



Fiscal Policy Design in Iran



By [Olivier Basdevant](#)

July 27, 2016

Over the past several years, the Iranian economy has experienced several significant adverse shocks. Our [research](#) shows that one important lesson has been the need for Iran to strengthen its fiscal framework, so that fiscal policy supports economic stability rather than exacerbating the impact of the shock. Many resource-rich countries have fiscal frameworks with features that could serve Iran well. A common feature is a medium-term framework anchored on the non-oil fiscal deficit. Once a medium-term fiscal framework is in place, Iran could also consider adopting a fiscal rule.

The recent removal of economic sanctions has raised hopes for Iran's economy. Iran has fully re-entered the oil market and increased its oil production and exports, while the non-oil sector will gradually benefit over time from lower trade and financial transaction costs. However, several challenges remain. One challenge is that Iran lacks adequate fiscal buffers, in the form of liquid assets. When sanctions were tightened in 2012/13, a lack of this fiscal space forced the Iranian government to cut spending, which worsened the economic recession the country was experiencing. Iran will need to rebuild its fiscal buffers so that it will be in a better position to respond to the next shock.

Another challenge is that oil prices are at their lowest level in a decade, starving the government of badly needed revenues. The government is seeking to reduce inflation, which requires reducing the fiscal deficit. At the same time, further investment in infrastructure and human capital is needed to promote higher and more inclusive growth. Reconciling these two objectives requires raising additional revenues. With low oil prices dampening oil revenues, it will be critical for Iran to raise more non-oil revenues, which are much less volatile than oil revenues.

Adopting a strategy to strengthen its fiscal framework, can help Iran cope with these challenges. The following four areas could be at the center of this strategy:

- First, we recommend that the authorities set an explicit, long-term fiscal objective, with the goal of containing the non-oil fiscal deficit to a level consistent with the returns on sovereign wealth (primarily generated by oil revenue). This objective would ensure a sustainable fiscal path and a more predictable fiscal policy. Applying this methodology, the current non-oil deficit of about 8½ percent of non-oil GDP in 2014/15 would need to be reduced by about 3 percentage points over the medium term.
- Second, over the medium term, fiscal policy should focus on (i) reducing the non-oil fiscal balance to support the disinflation objective and to bring the

deficit more in line with a sustainable use of oil revenues, and (ii) rebuilding fiscal buffers through, for example, the reinstatement of the Oil Stabilization Fund (OSF) or some similar mechanism. Over time, the need for buffers in the form of financial assets could be reduced as Iran gains greater access to domestic and international financial markets.

- Third, by increasing the share of value-added taxes in total revenues—in line with international good practices—more room for development spending can be created without increasing the deficit. In addition, we recommend that the authorities adopt a strategy to eliminate implicit fuel subsidies, which, at about 4 percent of GDP, remain large.
- Fourth, once the fiscal objectives have been established, the authorities could develop a medium-term framework to provide guidance on *expenditure levels*, consistent with fiscal deficit targets and expected revenues. Setting expenditure levels over the medium term would be particularly helpful to assess (i) the space available for additional development spending in the short and medium term, and (ii) the need for fiscal adjustment to create space for higher age-related spending, or for higher interest payments, in the medium and long term.

Iran can further strengthen its fiscal framework by adopting fiscal rules. Fiscal rules could help Iran in its management of oil revenues. For example, Iran could, as some other resource-rich countries do, use a price-smoothing rule, i.e., smoothing oil prices over the cycle for budgeting purposes to protect spending against large swings in oil revenues. In addition, an expenditure rule would prevent too rapid an increase in spending during boom cycles, thus preserving fiscal buffers for bad times. To increase the odds of compliance and build support for their objectives, fiscal rules could be backed by sound budget practices, enshrined in law, and monitored independently.

Olivier Basdevant is Senior Economist at the IMF, where he currently works as Senior Desk for the Islamic Republic of Iran. At the Fund he has worked in the Fiscal Affairs and African Departments, where he developed experience on fiscal policy design. He holds a PhD in Economics from the Sorbonne University in Paris. His publications focus on inclusive growth, macroeconomic modeling, inflation targeting, fiscal rules and fiscal adjustment strategies.