the current expenditures registered a declining trend during the 1980s, with the average growth rate of development expenditure falling to 18.43 percent between 1981-90. That shows 33.32 percent reduction compare with the 1971-80 period. The total development expenditure to GDP ratio touched 17.9 percent in 1977, but over the whole of the 1980s it did not exceed 8.5 percent. The average total development expenditure to GDP ratio which was 12 percent during the 1970s, declined to 5 percent in 1980s. A careful examination of Chart 4.2 shows that the average of current expenditure/GDP ratio, which stood at 23.9 percent during the 1970s, declined to 17.2 percent during 1981-90. The current expenditure/GDP ratio, which had increased considerably during the 1970s, registered a declining trend during the 1980s.
During the 1980s, the government’s current expenditures exceeded its revenues. But despite the facts that Iran’s economy faced a costly and devastating war with Iraq and a rapidly rising and more demanding population during the 1980s, the government managed to contain aggregate public expenditure. The compression was achieved mainly through cuts in development expenditure. These cuts in development expenditure were ensured through non-completion of projects started under the Pahlavi regime (1926-79).

The Period of Accelerated Growth (1970s):

The transition in the level and structure of government expenditures was linked to Iran’s oil fortunes. During the 1970s, expenditures grew rapidly because of improvement in the
financial position of the government resulting from an increase in oil export revenues. The year 1974 was the turning point for expenditure increases. In that year government expenditures increased considerably due to a 169 percent increase in oil revenues in comparison with the previous year (Table 4.1). During this period, though the level of capital expenditures was reasonable, the growth of current expenditures was very high. It increased by 201 per cent and amounted to 70.3 per cent of total expenditures in 1974.

The rapid rise in current expenditures forced a review of the plan. The country’s fifth development plan (1973-78), was an ambitious document. It called for a total investment (private and public) of 2,486.7 billion rials, with a targeted growth rate of 11.4 percent per annum (PBO, 1975). On the grounds that the program was close to maximum absorptive capacity, the Budget and Planning Organization (PBO) set to work on a series of alternatives aimed at achieving macroeconomic balance. The focus was on the level of public investment that could be productively absorbed by the society in the remaining years of the plan. However, within the PBO itself, the planning division and the division in charge of projects were at odds on the best option to pursue. The former warned against the danger of inflation if a maximalist expenditure scenario was followed. The latter pushed for a maximum increase in development expenditures, worrying only about the allocation between sectors.

The planning division’s argument on the macro balance implications of increased plan expenditures was based on three scenarios of public investment: (1) a small increase of 31 percent from 1,545.8 billion rials in the original plan to 2,031.8 billion rials in the
proposed revision; (2) a moderate increase of 98 percent to 3,064.5 billion rials; and (3) a large increase of 141 percent to 3,732.8 billion rials (PBO, 1975). By contrast, the requests from the ministries exceeded even the high scenario by a little more than 945.0 billion rials.

Within the government there was no clear strategy regarding the public investment especially after the 1974 oil boom. The planning division argued for a low expenditure scenario, on the grounds that Iran lacked absorptive capacity. The two major bottlenecks—human capital and port capacity were included in the different scenario as binding constraints, and the trade off between growth and inflation presented. The argument was that Iran could in no way engage in a public investment program of over 2,031.8 billion rials without running into supply-side bottlenecks and triggering inflation. The supervision and coordination division, on the other hand, presented a maximalist approach in which Iran would not only spend its new financial resources but even opt to borrow. Finally, the government opted for a 2,848.5 billion rials public-investment figure, which was well over the recommendation of the PBO’s planning division. In fact, this revision disrupted the fifth development plan's (1973-78) internal cohesion, replacing it with a series of disjointed and incompatible policies.

Despite this, since the pressures for an increase in current domestic spending were immense, during this period the level of current expenditures was always more than that of development expenditures. However, there were also fluctuations in the relative importance of each area. The share of economic and defense affairs in government public
expenditures registered particularly large fluctuations. Having increased to 28 percent in 1973 from 12 percent in 1971, it gradually declined to 7 percent in 1978. Similarly, the share of activities related to human resources development in the government sector fluctuated between 10 and 20 percent.

Prior to the oil price increases, over 1970-1974, the ratio of government investment to government consumption expenditures was gradually decreasing, falling to 5.0 percent in 1974 (Rahimi Broujerdi, 1994). However, this ratio increased to 8.0 percent in 1976. This trend then reversed itself and during 1976 to 1979, because of more rapidly growing government current expenditures in comparison with development expenditures. Over time, the ratio of government investment to government consumption decreased to 4.2 percent.

| Table 4.1: The Government Expenditures (in billions of rials) |
|------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Expenditures     | 260.5  | 415.2  | 435.6  | 1174.4 | 1496.2 | 1675.4 | 2174.9 | 1979.6 | 2014.4 | 2197.4 |
| Current          | 144.5  | 283.4  | 274.3  | 825.8  | 969.4  | 1083.7 | 1248.1 | 1322.5 | 1494.9 | 1683.7 |
| Fixed capital formation | 116.0  | 131.8  | 161.2  | 348.6  | 526.8  | 591.6  | 926.8  | 657.1  | 519.5  | 513.7  |

Source: Central Bank of Iran Annual and Economic Reports, various years.

The Erosion of Development Finance (1980s):

After the 1979 revolution one of the most important developments was the shift away from development to current expenditures, with the share of development expenditures in GDP declining from 12.9 percent in 1978 to 3.4 percent in 1989. As a result of this
decline, maintenance and improvement of the country’s infrastructure was delayed at heavy long-term expense. This reduction in development expenditures is possibly explained by the fact that the Iran-Iraq war (1980-88) and reduction in oil revenues limited the available aggregate resources, which in turn was handled by a reduction in the allocation of funds for development purposes. The oil revenues share in total public revenues during the 1980s decreased in comparison with its share during the preceding years. The post-1979 expenditures were mostly composed of subsidies to private goods rather than social expenditures and public investments, which tend to be the only parts of government spending with positive growth effects (Easterly and Rebelo, 1993). During this period, because of the difficulties of collecting taxes under exceptional circumstances the government experienced a continuous and large budget deficit.

| Table 4.2: The Government Expenditures (in billions of rials) |
|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| Expenditures       | 2636.9  | 3083.5  | 3576.5  | 3331.3  | 3272.1  | 3147.7  | 3577.4  | 4195.5  | 4301.5  | 6031.4  |
| Current            | 2032.4  | 2252.6  | 2523.7  | 2475.6  | 2548.1  | 2413.3  | 2911.2  | 3394.6  | 3385.2  | 4284.8  |
| Fixed capital      | 604.5   | 830.9   | 1052.7  | 855.8   | 724.1   | 734.4   | 666.2   | 800.9   | 916.3   | 1746.7  |

Source: Central Bank of Iran, Annual and Economic Reports, various years.

The rapid decline in development costs indicates that in a state of financial stringency, development costs were curtailed more than current expenditures. The financial support from government for state run companies for developmental activities in this period decreased, so the government preferred to use bank networks. Current expenditures during 1971-1980 constituted 67.49 percent of total expenditures, whereas in the 1980s they constituted 75.96 percent of the government’s expenditures. The average growth of
current expenditures during 1971-1980 was 46.24 percent, whereas it was 10.27 percent during the 1980s (Table A.1).

The next section analyses the declining trend in the rate of growth of infrastructure expenditures in the Iranian economy in the early 1970s. This slowing down trend was mainly due to lack of foresight and policy errors made by the government as also the various unforeseen external shocks. This was due to lack of accurate data and information for planners and various decision making units. Therefore, the rapid increase in the incomes and demand could not match with the increase in the infrastructure expenditures. After the 1979 revolution, a rising share of oil revenues were allocated to meeting the welfare objectives of the government largely because of the Iran-Iraq war(1980-88) and the 1979 revolution. The government had to increase non-oil revenues to finance infrastructure expenditures in a non-inflationary way, which it did not do. As a result infrastructural growth became dependent on oil revenues. Naturally, negative price shocks during the 1980s, hampered the rate of growth of the infrastructure expenditures.

**Government Expenditure in Infrastructure:**

Since the beginning of development planning in Iran in the early 1950s, the share of infrastructure expenditure (telecommunication, transport, electricity and water) has been high compared with expenditure on other sectors. The per capita supply of electricity, telephones, roads, and water in Iran started from very low levels in the 1960s and grew rapidly until the mid 1970s. The investment in these sectors was entirely public. It is clear
that the government allocated huge shares of the country’s resources to infrastructure development.

Infrastructural shortages emerged in the mid-1970s. Throughout the early years of the oil boom the government reacted to physical bottlenecks as if their resolution required more effort and better organization. The problems were more serious in the area of transport, energy and manpower. For instance, some shortages emerged in the mid-1970s, especially in power. The government blamed most of the country’s power difficulties on the failure of foreign firms to complete on schedule work on the 750 MW generating plant at Reza Shah Dam in Khuzestan. The project was originally supposed to be operational in 1977, but the indication was that it might be some time before any electricity would be generated from the project. Though, the failure of the Reza Shah Dam to come on stream was clearly a contributing factor to the country’s power shortages, it was not the only reason. The other reason was the degree to which industrial and domestic consumption of electricity was increasing under the revised fifth five year development plan (1973-78). In absolute terms, government expenditures on electricity reached 83.3 billion rials in 1979. This expenditure declined to 24.9 billion rials in 1989 (Chart 4.3).

Bottlenecks appeared in the production chain so that firms relying on inputs such as electric power were forced to operate at less than full capacity as overall growth accelerated. The country’s total electricity generation rose to 64.1 billion KWh by late 1980s. Impeding even faster growth of power generation were shortages of skilled
linkage between communication and transport since all tangible communications have to be sent by transport. Improvements in transport help to speed communications via the postal services, telephone services, radio and television. After the 1974 oil boom the average share of transport and electricity was the highest among infrastructural expenditures. During the 1980s the average share of transport increased more than the other sectors, so that the share of other sectors throughout the periods under investigation remained considerably below electricity and transport shares.


The Grounds for Subsidies in Iran:

Along with the increases in national income there occurred a rapid growth in demand for consumer goods. But the government faced a problem in ensuring the supply of these
manpower, dependence on foreign equipment and machinery, costly investment requirements and waste of energy in production and transmission.

The problem of port capacity was another case in point. At the beginning of the fifth plan (1973-78), port capacity was 3.8 million metric tons and the plan envisaged an increase to 9.8 million-ton capacity by 1978 (Razavi and Vakil, 1984, p.84). The plan revision increased requirements to 29 million tons by the end of the same year. To solve the congestion, the government needed to expand port capacity and transport facilities. Emergency programs were instituted. However, attempts to remove serious physical obstacles through high cost programs led to the emergence of other constraints.

The government’s aggregate expenditure for transport is allocated to railroads, surface roads, air, sea and pipelines. The expansion of government expenditures on this sector was relatively high. However, the development in this sector was inadequate, and a good part of existing facilities that were damaged by the Iran-Iraq war (1980-88) and by poor maintenance remained in disrepair. The system was also overloaded because the bulk of imports delivered at southern and northern ports of entry routinely go to the capital first and from there the cargo is sent to the other parts of the country and production centers.

Communication means the imparting or transmission of information. The difference between transport and communication is that while the former implies the conveyance of goods, the later implies the conveyance of information. The transfer of information is very necessary for the development of industries, commerce and trade. There is a close
goods due to lack of fundamental industries. The shortages were then met by importing the goods concerned. So imports were viewed as an alternative to solve the problem. The difference between the price of imported articles and domestic ones, particularly the capital and strategic agricultural goods (protein and starch) necessitated a compensation payment.

During 1971-74 the average growth rate of imports was 33.43 percent (CBI, 1975). The growth of imported goods, mainly food articles, reached 100 percent. The lack of efficient transportation systems including ports, roads and airports caused the delivery to be postponed. Together with increases in international prices, these problems caused inflation to rise. The main outcome was a rise in price index of goods and consuming services which rose by 5.6 percent and 6.3 percent respectively during 1971 and 1972, and then more rapidly by more than 11 percent and 15 percent during 1973 and 1974 respectively (CBI, 1984).

The Pahlavi regime (1926-1979) took some measures to confront the price increase, including price control and instituting a Consumer Protection Fund in August 1974 with the following objectives:

(i) Protecting the consumers against fluctuations in prices.

(ii) Protecting the consumers against changes in costs of production in domestic and foreign markets.
The mechanism of the fund was such that some articles, including sugar, cooking oil, grains, rice, barley, corn, milo and cement would enter the list of subsidized goods after being proposed by the concerned ministry and finally approved by the Economic Council. The final prices were then determined by the Ministry of Commerce, which communicated them to the funds. The funds then, according to the statement of account received from the suppliers, paid some subsidy to them. When the amount of subsidies was more than the primary credit, based on article 8 of the law concerning the constitution of the consumers' protection fund, a loan from banks and domestic credit institutions was provided. When necessary, the CBI (Central Bank of Iran) also provided the necessary credit for the goods covered by the subsidy system.

To support price control, public funding efforts were instituted on 6 August 1975 under the title of campaign against overcharging as the 14th principle of the so called White Revolution (engelab-e safid). The last action to control the prices before the 1979 revolution was the ratification of the law on constituting the organization for producer and consumer protection on 5th August 1977. Based on the law, the legal duties of the Consumer Protection Fund were transferred to the said organization.

After the 1979 revolution, some change appeared in the executive structure and the articles relating to the subsidies. In February 1980 according to the ratifications of the Revolutionary Council (shoray-e engelab), the organization for consumers and producers protection was formed through the combination of the prices study center and the protection organization. The volume of activities in the organization during 1979 and
1980 was very limited and pricing was done in most cases by the economic mobilization headquarters, the Guild system courts and the Guilds affairs committee.

The pricing of imported goods and fundamental domestic products was executed by the organization of consumers and producers protection after 1980. During 1986-1988 following the necessity of exporting and due to the emergence of a black market in foreign currency, the prices of most domestic products increased two or three times relative to the previous years.

The Aim of Subsidies in the Post 1979 period:

After the 1979 Revolution, subsidy payments had more or less followed the previous trends\(^9\). However, economic stabilization and the control of inflation were the government’s main economic goals in this era. Because of the Iran-Iraq war (1980-88) and U.S led economic sanctions, the government began rationing basic goods using a coupon system. A minimum amount was identified for each individual. That amount was equal throughout the country and was purchasable at rates specified by the government. Thus, the low-income classes benefited more from these payments. However, the rural population faced a number of difficulties obtaining access to these goods.

\(^9\) Items which covered under consumer subsidies were: Imported meat, Milk, Cement and oil off loading, Green leaf of tea, chicken & egg, rice, price difference of cement, Vegetable oil, price stabilization of Iron wave, flour and bread for provinces center and flour off loading.

a) Items which covered under production subsidy payments were: Chemical fertilizer purchasing fodder, the difference in buying tractor, free of charge seed, poison, sugarcane, mother seeds, and insurance and crop damages.

b) Items which are covered and the services subsidy were: Taxi gasoline, Price difference of flour cooking oil and sugar, Free of charge feeding, Exchange price difference of newspapers and paper, capital goods coupon expenses and transporting capital goods to rural areas.
Table 4.3: Iran’s subsidy/GDP and Subsidy / Government Budget Ratios

<table>
<thead>
<tr>
<th>Year</th>
<th>Subsidy/GDP Ratio</th>
<th>Subsidy/Government Budget Ratio</th>
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<tr>
<td>1973</td>
<td>1.1</td>
<td>3.6</td>
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<tr>
<td>1974</td>
<td>2.6</td>
<td>5.9</td>
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<tr>
<td>1975</td>
<td>3.8</td>
<td>7.3</td>
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<tr>
<td>1976</td>
<td>2.3</td>
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<td>1977</td>
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<tr>
<td>1978</td>
<td>1.8</td>
<td>4.3</td>
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<td>1979</td>
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<tr>
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<tr>
<td>Average 1983-89</td>
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Source: Computed from Central bank of Iran annual reports and balance sheet various years.

After 1979 the subsidy/GDP ratio registered an increasing trend up to the early 1980s. During 1983-89 the subsidy/GDP ratio was more or less stable. There was a huge volume of subsidies paid on delivery of almost all goods and services by the government. So the average subsidy/government budget ratio, which stood at 8.01 percent during the 1973-83, remained at 7.66 percent during 1983-89 (Table 4.3).

The revolutionary government had promised to improve living conditions of the poor and vulnerable groups and protect them against the inflationary pressures. Further the government also tried to maintain a certain level of consumption of the middle class and
the poor. The government increased the level of wheat, sugar, and milk subsidies after the 1979 revolution. The highest share of subsidy among food items belonged to wheat which was 62.05 percent of the total food subsidies provided during the 1980s, whereas the government paid 324.2 billion rials for sugar and milk subsidies (Table A.2).

According to Rahimi (1989) during the years following the revolution, the low-income families enjoyed the benefits of such a system much more than others, i.e. to say their welfare had increased more. These payments have had an important role in alleviating the debilitating effects of inflation. Among the basic goods, the exception was bread. Any one could buy any desired amount of it. But bread is a low-valued article consumed by low-income families as well. Consequently, the opinion that the subsidy system is in favor of the rich is not true. During the 1980s, the percentage of subsidies allocated to essential goods production increased relative to the average ratio of production subsidies to total subsidies paid. This had increased from 13.7 percent (before the revolution) to 25.2 percent in 1989.

The government’s aim may be to provide welfare aid to a certain group of consumers or to the whole people. It could also be to modify the incomes of social groups and to increase the relative welfare of the lower-income groups or to regulate the consumption trend in such a way as to encourage purchase of goods that can be produced inside the country. Further, the aim may be to prevent misreporting of consumption of certain articles. Covering the price difference between the purchase and sale prices of basic articles needed by the low-income groups, and compensating losses incurred in the sale
of the goods protected by the government appear to be the objectives of most consumer subsidies.

Conclusion:

Iran opted for a mixed economy, implying the co-existence of public and private sectors. The initiative of the state in such a system is restricted to sectors which fail to develop either due to special constraints or the indifference of the private sector. Thus the state accorded very high priority in Iran to development expenditures to ensure a conductive environment for economic development, by funding capital accumulation. It has been argued that it is inappropriate to treat current expenditure as not contributing at all to growth while all development expenditure is treated as being growth promoting. There is merit in this argument. Part of some items of development expenditure such as transfers to cover the losses of bonyads may contribute little investment and growth.

On the other hand, part of the non-development expenditures was on defense, general administration and education. Current expenditure is considered desirable from an administrative point of view and has a tendency to increase with the growth in population. However, current expenditure also includes expenditure on the provision of education, health services and other human development areas that may also contribute to growth. We have argued that the pattern of government expenditures was different during the two sub periods. Basically, in an oil exporting country such as Iran where the state has a strong presence in the economy and was assigned a significant role in the
development strategy, especially in the development of infrastructure, the share of
government expenditures in GDP is bound to be large. Hence; the degree of instability in
government expenditures (relative to GDP) is of significance.

During the 1980s the level of current expenditures was still as high as the previous
decade. This was partly because of rising allocations to subsidies. The most important
item of consumer subsidy in Iran is the food subsidy that helps control prices of food
exchanged in official markets. These subsidies were financed from the general budget as
well as through special import levies on some goods. Two different subsidy mechanisms
were used: i) universal subsidies through fixed prices without quantity limitation; and ii)
general coupons valid for specific goods up to some set quantity. Price controls are set
along the import substitution chain and at each stage are applied to domestic producers as
well. The consumer subsidies were on the increase particularly during the Iran-Iraq war
(1980-1988), as the idea was to protect the consumers from inflationary trends. Barring
short periods, production subsidies never recorded a significant fall in the 1980s.