

**EXECUTIVE
BOARD
MEETING**

SM/17/26

February 13, 2017

To: Members of the Executive Board

From: The Secretary

Subject: **Islamic Republic of Iran—Selected Issues**

Board Action:	Provides background to SM/17/25—Staff Report for the 2016 Article IV Consultation
Tentative Board Date:	Friday, February 24, 2017
Publication:	Yes*
Questions:	Ms. Purfield, MCD (ext. 36836) Mr. Basdevant, MCD (ext. 36617) Mr. Cakir, MCD (ext. 34310)
Document Transmittal in the Absence of an Objection and in accordance with Board policy:	After Board Consideration—Food and Agriculture Organization, Islamic Development Bank, United Nations Development Programme

***Unless an objection from the authorities is received prior to the conclusion of the Board's consideration, the document will be published.**



ISLAMIC REPUBLIC OF IRAN

SELECTED ISSUES

February 10, 2017

Approved By
Aasim M. Husain

Prepared By Olivier Basdevant, Selim Cakir, and Gaëlle Pierre (MCD), Aqib Aslam, Geerten Michielse, and Christopher J. Heady, (FAD), and Chady Adel El Khoury (LEG), Tohid Atashbar (Iran Parliament Research Center)

CONTENTS

IMPEDIMENTS TO CORRESPONDENT BANKING WITH IRAN _____ **3**

A. Sanctions on Iran's Financial System Have Been Only Partly Lifted _____ 3

B. Progress in Re-connecting Iranian Banks with Global Financial Banks _____ 6

C. Potential Policy Options that can Facilitate the Reconnection to Non U.S. Global Banks _____ 8

Boxes

1. Glossary of U.S. Economic Sanctions _____ 5

2. Iran's Action Plan with the FATF _____ 8

Figures

1. Correspondent Banking Relationships, by Country _____ 6

2. Correspondent Banking Relationships, by Currency _____ 6

References _____ 10

REFORMS TO THE MONETARY POLICY FRAMEWORK _____ **11**

A. Strengthening the Monetary Policy Framework _____ 11

B. Using a Financial Conditions Index to Assess Economic Conditions _____ 15

C. Long-Run Determinants of Inflation _____ 17

Box

1. Authorities' Financial Sector Reform Plan _____ 13

Figures

1. Current Monetary Framework in Iran	12
2. Interbank Market	12
3. Alternative Monetary Framework	15
4. Financial Conditions Index	16
5. Financial Conditions Index & Non-oil GDP	16

Table

1. Long-Run Coefficient Estimates of the Inflation Model	17
--	----

References	18
-------------------	----

A ROADMAP FOR STRUCTURAL FISCAL REFORMS IN IRAN 19

A. Iran Faces Spending Pressures	19
B. Envisioning a Medium Term Fiscal Framework (MTFF)	21
C. Implementing a MTFF in Iran	24

Tables

1. Medium-Term Fiscal Framework, 2014/15–2021/22	22
2. Fiscal Risks	25

References	27
-------------------	----

INTERNATIONAL TAXATION IN IRAN 28

A. Introduction	28
B. Maintaining the Integrity of the Tax System	28
C. Domestic Legal Framework	32
D. Tax Treaty Network	35

Boxes

1. Investment Tax Incentives in Iran	30
2. Eligible Persons Under a LoB Provisions	31
3. Domestic Taxes on Cross-Border Payments	34
4. Re-Allocation of Tax Cost	36

Table

1. Corporate Income Tax and Withholding Tax Rates for Selected Economies	35
--	----

References	37
-------------------	----

FOSTERING PRIVATE SECTOR JOB CREATION IN IRAN 38

A. The Opportunities and Challenges in the Iranian Labor Market	38
B. Key Elements of a Strategy to Foster Private Sector Employment	40

References	47
-------------------	----

IMPEDIMENTS TO CORRESPONDENT BANKING WITH IRAN¹

- Iran has faced economic sanctions that contributed to severe damage in its correspondent banking relationships disconnecting Iran from the global financial system and disrupting cross-border flows including trade finance and remittances.
- Despite the lifting of international nuclear sanctions on January 16, 2016—"Implementation Day" under the Joint Comprehensive Plan of Action (JCPOA)—Iranian banks face protracted difficulties in re-entering the international financial system through correspondent relationships with global banks.
- SWIFT reconnected the Central Bank of Iran (CBI) and large number of Iranian banks, and over 200 small and medium-sized international banks have started correspondent relationships with Iranian banks which reduced the cost and improved the timeliness of payments.
- Important challenges that prevent Iranian banks fully-reconnecting to global banks remain. Those mostly relate to remaining U.S. sanctions as well as the regulatory environment of enforcement, the significant deficiencies in Iran's Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework including lack of transparency of Iranian companies. The absence of larger correspondent banks (Tier I) can hamper trade and investment, as large-scale operations often require banks with adequate financing capacity.
- Domestic policy reforms can potentially facilitate the reconnection to non-U.S. global banks. These reforms need to be targeted to bolstering the effectiveness of the AML/CFT framework including increasing entity transparency to improve the integrity of the financial sector and getting removed from the Financial Action Task Force's (FATF) list of high-risk and noncooperative jurisdictions.

A. Sanctions on Iran's Financial System Have Been Only Partly Lifted

- 1. For the past 10 years, Iran has faced economic sanctions that severely damaged correspondent banking relationships (CBRs).** The first sanctions were imposed following the Iranian revolution in 1979. In 2006, the United Nations (UN) introduced its first sanctions on Iran to halt its uranium enrichment program. In 2012, the U.S., UN and the European Union (EU) tightened sanctions introducing an oil embargo and banning financial transactions with Iranian banks. This resulted in withdrawal of foreign banks from CBRs with Iranian banks. According to the CBI, the number of CBRs dropped from 633 in 2006 to around 50 in 2014.
- 2. The JCPOA resulted in significant sanctions relief.** The EU economic sanctions targeting Iran which related to the nuclear program have been amended or removed altogether, lifting many of the restrictions for European banks to process transactions with Iranian banks or on behalf of Iranian entities. U.S. so-called "secondary" sanctions (see Box 1) have also been removed, with some exceptions,² reducing the risk that non-U.S. financial institutions will be sanctioned by

¹ Prepared by Chady Adel El Khoury.

² Secondary sanctions continue to apply to non U.S. persons who knowingly facilitate significant transactions with or provide material or certain other support to individual and entities on the SDN list.

U.S. authorities for engaging in transactions with Iran or sanctioned Iranian entities. Thus, in principle, EU financial institutions are now free to undertake a wide range of transactions in Iran including in finance and energy sectors.

3. However, other sanctions remain in place. U.S. primary sanctions³ apply to U.S. financial institutions and companies, including their non-U.S. branches (but not their subsidiaries). Moreover, with very limited exceptions, businesses and individuals related to the U.S. continue to be prohibited generally from dealing with Iran, including with the government. The so-called “U-Turn” transactions (Box 1) remain prohibited. U.S. dollar clearing restrictions have not been lifted and pose a significant challenge for non-U.S. banks who may do business in Iran, but may not be paid in U.S. dollars.⁴ Foreign financial institutions may process transactions denominated in U.S. dollar or maintain U.S. dollar-denominated accounts that involve Iran provided that such transactions or account activities do not involve, directly or indirectly, the U.S. financial system or any U.S. person and do not involve any person on the Specially Designated Nationals (SDN) list (box 1). As a result, non-U.S. companies are unable to access the U.S. financial system for transactions with Iranian counterparties. Companies with U.S. bank accounts cannot send or receive funds that are connected to Iranian business. Furthermore, transactions related to Iran involving significant amounts in nondollar currencies (e.g. India, Korea, Oman) are also proving difficult to convert into other currencies without converting into dollars first.

4. The United Nations, the EU and the U.S. maintain “black lists” of prohibited individuals and entities under Iran sanctions. Not all listed entities under the Iran program were removed on Implementation Day, and U.S. and non-U.S. companies continue to be prohibited from dealing with listed individuals and entities. Additionally, companies still face restrictions on doing business with Iranian individuals and entities—even if they are removed from the SDN List—because of continuing U.S. sanctions on Iran’s weapons program and human rights violations.

5. In relation to the (AML/CFT), the Financial Action Task Force (FATF) listed Iran on its “black list.” In October 2007, the FATF originally called on countries to take measures to mitigate the money laundering and terrorism financing (ML/TF) risks emanating from Iran, primarily by asking financial institutions to apply enhanced due diligence measures when dealing with transactions to or from Iran. From February 2008 onwards, it called on countries to apply effective countermeasures to protect the international financial system from the ML/TF risks emanating from Iran. In June 2016,

³ The U.S. maintains sanctions against Iran related to support for terrorism, proliferation of weapons of mass destruction including ballistic missiles, support for persons involved in human rights abuses in Syria or for the Government of Syria and support for persons threatening the peace, security, or stability of Yemen, and human rights abuses. For more information: https://www.treasury.gov/resource-center/sanctions/Programs/Documents/jcpoa_faqs.pdf

⁴ Non-U.S. banks also need to conduct due diligence to ensure that they are not transacting with entities and individuals on the Specially Designated Nationals list.

following Iran's commitment to addressing the significant deficiencies in its AML/CFT framework, the FATF decided to keep Iran on the public statement (the "black list"), while calling for a suspension of countermeasures for a period of twelve months.

Box 1. Glossary of U.S. Economic Sanctions

JCPOA: On July 14, 2015, the P5+1 (China, France, Germany, Russia, the United Kingdom, and the United States), the European Union, and Iran concluded a Joint Comprehensive Plan of Action (JCPOA) to ensure that Iran's nuclear program will be exclusively peaceful. October 18, 2015 marked Adoption Day of the JCPOA, the date on which the JCPOA came into effect and participants began taking steps necessary to implement their JCPOA commitments. January 16, 2016, marks Implementation Day of the JCPOA.

Primary Sanctions: For the purpose of primary U.S. sanctions administered by the U.S. Treasury-Office of Foreign Assets Control (OFAC), the term "U.S. person" means any U.S. citizen, permanent resident alien, entity organized under the laws of the U.S. or any jurisdiction within the U.S. (including foreign branches), or any person in the U.S. Secondary sanctions generally are directed toward non-U.S. persons for specified conduct involving Iran that occurs entirely outside of U.S. jurisdiction and does not involve U.S. persons.

Secondary Sanctions: Those are generally being directed toward non-U.S. persons for specified conduct involving Iran that occurs entirely outside of U.S. jurisdiction. "Non U.S. person" means any individual excluding any U.S. citizen, permanent resident alien, entity organized under the U.S. laws or any jurisdiction within the U.S. (including foreign branches), or any person in the U.S.

SDN List: As part of its enforcement efforts, OFAC publishes a list of individuals and companies owned or controlled by, or acting for or on behalf of, targeted countries. It also lists individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. Collectively, such individuals and companies are called "Specially Designated Nationals" or "SDNs." Their assets are blocked and U.S. persons are generally prohibited from dealing with them.

U-Turn general license: These licenses allowed U.S. dollar clearing activities involving Iran prior to its revocation in November 2008, was not reinstated on Implementation day, and U.S. financial institutions continue to be prohibited from clearing transactions involving Iran with the exception of transactions that exempt or authorized by a general or specific license.¹

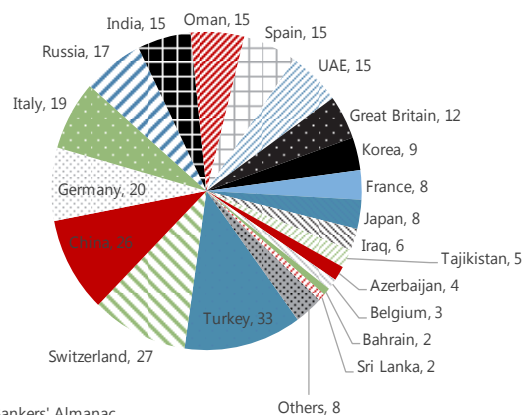
Snap-back of sanctions: Under the JCPOA, there is a period of 10 years during which Iran could be subjected to the reinstatement of sanctions in case of nonperformance of its nuclear-related obligations. Both the UN and the U.S. have "snap-back" provisions to reinstate sanctions instantly in such event.

¹ Prior to November 2008, U.S. financial institutions were authorized to process certain transfers for the direct or indirect benefit of Iranian banks, other persons in Iran or the Government of Iran, provided such payments were initiated offshore by a non-Iranian, non-U.S. financial institution and only passed through the U.S. financial system en-route to another offshore, non-Iranian, non-U.S. financial institution.

B. Progress in Re-connecting Iranian Banks with Global Financial Banks

6. JCPOA sanction relief resulted in reconnecting Iran's financial system to small and medium-size non U.S. banks. According to the CBI, 238 small and medium-sized international banks⁵ have started correspondent relationships with Iranian banks. Bankers' Almanac has 178 reports of CBRs in 11 different currencies (See Figures 1 and 2). Those are opening accounts and letters of credit with foreign banks and conduct currency transfers in the form of issuing payment orders for foreign exchange services and imports. However, the lack of larger correspondent banks (mostly Tier I) can hamper trade and investment, as large-scale operations often require banks with adequate financing capacity.

Figure 1. Correspondent Banking Relationships, by Country

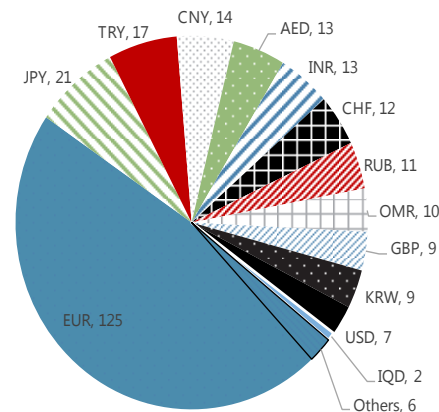


Source: Bankers' Almanac
Note: The database includes CBRs reported by banks as of December 2016.

7. Increased access has bought benefits. SWIFT reconnected the Central Bank of Iran and 15 nonsanctioned Iranian banks⁶ in February 2016 (having been disconnected in March 2012), allowing them to resume cross-border payment transfers related to oil shipments and other foreign trade with foreign counterparts. In addition, international branches of Iranian banks opened in Europe and were reconnected to TARGET 2.

8. Important challenges remain that prevent Iranian banks fully-reconnecting to global non-U.S. banks. Those are mainly related to:

Figure 2. Correspondent Banking Relationships, by Currency



Source: Bankers' Almanac
Note: The database includes CBRs reported by banks as of December 2016.

⁵ According to same report, 13,995 letters of credit (worth \$12.8 million) were opened. The report notes that in 2014, Iranian banks had 50 CBRs (633 before the sanctions) and has risen to 238 by end-2016.

⁶ Not all of the EU sanctions on Iranian banks have been repealed. Swift continues to be prohibited from providing specialized financial messaging services to several EU-sanctioned Iranian banks under EU regulation (which are also those still under the U.S. Specially Designated Nationals List).

- a. **The complexity of the remaining sanctions:** For the first time in many years, U.S. and EU sanctions on Iran are no longer broadly aligned. The commitments of the United Nations, U.S. and EU under the JCPOA and related sanctions relief vary widely, raising significant compliance challenges for financial institutions which follow both U.S. and EU rules. In addition, half of U.S. states have restrictions on companies that do business in Iran⁷. As of June 2016, thirty-two states (including New York where most global U.S. banks conduct their operations including CBRs) and Washington D.C have some form of state-level sanctions with the most frequent being measures to block investments of pension funds and government contracts with companies doing business in Iran. Furthermore, non U.S. global banks must also take into account the possibility that nuclear sanctions could be re-imposed or “*snapped back*” (see box 1) in the event that Iran has not fulfilled its obligations. Finally, sanctions are in some instances being renewed or intensified. On December 15, 2016, the Iran Sanctions (10 years) extension Act⁸ became law. On February 3, 2017, other nonnuclear sanctions, including SDN list restrictions, were broadened to cover new individuals (13) and companies (12) in February 2017 following Iran’s test of ballistic missiles.
- b. **The regulatory environment related to major enforcement actions against banks:** Global banks face an extremely high compliance burden to do business with Iran. In recent years, various financial institutions have faced large fines for violations of economic sanctions. As a result, banks have upgraded their compliance measures and this has increased their costs and which has eroded the profitability of CBRs.
- c. **FATF listing and deficiencies in the AML/CFT regime.** Although the FATF eased its stance on Iran in light of action plan to address AML/CFT deficiencies, Iran will need to enhance its AML/CFT framework substantially in order to be removed from the “black” list which would ease its full return to the international financial system.
- d. **Difficulty of foreign banks in identifying prohibited individuals and entities.** Non-U.S. companies have to conduct careful due diligence to ensure that they are not dealing with prohibited counterparties, and the compliance process is extremely difficult and costly in part because of lack transparency and complex ownership structure of many Iranian corporates that makes it very difficult to identify their ultimate beneficial owner(s).

⁷ https://www.washingtonpost.com/news/monkey-cage/wp/2016/06/01/most-u-s-states-have-sanctions-against-iran-heres-why-thats-a-problem-2/?utm_term=.48a1a459d268.

⁸ The Iran and Libya Sanctions Act of 1996 (ILSA) was a 1996 Act of Congress that imposed economic sanctions on firms doing business with Iran and Libya. On September 30, 2006, the act was renamed to the Iran Sanctions Act (ISA), as it no longer applied to Libya, and extended until December 31, 2011.

C. Potential Policy Options that can Facilitate the Reconnection to Non U.S. Global Banks

9. Domestic policy reforms can potentially facilitate the reconnection to non-U.S. global banks. Those mainly related to bolstering the effectiveness of the AML/CFT framework including improving entity transparency in order to improve the integrity of the financial sector, get removed from the FATF list of high-risk and noncooperative jurisdictions, and facilitate further the re-integration of the domestic financial system into the global economy.

10. Iran has already made progress in strengthening the AML/CFT framework. In March 2016, the Parliament adopted a CFT law and made a high-level political commitment to implement an action plan (Box 2). The authorities have requested a Fund assessment of the AML/CFT regime against the FATF standard which will take place late 2018. They also became an observer to the Eurasian AML/CFT group.

Box 2. Iran's Action Plan with the FATF

In June 2016, Iran made a formal high-level commitment to FATF to implement its action plan to strengthen its AML/CFT framework. As a result, although FATF decided to keep Iran on the public statement (the "black list"), it called for a suspension of countermeasures for a period of twelve months. Full implementation of the plan will allow Iran to be considered for complete removal from FATF listing. However, if the FATF determines that Iran has not demonstrated sufficient progress, the call for countermeasures will be re-imposed.

The suspension of the countermeasures eased Iranian banks reconnection to the small and medium size banks. Countermeasures comprise, among others, enhanced due diligence on the quality of respondent institution's AML/CFT controls; restrictions on opening of correspondent accounts; and not allowing Iranian banks to open subsidiaries in foreign jurisdictions. FATF maintained its call on members to apply enhanced due diligence to business relationships and transactions with natural and legal persons from Iran. Each member country can continue imposing countermeasures based on its own assessment of risks and independently of any call by the FATF.

Most of the items under the action plan are related to legislation and regulations. The action plan with the FATF includes 10 items with deadlines between May 2017 and January 2018 that are intended to rectify Iran's strategic AML/CFT deficiencies. They are related to the proper criminalization of the money laundering and terrorist financing offenses, confiscation and provisional measures, freezing of terrorist financing assets in line with relevant United Nations Security Council Resolutions, ensuring proper AML/CFT requirements (preventive measures and customer due diligence) for the financial sector, enhancing the role of the financial intelligence unit and the reporting of suspicious transactions, ratifying relevant United Nations Conventions (Palermo convention on transnational organized crime, 2000; New York convention for the suppression of the financing of terrorism, 1999), and improving international cooperation in regulating alternative remittance systems, wire transfers, and cash couriers.

11. However, the Iranian AML/CFT framework needs further strengthening as a matter of priority. Iran needs to adopt significant reforms to bring its framework in line with international standards and improve its effectiveness. This will take time as the authorities have to develop an effective framework to address and mitigate underlying inherent risks, which will allow correspondent banks to improve the risk profile of Iran. In addition to meeting the action plan with the FATF, reforms should prioritize improving the understanding of ML/TF risks, enhancing the regulatory and supervisory frameworks, and bolstering entity transparency:

- a. **Iranian authorities should improve their understanding of ML/TF risks** by conducting a national risk assessment in line with the FATF standards.
- b. **AML/CFT regulation and supervision should be built around a forward-looking risk-based assessment.** The CBI should enhance the risk-based supervision of banks and impose corrective actions and sanctions when relevant.
- c. **Mechanisms need to be developed to ensure entity transparency.** This would improve compliance with international standards and lower the cost of compliance for correspondent banks. A public registry for beneficial ownership would allow timely access to adequate, accurate, and current information on beneficial ownership of all types of entities in Iran. In June 2016, the United Kingdom launched a public register for beneficial ownership information of companies to enhance their transparency. This made the information available and accurate, and easily accessible.
- d. **Iranian banks should continue improving their compliance to enhance their relationship and bolster trust with correspondent banks.** This could be done by investing in AML/CFT internal controls including by upgrading compliance systems and training staff, specializing in low risk business, and getting external certification or third part audit of their AML policies and procedures. Correspondent banks can provide technical assistance to clarify their risk tolerance policies to Iranian banks as well as help build their capacities.

Finally, continued strengthening of the framework in line with international standards will help mitigate the risks related to ML/TF and underlying offenses (e.g., corruption, tax crimes).

References

- Basel Committee on Banking Supervision, 2016, "Revised on Correspondent Banking," Consultative Report <http://www.bis.org/bcbs/publ/d389.htm>
- Committee on Payments and Market Infrastructures (CPMI), 2014, "Non-Banks in Retail Payments," (Bank for International Settlements: Basel) <http://www.bis.org/cpmi/publ/d118.htm>
- , 2016, "Correspondent Banking," (Bank for International Settlements, Basel) <http://www.bis.org/cpmi/publ/d147.pdf>
- Committee on Payments and Market Infrastructures (CPMI) and Technical Committee of the International Organization of Securities Commissions (IOSCO), 2016, "Guidance on Cyber Resilience for Financial Market Infrastructures," (Bank for International Settlements: Basel) <http://www.bis.org/cpmi/publ/d146.pdf>
- Cook, Samantha and Kimmo Soramäki, 2014, "The Global Network of Payment Flows," Swift Institute Working Paper No. 2012-006, (The Swift Institute: London); https://www.swiftinstitute.org/wp-content/uploads/2014/09/SWIFT-Institute-Working-Paper-No.-2012-006-Network-Analysis-of-Global-Payment-Flows_v5-FINAL.pdf
- Erbenová, Michaela, Yan Liu, Nadim Kyriakos-Saad, Alejandro López-Mejía, Giancarlo Gasha, Emmanuel Mathias, Mohamed Norat, Francisca Fernando, and Yasmin Almeida, 2016, "The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action," IMF Staff Discussion Note 16/06, (International Monetary Fund: Washington) <https://www.imf.org/external/pubs/ft/sdn/2016/sdn1606.pdf>
- Financial Action Task Force (FATF), 2016, "Guidance on Correspondent Banking," (Financial Action Task Force: Paris) <http://www.fatfgafi.org/publications/fatfrecommendations/documents/correspondent-banking-services.html>
- Security Council Report, 2013, "UN Sanctions," Special Research Report 3, (United Nations: New York) <http://www.securitycouncilreport.org/special-research-report/un-sanctions.php>
- World Bank, 2015a, "Withdrawal from Correspondent Banking: Where, Why, and What to do About It," Working Paper 101098, (World Bank: Washington) <http://documents.worldbank.org/curated/en/2015/11/25481335/withdraw-correspondent-banking>

REFORMS TO THE MONETARY POLICY FRAMEWORK¹

- The current monetary framework in Iran is shaped by credit allocation decisions to support government credit policies, and the Central Bank of Iran (CBI) lacks the means and tools to safeguard low and stable inflation as liquidity is controlled more by rationing than pricing.
- The authorities are taking steps to modernize the monetary policy framework but additional elements need to be put in place.
- A financial conditions index would help the CBI gauge the impact of its policy decisions on economic activity and assist monetary policy formulation.
- A better understanding of the key determinants of inflation will be central to the monetary policy decisions of the CBI.

A. Strengthening the Monetary Policy Framework

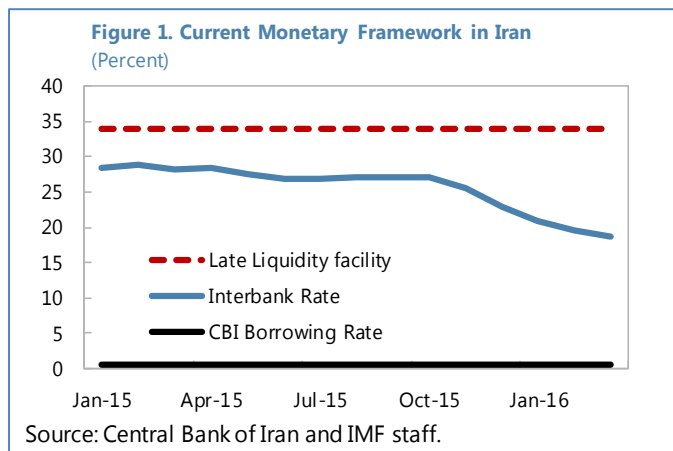
- 1. Currently, monetary policy in Iran is geared to achieve the objectives set in the Five-Year Plans and is guided by the Money and Credit Council (MCC) of the CBI.** The MCC is dominated by representatives of other government agencies. The CBI, on the directives of the MCC, implements the government's credit policies to support the plan by allocating credit limits to each sector, sometimes at subsidized rates. As a result, credit policies imposed by the government have a direct bearing on the pace of liquidity growth and hence inflation. In addition, interest rates, on both deposits and lending, are fixed and financial institutions are obliged to follow the CBI's directions in their operations.
- 2. The CBI's funding facilities are not collateral based, there is no clear emergency lending framework, and unhealthy banks remain in the system.** In practice, the CBI is obliged to provide liquidity to all banks irrespective of their health. The absence of corrective measures to recapitalize the banks and wind down unviable ones reflect themselves as rising pressures on the CBI's overdraft facility. The use of the CBI's so called "overdraft facility" by banks (at the penalty rate of 34 percent) has gained considerable pace in 2016.
- 3. The CBI has some tools to manage liquidity but they have not been used in recent years.** It can issue participation papers to mop-up liquidity. This requires MCC approval. It can also issue Special Certificates of Deposit to absorb excess liquidity.
- 4. Under the current monetary framework, the CBI has no regular funding facility and hence no specific policy rate.** The CBI needs to provide funding to the market for the money market to clear. Accordingly, the policy rate has to be a lending rate. The only available lending rate

¹ Prepared by Selim Cakir

to banks, other than the directed credit schemes, is the CBI overdraft facility rate of 34 percent. Accordingly, the current “interest rate corridor” is very wide. At the bottom of the corridor, there is the CBI’s borrowing rate with no interest, and at the top of the corridor, there is the CBI’s overdraft rate at 34 percent (Figure 1).

5. The monetary policy framework in Iran, has resulted in high and volatile inflation

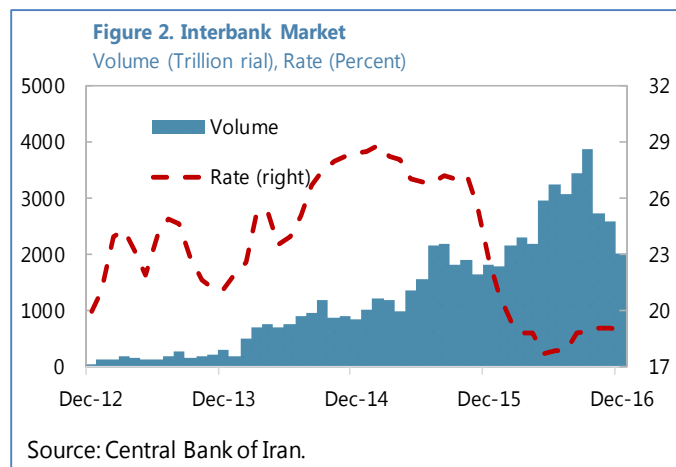
(Blotevogel, 2014). Contrary to many emerging market economies which have experienced notable and sustainable declines in inflation in the last decade, Iran has experienced periods of sustained high inflation, particularly during the sanctions era. The authorities have successfully reduced the inflation rate as a result of sound macroeconomic policies. But the annual inflation rate is barely in single digits and the recent monetary expansion endangers the hard-earned reduction of the inflation rate.



6. Changing the design of the monetary policy framework can give a greater priority to inflation stabilization. The exchange rate has long been a nominal anchor for Iran’s monetary policy. The authorities continue their efforts to remove foreign exchange restrictions and shift further goods to the bureau market, thus paving the way for a full foreign exchange market unification. Once unified, their intention is to move to a managed float. Greater exchange rate flexibility will require a modern, market-based monetary policy framework focused on maintaining price stability.

7. The authorities are moving to a market-based monetary policy framework.

Short-term market interest rates increasingly contain information about the monetary policy stance as the operational conduct of the CBI is increasingly focusing on the interbank market. The CBI has started to inject liquidity to the financial system through the interbank market (Figure 2) and aims to keep interbank rates within a target range. Under the authorities’ Financial Sector Reform Plan (Box 1), draft Central Bank and Banking bills aim to modernize the monetary policy framework and strengthen supervisory powers.



Box 1. Authorities' Financial Sector Reform Plan

Iran's President Hassan Rouhani issued a directive on July 4, 2015, ordering reform of the financial and banking system. Accordingly, a comprehensive financial reform plan was devised to reform Iran's banking system, help develop the capital market and manage government debt. Its key elements are:

- **Improve oversight of the financial sector.** Strengthening the capacity of the CBI to maintain monetary and financial stability by revising the banking and central bank laws, which would clarify and strengthen regulatory and supervisory powers of the CBI, among others.
- **Regulate unlicensed financial institutions.** Strengthening and harmonizing the regulation and supervision of financial intermediaries by updating laws and regulations, methods of supervision, stricter enforcement of prudential rules and bringing all financial intermediaries, including the unlicensed credit institutions within the regulated financial system.
- **Undertake asset quality reviews of banks and develop bank specific restructuring plans.** Ranking banks using CAMELS rating system, and differentiating reserve requirement ratios based on the ranking of banks. Other measures include strengthening supervision of problem banks, preparation of regulations and guidelines for restructuring, merger, resolution of banks, strengthening private banks' balance sheets through injection of capital by shareholders, setting a target capital adequacy ratio for each bank.
- **Address nonperforming assets.** Reducing nonperforming loans through creating an asset management company and improve the ability of the banking industry to make more informed credit decisions by establishing a credit bureau and a domestic ratings agency. Other measures include revising the laws and regulations to allow banks to write-off bad loans in a timely manner, oblige banks to form nonperforming loans (NPL) collection committees and provide quarterly reports to the CBI and introduce new provisioning guidelines.
- **Strengthening credit market.** Strengthening the credit market by diversifying the funding sources of banks through more active use of the interbank market and issuance of securities, such as certificate of deposits and sukuk, giving priority to financing of SMEs and working capital financing of manufacturing companies, and extending microloans to impoverished borrowers.
- **Use open market operations in implementing monetary policy.** Establishing the bond market is the initial step. Other measures include ensuring issuance of securities in the electronic form, providing incentives to banks to issue sukuk and trade government bonds and other securities, engaging the CBI in open market operations when the bond market is fully functioning.
- **Develop the interbank market.** Developing the interbank market through revision and completion of operational guidelines for interbank market operations, allowing the CBI to receive and place deposits at the market, acceptance of securities as collateral, and use of new financial instruments in the interbank market.

8. The draft Central Bank bill aims to modernize the monetary policy framework and puts price stability as the core objective of monetary policy. It incorporates major improvements relative to the current law with regards to the clarity of the objective function, the supervisory authority and governance of the CBI. The draft Banking and the CBI bills grant the CBI the power to supervise all deposit-taking institutions. Financial stability is included among the core objectives of the CBI. Helping with economic growth and preservation of the value of foreign currency are other

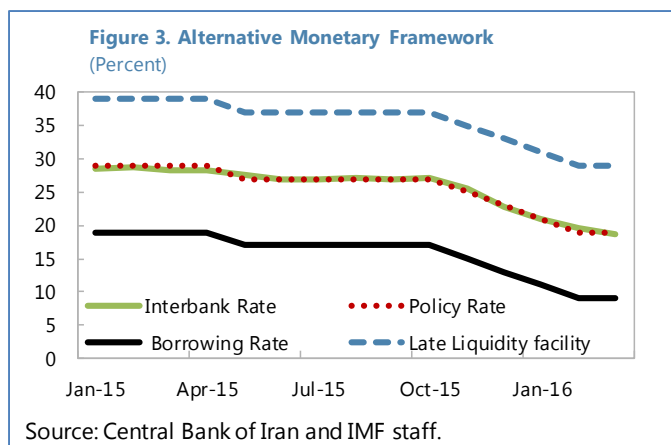
stated objectives but their undertaking is secondary to price stability objective. The bill obliges the government to repay all the funds it receives from the Central Bank by the end of the same fiscal year.

9. The development of the bond market would help the CBI collateralize its funding operations and provide it with the tools to implement open market operations. The authorities started issuing government debt instruments and making them marketable as they clear government arrears. Although limited in size, the amendment to the 2016/17 budget allows for some bond issuance to recapitalize banks. As securitization and recapitalization gains pace, in tandem with the implementation of the financial sector reform, the existence of the bond market would help the CBI to collateralize its funding facilities and engage in open market operations.

10. Despite these positive steps, several additional elements are needed to support the transition to a market-based monetary policy framework.

- **Financial sector reform.** Priority should be given to the restructuring and recapitalization of banks to sustain financial stability and alleviate liquidity pressures. Distressed banks are increasingly reliant on CBI funding which makes it difficult for the CBI to control liquidity growth. In addition, these banks are pushing deposit interest rates up, damaging the balance sheet of healthier banks and disrupting the monetary transmission mechanism.
- **Management of financial system liquidity and lender of last resort functions need to be clearly defined in the law.** Under the current system, banks can borrow from the CBI without collateral. The CBI in a way meets its lender of last resort function but exposes its balance sheet to significant credit risk at the same time. A well-defined regime for emergency liquidity assistance needs to be incorporated in the law.
- **The CBI needs greater operational independence in conducting its monetary policy.** The draft Central Bank bill falls short in ensuring operational and financial independence for the CBI. Decision making bodies in the CBI should consist of qualified independent experts and not contain government representatives. A better ring fencing of CBI's resources is needed. The CBI needs to hold a capital buffer against variation in its net income that arises, for example, from revaluations and against credit losses. Payouts should be avoided from unrealized valuation gains. A capital buffer would also create space for the CBI to address valuation fluctuations arising from two-way exchange rate movements.

- The CBI, then could set a policy rate consistent with its inflation target and start funding healthy banks at its policy rate against collateral.** In the interim, the CBI can target an inflation band around the current level of annual inflation (9 percent) and aim for a gradual reduction in the following years. The new policy rate can be a daily or weekly repo rate. The banks would be able to borrow at the policy rate on a collateralized basis. The CBI has to manage daily liquidity so that the money market rate, i.e., the interbank rate, does not deviate significantly from the policy rate. The CBI's overnight borrowing rate will set the floor of the interest rate corridor and the overdraft rate will set the ceiling rate (Figure 3).



- Fiscal policy has to support the framework.** Iran has a long history of fiscal dominance. A prudent fiscal stance, focusing on reducing the non-oil fiscal deficit will help ensure the spending of government's oil revenue does not fuel aggregate demand excessively. However, it will also be important for the government to stop using the banking system to implement quasi fiscal policies—such as subsidized funding from the CBI to finance government-mandated credit programs, which affects monetary growth. In addition, the government should bear the cost of the subsidized lending to preferred sectors, such as housing, SMEs, or industry, through allocations in the budget to prevent dilution of the interest rate transmission mechanism.

B. Using a Financial Conditions Index to Assess Economic Conditions

11. Analyzing information about financial conditions will be essential if the CBI is to better assess the state of the economy to inform monetary policy decisions. A well-designed financial conditions index (FCI) could serve as a guide to the effective stance of policy, after taking into account all the other factors that affect financial variables.

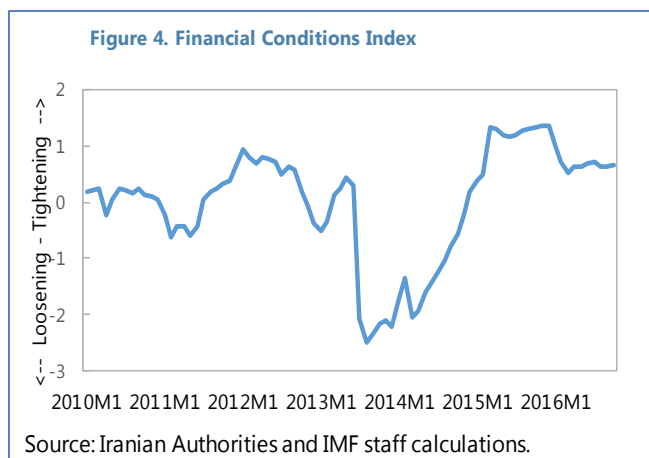
12. There are several challenges to building an FCI for Iran. The lack of timely data reduces the variables that could be included. In addition, absence of a clear policy rate or market rate that is effective in setting loan and deposit rates complicates the task. Absence of data on inflation expectations makes it difficult to determine inflation-adjusted real returns. There is no liquid government bond market or yield curve. Therefore, changes in the yield curve or the term spread cannot be used as an indicator in the FCI.

13. Therefore, our FCI for Iran includes:

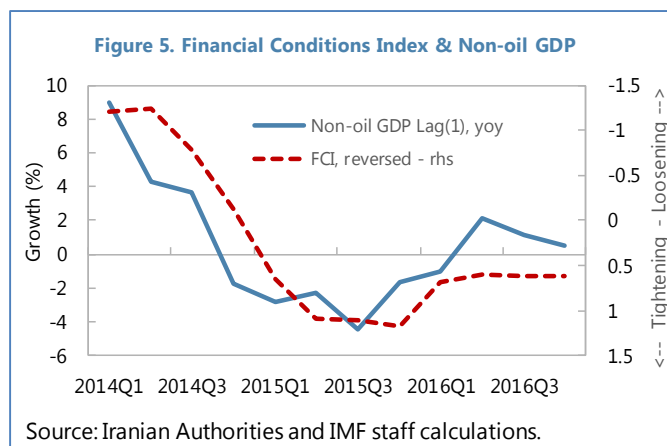
- Money growth**, M2 (y/y), as a measure of liquidity.
- Stock market** (y/y) as equity prices impact household wealth.

- **Real lending rate for banks set by the CBI.** As the CBI does not have a policy rate, we used the CBI's rate of return on facilities weighted by the loans allocated to the relevant sectors, adjusted for inflation. We used latest annual inflation rate for calculating the real rate.
- **Real effective exchange rate.** Appreciation in the real effective exchange rate represents a tightening in the FCI whereas a depreciation represents a loosening in the index.

14. We weight each variable by giving the variable with the highest volatility the lowest weight. Because of its volatility, the equity market has the lowest weight in our FCI. Liquidity growth has the highest weight, followed by the Real Effective Exchange Rate (REER) and the real lending rate. We standardized the series by subtracting the FCI's mean and dividing by its standard deviation. Accordingly, an FCI value above zero implies a tightening and below zero implies a loosening in the financial conditions (Figure 4). As a gauge of activity, we have used the quarterly averages of FCI and employed it as an early indicator of non-oil GDP growth.



15. The model shows that loosening (tightening) in FCI is followed by an increase (decrease) in non-oil activity with one quarter lag (Figure 5). The tightening in the FCI (reversed in Figure 5), which started in 2013, has been partially reversed since early 2015. The tightening in the FCI was broad-based as almost all the variables moved in the same direction during that period. Despite remaining tight, the FCI changed course in 2015 and loosened during the first half of 2016. The increase in liquidity, driven by looser fiscal and monetary policies, and the rise in stock market following the Joint Comprehensive Plan of Action (JCPOA) agreement, both have been contributing to the easing in the FCI. The relative easing in the FCI was followed by a rise in non-oil activity starting from the third quarter of 2015. The current level of the FCI suggests that financial and monetary conditions remain tight despite some loosening in 2016 and it does not suggest a further increase in the pace of economic activity.



C. Long-Run Determinants of Inflation

16. A better understanding of long-term determinants of inflation in Iran will be central to the monetary policy decisions of the CBI. Models of inflation that envision inflation as a cost-push phenomenon in the context of a long-term constant mark-up over costs, have been frequently employed in emerging market economies to investigate inflation drivers. To investigate the long-run properties of the mark-up model, we employ an Autoregressive Distributed Lag (ARDL) (Peseran and Shin, 1997) for the period spanning January 2012 through June 2016

17. Table 1, reports the estimated long-run model. AP, ER, FAO and IP stand for the seasonally adjusted regulated prices, bureau market exchange rate, FAO Food Price Index and Iran's seasonally adjusted industrial production, respectively. All variables are expressed in logs. The regulated price index is obtained from the CBI, global food prices from the Food and Agriculture Organization of the United Nations and industrial production from the World Bank.

Table 1. Long-Run Coefficient Estimates of the Inflation Model			
Variable	Coefficient	t-Statistic	Prob.
AP	0.6531	9.47	0.00
ER	0.4449	13.56	0.00
FAO	0.3383	3.67	0.00
IP	-0.1039	-2.05	0.05
Constant	-4.1351	-5.73	0.00
Note: ARDL (2,2,0,1) model selected by Schwarz Bayesian criterion. The t-ratios calculated by using the symphotic standard errors of long-run coefficients.			

18. Our results show that regulated prices, the exchange rate and global food prices are important determinants of inflation in the long-run, while inflation is negatively correlated with production. The model suggests that a 1 percent rise in the regulated prices, increases inflation by 0.65 percent in the long-run. The authorities often use administrative price adjustments to close the financing gap of state-owned enterprises, and recently to eliminate gasoline subsidies, which in turn has a sizable impact on the inflation rate through first and second round effects. As expected, exchange rate pass through is strong in Iran. An exchange rate depreciation of 1 percent increases inflation by 0.4 percent. The pass-through of a depreciation into domestic prices is possibly larger than the share of imported goods in the consumption basket would indicate. This is because an increase in the price of imports in the face of a depreciation would also affect inflation expectations. Iran is a major importer of foodstuffs and changes in global food prices is an important driver of inflation in Iran. An increase of 1 percent in global food prices would increase inflation by 0.34 percent. As expected, an increase in production leads to a decline in the inflation rate. An increase of 1 percent in industrial production would reduce inflation by 0.1 percent.

19. The findings shows the importance of setting prudent macroeconomic policies to avoid sizable fluctuations in the exchange rate and hence inflation. Fiscal and structural reforms are needed to prevent fiscal dominance and put state owned enterprise SOE finances on a sounder footing and reduce need for regulated price increases. Finally, our analysis also shows that the rise in production in Iran is helping lower inflation by addressing supply constraints. This suggests that structural reforms and infrastructural improvements to increase the country's productive capacity can also play a role in the long-run in safeguarding low inflation.

References

- Angelopoulou, E., Balfoussia, H., and Gibson, H, 2013, "Building a Financial Conditions Index for the Euro Area and Selected Euro Area Countries: What Does It Tell Us About the Crisis?" European Central Bank Working Paper No. 154, (Frankfurt: European Central Bank). Available via the Internet: <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1541.pdf?9f20d9e7140c6c9919c81ae7d9ba2152>
- Blotevogel, B. and Liu, Y., 2014, "Monetary Policy and the Inflation-Output Tradeoff in Iran," IMF Selected Issues (Washington: International Monetary Fund). Available via the Internet: <http://www.imf.org/external/pubs/ft/scr/2014/cr1494.pdf>
- Carlos, E. and Domac I., 1998, "The Main Determinants of Inflation in Albania", World Bank Policy Research Paper No. 1930 (Washington: World Bank).
- English, W., Tsatsaronis, K., and Zoli, E., 2005, "Assessing the Predictive Power of Measures of Financial Conditions for Macroeconomic Variables," BIS Papers No. 22. Available via the Internet: <http://www.bis.org/publ/bppdf/bispap22n.pdf>
- Erdem, M. and Tsatsaronis, K., 2013, "Financial Conditions and Economic Activity: A Statistical Approach," Bank for International Settlements, BIS Quarterly Review March 2013, (Basel: Bank for International Settlements). Available via the Internet: http://www.bis.org/publ/qtrpdf/r_qt1303f.pdf
- Gauthier, C., Graham, C., and Liu, Y., 2004, "Financial Condition Indexes for Canada," Bank of Canada Working Paper No.22, (Ottawa: Bank of Canada). Available via the Internet: <http://www.bankofcanada.ca/wp-content/uploads/2010/02/wp04-22.pdf>
- Hatzius, J., and others, 2010, "Financial Condition Indexes: A Fresh Look after the Financial Crisis," NBER Working Paper No.16150, National Bureau of Economic Research, (Massachusetts: National Bureau of Economic Research). Available via the Internet: <http://www.nber.org/papers/w16150.pdf>
- Pesaran, M.H. and Shin Y., 1997, "An Autoregressive Distributed Lag Modelling Approach to Cointegration Analysis," (Cambridge: University of Cambridge)
- Pesaran, M.H., Shin, Y. and Smith, R.J., 1996, "Testing for the Existence of a Long Run relationship," Department of Applied Economic Working Paper No. 9622, (Cambridge: University of Cambridge.)

A ROADMAP FOR STRUCTURAL FISCAL REFORMS IN IRAN¹

- Iran faces the difficult challenge of reducing its non-oil deficit to support low inflation and to entrench fiscal sustainability, even though spending pressures are mounting, with government debt securitization, translating into higher interest payments, banks' restructuring leading to potentially large fiscal costs, and supporting the authorities' growth objective, requiring higher infrastructure investment.
- Developing a medium-term fiscal framework (MTFF) would provide the authorities with an adequate tool to formulate such a strategy. Within a MTFF, the authorities could establish fiscal rules, tax policies and expenditure policies that would meet all of their fiscal objectives.

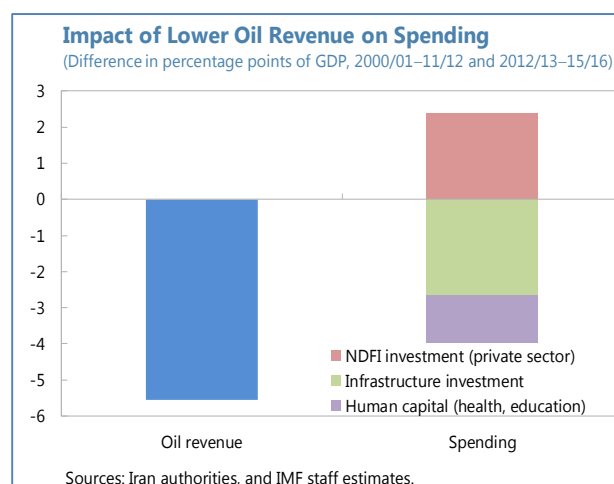
A. Iran Faces Spending Pressures

1. Iran has sustained a relatively low overall fiscal deficit in challenging circumstances.

Over the past 5 years, the overall fiscal deficit of the central government was kept below 2 percent of GDP despite the drop in oil revenues arising from the impact of the oil embargo and then the decline in world oil prices since-2014. This reflected the government's policy that aimed to contain the deficit in line with available financing and its longer-term strategy to gradually reduce its dependency on oil revenue. For example, VAT was introduced in 2008, and the rate was gradually increased, to reach 9 percent in 2015/16. In parallel, tax administration was strengthened leading to increasing numbers of registered taxpayers and continued improvements in tax collection. In 2015/16 tax receipts exceeded oil revenues for the first time.

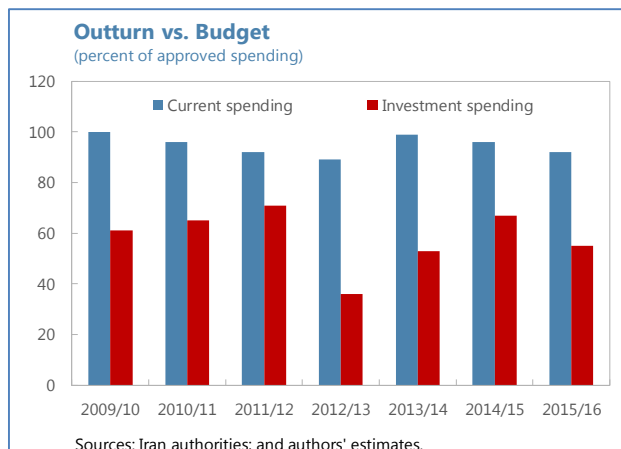
2. Nonetheless, the shock to oil revenues in recent years has exposed a number of underlying vulnerabilities in Iran's fiscal system:

- *Pro-cyclical fiscal policies:* Notwithstanding the improvements made in recent years, the budget continues to rely on oil receipts for about 40 percent of its total revenue. In the wake of the sharp decline in oil receipts and facing limited access to financing, the government cut pro-growth spending to contain the overall level of the deficit. These cuts were pro-cyclical as they occurred when economic growth was already being adversely impacted by the oil revenue shock. The cuts in infrastructure, health and education spending during the period 2012/13–2015/16 were sizeable and

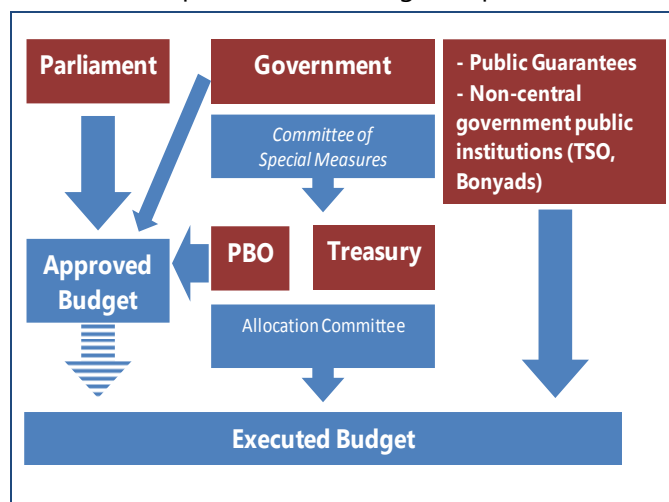


¹ By Olivier Basdevant (IMF) and Tohid Atashbar (Iran Parliament Research Center).

amounted to 4 percentage points of GDP. Owing to rigidities in current spending, in large part due to laws superseding the budget (e.g., the law on public wages mandates inflation indexation), investment spending bore the brunt of the cuts. Over the past decade, the execution rate for the investment budget was just 60 percent. The cuts in spending occurred because the budget lacked buffers that it could draw upon to safeguard spending because the Oil Stabilization Fund (OSF), was discontinued in 2011/12.² As a result when revenue collections fell short of the targets set in the annual budget that is approved by parliament, the Committee of Special Measures determined the allocation and relocation of resources at a strategic level, while the Planning and Budget Organization (PBO) and the Ministry of Finance (Treasury) Allocation Committee then had to bring spending in-line with actual revenue and financing.



- Weaknesses in spending control and extensive off-budget fiscal activities:* In 2015/16, an audit of government arrears revealed a total debt stock of about 42 percent of GDP, against previous estimates of about 17 percent. The additional liabilities reflected unpaid bills of the central government as well as arrears on commitments accumulated outside the central government that were not captured in the fiscal accounts. Estimates suggest that while the central government represents about 17 percent of GDP, the broader public sector represents about 70 percent of GDP (Nasiri and Fatehizadeh, 2011). Noncentral government agencies can commit government funds (e.g., through public guarantees) and shift the cost of these commitments to the central government who then fund these obligations. Moreover, there is no system to record these commitments or monitor arrears as the annual budget and fiscal accounts are prepared on a cash basis. This also dilutes parliamentary oversight of fiscal activity and the budget.



² The OSF was replaced by the National Development Fund of Iran (NDFI), which on-lends oil proceeds to the private sector for investment and it is legally prohibited from financing the budget.

3. Iran enters 2017 facing sizeable new spending pressures that will further test the annual budgeting process.

- Interest payments will rise from less than 1 percent of GDP in 2016/17 to about 3 percent over the medium-term. The main reason is that recognition of the government's payment arrears has required the authorities to start securitizing this debt with interest-bearing instruments. As the securitization process continues budgeted interest payments will rise.
- Banks restructuring and recapitalization will put additional pressure on the interest bill and debt burden. With the majority of banks being publicly-owned, these costs will largely fall to the government. At present the magnitude of the fiscal impact is unknown, but cross-country experiences suggest that it could represent a significant share in GDP.
- Restoring public investment to its pre-sanctions level of about 6 percent of GDP will be necessary to support the authorities' growth objectives. Higher quality public investment is also required if Iran is to increase its domestic productive capacity and improve its competitiveness. Sadeghi (2017) shows that the growth impact of higher public investment spending is amplified and longer lasting when accompanied by measures to improve the efficiency of public investment management processes in the areas of project selection and implementation.
- Health and age-related spending is also set to rise. The commitment to move to a universal health care system (Rouhani Care) could cost about 2 percent of GDP, unless accommodated by a reallocation of existing health spending. Similarly, while not immediate, age-related costs (health, pension) could also amount to about 2 percent of GDP annually over the long term.

B. Envisioning a Medium Term Fiscal Framework (MTFF)

4. **A MTFF would provide policy makers a comprehensive framework to assess how fiscal policy can balance the need to ensure the sustainable use of oil resources while addressing new spending pressures and supporting the economic recovery.** Casting the budget in a MTFF and shifting away from an annual budgeting process would provide the government a more comprehensive tool to assess what the appropriate level of the fiscal deficit is taking into consideration macroeconomic conditions, the level of debt and its sustainability to shocks, and what would be a sustainable use of its oil proceeds. It can inform decisions about the fiscal space available for discretionary fiscal stimulus or in cases where adjustment is needed, the space available for a more gradual adjustment. The framework can also be used to help evaluate the cost, growth and distributional impacts of different policy measures.

5. Table 1 summarizes the medium-term fiscal framework prepared by staff for the 2016 Article IV Consultation. In conducting this analysis of fiscal space we found that Iran has some space to implement a gradual adjustment. This would have the advantage of providing time to implement thorough reforms, which, to be sustainable, will require time to secure broad support and ensure that there is adequate administrative capacity to implement them. In preparing the MTF, we used the following steps to assess the space and pace of adjustment that would preserve sustainability while balancing the need to support the economic recovery and underpin the credibility of the macroeconomic policy framework:

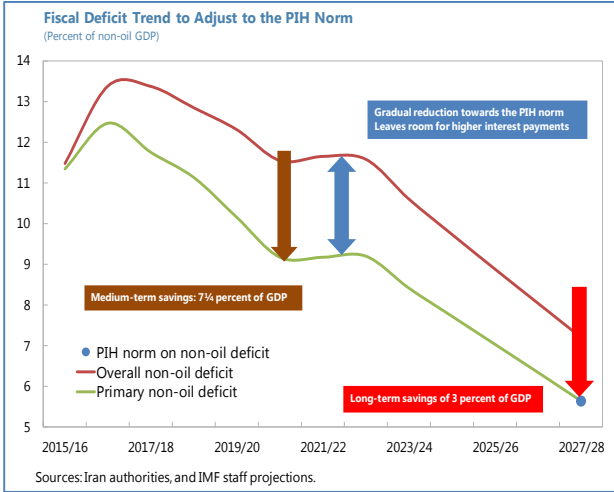
Table 1. Medium-Term Fiscal Framework, 2014/15-2021/22								
	2014/15	2015/16	Projections					
			2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
			(percent of non-oil GDP)					
PIH norm on the non-oil fiscal balance	-5.6	-5.6	-5.6	-5.6	-5.6	-5.6	-5.6	-5.6
Non-oil balance as a result of spending pressures	-11.0	-11.5	-13.4	-14.8	-16.2	-17.4	-18.1	-18.8
Key contributors	6.2	12.3	13.2	14.0	14.7	15.4	15.7	16.1
Interest payment	0.1	0.1	0.9	1.6	1.7	2.1	2.4	2.5
Investment spending (including NDFI)	6.1	5.5	5.6	5.7	6.3	6.6	6.7	6.9
Staff assessment on non-oil balance to support disinflation and a gradual adjustment to the PIH norm	-11.0	-11.5	-13.4	-13.4	-12.8	-12.3	-11.5	-11.6
Options to create fiscal space 1/	...	...	...	1.5	1.9	1.7	1.5	0.6
Tax revenue	...	...	...	-0.2	0.9	0.9	0.9	0.3
Primary current spending	...	...	...	1.0	0.5	0.4	0.3	0.1
Subsidies reform	...	...	...	0.7	0.6	0.5	0.4	0.3
Other measures	...	...	...	-0.1	-0.1	-0.1	-0.1	-0.1
Cumulated impact	...	...	...	1.5	3.3	5.1	6.6	7.2

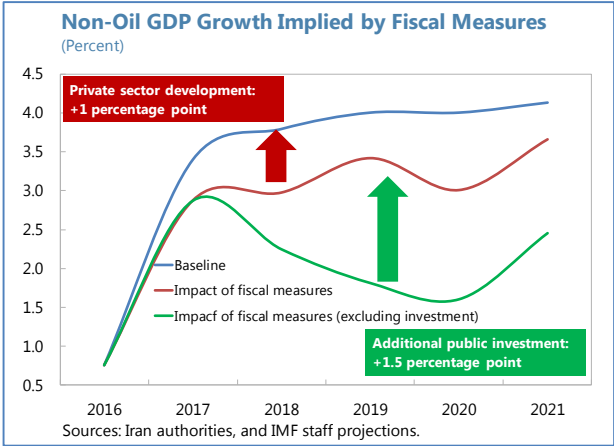
Source: Iran authorities, and IMF staff projections.

1/ Staff estimates of permanent measures to be taken every year.

- Determining the gap between the level of the fiscal deficit consistent with sustainable use of oil revenues relative to that implied by current policies. The permanent income hypothesis (PIH) determines the level of government expenditure that is consistent with financial income from the wealth generated by oil revenue and existing non-oil revenue. It ensures that the overall level of the fiscal deficit, excluding oil revenues (i.e., non-oil deficit) can be sustained without a sharp increase in debt or cut in spending when oil proceeds are exhausted. The permanent income hypothesis norm for Iran suggests that the sustainable non-oil deficit is 5.6 percent of non-oil GDP (PIH, see IMF, 2012 and 2015). Given the spending pressures outlined above, the non-oil deficit is set to rise from the current level of 11.5 percent of non-oil GDP to almost 20 percent over the medium-term.

- Determining the space for a more gradual pace of adjustment to long-term sustainable levels. Iran has some space to implement a gradual adjustment towards the PIH norm which would help minimize the impact of fiscal adjustment on the non-oil economy when growth remains weak due to the legacy of sanctions and structural bottlenecks. Iran has proven oil and gas resources of 100 years and it currently allocates between 2-3 percent of GDP of its annual flow of oil revenues to the NDFI. Its overall level of gross debt is just over 40 percent of GDP and it has financial assets of about 15 percent of GDP. The public debt sustainability analysis (Appendix II of the Staff Report) shows that gross public debt remains low and sustainable under a wide range of shocks if the overall non-oil deficit is kept in the 12 percent of non-oil GDP range over the next 5 years. This level of deficit would also be compatible with the financing available from the nascent domestic government debt market and would underpin the credibility of the new monetary policy framework.


- Identifying and evaluating fiscal adjustment measures. To bring the non-oil deficit to the level of about 12 percent of GDP, measures of about 7¼ percent of GDP needed to be identified over the next five years. Staff analysis of the impact of tax and spending measures on growth suggests that measures that focus on increased tax collections, would minimize the adverse impact on growth. Moreover, analysis by Atashbar (2016), and Arabmaza and Zayer (2008), of 20 years of tax collection in Iran, suggests that almost half of the country's total tax capacity is untapped. In addition, the impact of new fiscal measures on growth could be modified if space is found to fund an increase in public investment spending to about 6 percent of GDP.


- Finally, the distributional impact of proposed fiscal measures should also be assessed. Iran already has experience in crafting policies to address the distributional aspects of reforms. The fuel subsidy reform implemented in 2010 saw the revenue gains from the increases in fuel prices redistributed to citizens in the form of a universal cash transfer. This helped reduce the Gini coefficient by about 2¾ points. Analysis by Berg, Ostry and Zettlemeyer (2008) suggests distributional improvements of this kind have the potential to boost growth over a period of about 6–7 years. Continuing the subsidy reform, notably by targeting transfers more specifically at the poor could greatly help alleviate the cost of reforms by financing effective social safety nets, and also support the authorities' growth objective through its redistribution impact.

C. Implementing a MTFF in Iran

6. Casting the government's budget in a MTFF and shifting away from an annual budgeting process would require several supporting reforms. A MTFF typically contains a statement of fiscal policy objectives and a set of integrated medium-term macroeconomic and fiscal targets and projections. The approach is “top-down” where the PBO would set the overall fiscal space for government spending. Key elements that should be included in the MTFF are:

- A statement of fiscal policy objectives and how they are articulated. This step would be essential to formulate a consistent fiscal strategy, by defining long-term objectives (e.g., supporting low and stable inflation, ensuring fiscal sustainability and securitizing arrears), and making the non-oil primary balance the main fiscal anchor. Iran could use its 5-year National Development Plans (NDP) to set the strategic guidance on fiscal objectives. However, NDPs are, at present, weakly linked to the annual budget, as executed budgets depart significantly from approved budgets and the NDP. Creating stronger links between the NDPs and MTFF would also need to be complemented by steps to strengthen the budget preparation, implementation, monitoring and evaluation processes.
- Projections and targets for medium- and long-term fiscal indicators, including the non-oil and overall fiscal deficits, PIH, and public debt levels. For the MTFF to be a meaningful guide for fiscal policy, it will be necessary to expand the coverage of the fiscal accounts to the general government.
- Overall spending envelopes. These would be used to define binding expenditure ceilings for line ministries and agencies falling under the MTFF. Over time, depending on administrative capacity and broad political support for the MTF objectives, a more bottom-up approach could be considered within a Medium-Term Expenditure Framework (MTEF).
- Closer coordination between key players in budget preparation and implementation, namely the Planning and Budget Office, the new Debt Management Office and Treasury. The new treasury single account and phased introduction of accrual accounting will assist the transition to an MTFF.
- A statement of fiscal risk. Fiscal risk should be assessed and mitigating measures disclosed, notably guarantees and quasi-fiscal operations. This would strengthen the credibility of fiscal policy, enhance its resilience and help to build a consensus on the measures needed. Currently, fiscal risks are not assessed in the annual budget process. Table 2 provides an overview of the potential fiscal risks facing Iran, which if they materialize, can increase spending pressures further. The most probable and sizeable risk is the prospective restructuring and recapitalization of the banking sector discussed above, where at present only a small budgetary allocation has been made (See Staff report).

Table 2. Fiscal Risks

	Impact	Incidence 1/	Identify/Monitor	Mitigation/Provision
Oil price shock	Annual cost of about 2 percent of GDP on average	Continuous	– Assess vulnerability of spending to oil revenue shocks	– Reduce oil dependency by increasing the share of domestic revenue in total fiscal revenue – Reinstate fiscal buffers (e.g., through the Oil Stabilization Fund) – Create spending contingencies in the budget
Addressing balance sheets	– One-off cost, could be high, but not assessed yet – Medium-term risks depend on banking reform	– Immediate – Probable	– Assess recapitalization need, including under stress tests – Strengthen banking supervision	– Saving measures to generate fiscal space to absorb restructuring cost (issuance of government bonds, use of NDFI financial assets) – Reduce government participation in commercial banks – Develop a banking resolution mechanism – Maintain buffers (deposit insurance funds, fiscal buffers)
Financial sector vulnerabilities				
Corporate restructuring	To be assessed	Possible	– Assess potential fiscal costs	– Reduce direct public participation in the corporate sector – Foster private (including foreign) participation and financing.
Public guarantees and contingent exposures				
Loans granted by the NDFI	To be assessed	Continuous	– Quantify implicit guarantees – Quantify opportunity cost of spending through the NDFI vs. the budget	– Strengthen oversight of the budget – Incorporate NDFI operations in budget documents
Transfer of public investment projects to the private sector, and PPP	To be assessed	Possible	– Maintain a central registry of guarantees – Quantify contingent exposures	– Strengthen oversight of the budget
Other non-central government agencies	To be assessed	Continuous	– Maintain a central registry of guarantees – Quantify contingent exposures	– Strengthen oversight of the budget – Reduce options for non-central government agencies to borrow
Health and Aging-related costs	Annual cost of 2–4 percent of GDP	Possible	– Prepare long-term forecast of fiscal implications of aging population – Assess pension funds financial situation	– Pension reform – Identify saving measures to accommodate spending pressures on health and pensions
Natural disasters and environmental risks	To be assessed	Possible	– Early warning systems – Assess impact of climate change on Iran	– Disaster contingency – Improve resilience to global warming through public investment

Source: IMF staff.

1/ Continuous = regular events that cause outturns to differ from forecasts; Probable = likely to materialize in the near term; Possible = likely to occur, but unlikely in the near-term; Remote = potentially significant but difficult to predict over a given timeframe.

7. Greater fiscal transparency and oversight will also be critical to support the MTFF and fiscal consolidation.

- Fiscal consolidations, especially those requiring fiscal structural reforms (e.g., tax reforms, strengthening the budget process), require strong consensus and support from all economic agents (Mauro, 2011). A new MTFF accompanied by a robust communication campaign could educate the public about the scale of fiscal challenges and explain tradeoffs involved in selecting measures.
- Strengthening budget oversight would also help the authorities implement their fiscal strategy. In this perspective Iran could consider developing a formal fiscal council, possibly building from the existing institutions, i.e. the Supreme Audit Court (SAC) and the Parliament Research Center (PRC). In line with best practices (IMF, 2013, and Debrun and Kinda, 2014) a formal independent monitoring of a government's fiscal policies, plans, and performance could help improve the

budget process, in particular by fostering a formal public debate where the authorities would need to discuss reasons/options to address vulnerabilities identified by the watchdogs. There is suggestive evidence that, all else being equal, fiscal councils contribute to fiscal discipline (IMF, 2013).

8. Finally, the MTFF could be accompanied by a revised fiscal rule to guide the allocation of oil revenues. The Fifth 5-year National Development Plan had introduced a fiscal rule on the repartition of oil revenue between the National Iranian oil company (NIOC), 14.5 percent, the budget (65.5 percent), and the National Development Fund of Iran (NDFI, 20 percent increasing by 3 percentage points each year to reach a share of 38 percent). However, this rule did not provide the budget a buffer to address shocks, and, as a result, the rule was amended in each of the past three budgets. The annual budget laws for 2015/16–2017/18 approved an ad-hoc adjustment of the NDFI share to increase the share of the oil revenue allocated to the budget. A revised rule that carves out a specific allocation for a stabilization buffer could protect budgeted spending against oil or other revenue shocks. This could be done, for example, by reinstating the OSF and/or allowing the use of NDFI financial assets to support the budget or bank recapitalization needs. Determining the share that would be allocated to the OSF would require an analysis of the level of buffers needed to address typical shocks. Since the past experience of Iran’s fiscal rule has been mixed, the authorities could consider adding to the rule a formal escape clause, in line with best practices.

References

- Atashbar, T., 2016, "Analyzing Iran Tax Revenue Potential," unpublished working paper.
- Berg, A., and J. Ostry, 2008, "Inequality and Unsustainable Growth: Two Sides of the Same Coin?" IMF Staff Discussion Note No. SDN/08/11 (Washington: International Monetary Fund). Available via the Internet: <https://www.imf.org/external/pubs/ft/sdn/2011/sdn1108.pdf>
- Debrun, X., and T. Kinda, 2014, "Strengthening Post-Crisis Fiscal Credibility—Fiscal Councils on the Rise. A New Dataset," Working Paper 14/58 (Washington: International Monetary Fund).
- IMF, 2012, "Managing Global Growth Risks and Commodity Price Shocks. Vulnerabilities and Policy Challenges for Low-Income Countries" (Washington: International Monetary Fund). Available via the Internet: <http://www.imf.org/external/np/pp/eng/2011/092111.pdf>
- _____, 2013, "Jobs and Growth: Analytical and Operational considerations for the Fund" (Washington: International Monetary Fund). Available via the Internet: <http://www.imf.org/external/np/pp/eng/2013/031413.pdf>
- _____, 2015, Fiscal Monitor, October (Washington: International Monetary Fund). Available via the Internet: <http://www.imf.org/external/pubs/ft/fm/2015/02/pdf/fm1502.pdf>
- Mauro, P. 2011. *Chipping Away at the Public Debt—Sources of Failure and Keys to Success in Fiscal Adjustment* Hoboken, N.J.: John Wiley and Sons.
- Nasiri, A., and M., Fatehizadeh, 2011, "Does Privatization in Iran Increase the Size of the Private Sector?" *Journal of Economic Essays*, Vol. 8, 16: pp. 9–48.
- Sadeghi, A., 2017, "How Public Investment Could Help Strengthen Iran Growth Potential: Issues and Options," Unpublished working paper.

INTERNATIONAL TAXATION IN IRAN¹

- Iran needs to ready its tax system to deal with cross-border flows and safeguard against the potential erosion of its tax base.
- Replacing open-ended tax incentives with accelerated depreciation allowances; introducing a thin capitalization and a 'limitation-of-benefits' provision in its tax treaties would help protect Iran's tax base.
- Defining income "derived from Iranian sources" and introducing a "permanent establishment" concept in the Direct Tax Act would strengthen Iran's tax treaties.
- Domestic withholding taxes on cross-border flows are low and could be raised and provision made for a withholding tax on service fee income.

A. Introduction

1. Cross-border economic activity, including flows of foreign direct investment, are expected to increase as Iran re-integrates into the global economy. It is therefore important for Iran to consider early how to best modernize its regime for international taxation and put in place provisions that can safeguard its domestic tax base against potential erosion. Such erosion could occur, for example, if business profits can escape Iran's tax system by being redirected to low(er) tax jurisdictions via the use of inflated payments for services procured outside Iran, e.g. financial services and license activities. As set out in the 2016 Article IV Staff Report, Iran derives a little over one-third of its tax collections from corporate income taxes (CIT) and as such would benefit from rules that limit the potential for such base eroding payments. Its tax treaties should also include rules to avoid abusive international tax planning arrangements. Examining the issue of international taxation now is even more opportune because there is increased global focus on issues of cross-border tax base erosion and profit shifting under the G20/OECD BEPS project.

B. Maintaining the Integrity of the Tax System

Redesigning Investment Tax Incentives²

2. Tax incentives are favorable tax provisions granted to qualified investment projects or firms. They can take several forms, e.g., an exemption from tax for a certain duration (tax holidays), preferential tax rates by region, sectors or asset types, or targeted allowances (tax deductions or credits). Besides encouraging domestic investment, an important motivation for such tax incentives is to attract foreign direct investment (FDI.) It is important to monitor the number of firms that apply for tax incentives, the impact on revenues, and effectiveness in generating new investment to prevent abuse.

¹ Prepared by Aqib Aslam, Geerten Michielse, and Christopher J. Heady.

² This paper does not cover taxation of oil investments.

3. Iran, under the Iranian Direct Taxes Act (IDTA), has over time offered various tax incentives ranging from tax exemptions, tax holidays and reduced tax rates to attract investment (Box 1). It also offers enhanced incentives for activities in free trade zones, special economic zones, and less-developed areas. Many of these incentives work by enhancing the recipient firm's profitability. These incentives have eroded Iran's tax base. In 2015, the CIT-to-GDP ratio in Iran was 2.5 percent, two-thirds of the comparator economy average.³ As in many countries, investment would have been undertaken in any case and the type of incentives offered by Iran only work to enhance investor's profits and so are redundant.

4. Iran could better attract investment by offering tax incentives linked to firms' actual investment as opposed to its profits. Investment-linked incentives lower the marginal cost of new investments and allow a greater number of investment projects to become profitable at the margin, especially less profitable projects (Box 1). Examples of investment allowances that are linked to investment expenses include accelerated depreciation schemes and investment allowances. Iran could transition to a new scheme of investment-linked incentives for all future tax incentives, but existing investments that have already qualified for current tax incentives should be grandfathered

Preventing Base Erosion: Introducing Thin Capitalization Rules

5. Like most countries, the Iranian tax system allows for interest expenses to be deducted from taxable income. However, a common concern in an international setting is the risk of erosion of the tax base by multinational enterprises (MNEs) via excessive interest deductions. Such "base erosion" can be problematic for emerging economies which are typically more reliant on CIT. Iran derives just over a third of its total tax revenues from CIT.

6. In Iran, investment financed by debt is taxed more lightly than that financed by equity.⁴ This advantage is amplified for MNEs that have the ability to choose the location of their borrowing. This gives them scope to arrange financing so as to locate interest deductions where they will be most valuable. For example, financing can be structured so that interest income is received in a jurisdiction that either does not tax the interest income or applies a low tax rate to it. Failure to tackle excessive interest payments gives MNEs an advantage over domestic businesses.

³ Comparator economies—based on nominal GDP, population, nominal GDP per capita, GDP at purchasing power parity, and GDP at market prices—are Colombia, Egypt, Philippines, Poland, South Africa, Thailand, and Turkey.

⁴ A highly-leveraged company—one with a high debt-to-equity ratio—is "thinly capitalized."

7. Iran's tax base as it opens to FDI. These rules can be designed in two ways: (1) determining a maximum amount of debt on which deductible interest payments are allowed; and (2) determining a maximum amount of interest that may be deducted, by reference to the ratio of interest expense to another variable (e.g., earnings before interest, tax, depreciation and amortization; EBITDA). The latter is increasingly popular⁵ and will be relevant for Iran because applying a uniform ratios or caps across diverse sectors and types of business could be problematic.

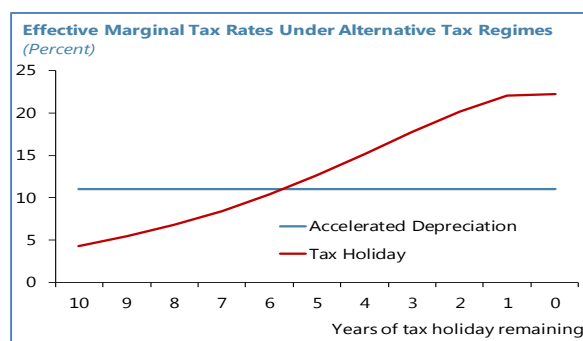
Box 1. Investment Tax Incentives in Iran

Tax incentives are defined in the IDTA and were recently amended in 2015. Prior to these amendments, fractions of taxable income were exempted. As of 2015, incentives operate through zero-rating taxable income.

For example, Article 132 sets out the incentives for producing and mining companies with exploitation licenses. For these enterprises, declared income will be subject to a zero rate for a period of 5 years after extractive activity begins. This period increases to 10 years if the activity occurs in less-developed regions. In addition, for producing or services-oriented enterprises, the period of exemption can also increase if they can raise their number of employees by at least 50 percent (from an initial labor force of 50). The period of reduced rates also increases by 2 (3) years if the enterprise is located in special economic zones (special economic zones in less-developed areas).

Incentives are also subject to geographical restrictions. The zero-rate taxation does not apply to the income of producing and mining entities in a 120km radius of the center of Tehran province, 50km from the center of Isfahan province, and 30km from the administrative centers of provinces and cities with a population greater than 300,000.

Our figure compares the effective marginal tax rate (EMTR) facing an investment under a temporary 10-year tax holiday versus an accelerated system of capital allowances.¹ By reducing the EMTR, the tax holiday makes a large profitable one-off investment very attractive at the start of the holiday. However, as it runs out, the investment becomes less attractive as tax rates increase and this deters additional investment. Over time, the effective tax rate quickly exceeds the rate firms would receive if that had benefited from accelerated depreciation. The latter is particularly beneficial when investments are less profitable and the statutory depreciation allowances provided exceeds the true rate of economic depreciation because firms can write-down investment costs more rapidly than the rate at which the asset depreciates.



¹ The EMTRs are calculated for an investment in plant and machinery financed by retained earnings, and assume: a CIT of 25 percent; inflation of 10 percent, a real interest rate of 10 percent; economic depreciation of 15 percent; taxes on interest, dividends and capital gains of zero. In the accelerated depreciation simulation, capital allowances of 50 percent (declining balance) are assumed. For the tax holiday (10 years), capital allowances of 25 percent (declining balance) are assumed. A profit rate for investments of 40 percent is also assumed in both simulations.

⁵ Recommended by the OECD in BEPS Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments.

Limitation of Treaty Benefits

8. In addition to base erosion, MNEs may use Double Taxation Treaty (DTT) networks of third countries to re-route income flows so as to reduce their worldwide tax burden (“treaty shopping”). Some countries have set themselves up as “conduits.” Such countries typically (1) negotiate DTTs with very low or no withholding taxes in the source country, (2) offer low or zero effective tax rates on specific activities in their domestic tax system, and (3) levy zero withholding taxes on outflows. Using legal persons as intermediaries in such countries allow MNEs to re-route their income to tax havens.

9. DTTs can contain specific provisions against treaty shopping: (1) a principal purpose test (PPT) or (2) a limitation of benefits (LoB) provision. Under a PPT rule, DTT benefits would be denied when it is reasonable to conclude that obtaining such benefits was one of the principal purposes of entering into an arrangement or transaction. LoBs, on the other hand, are provisions that provide a set of conditions to be met before a person can be considered as a ‘genuine’ resident in the other country and becomes eligible to the benefits of the tax treaty (Box 2). Iran’s new tax treaties should implement specific LoB provisions.

Box 2. Eligible Persons Under a LoB Provisions

Typically, the following persons are considered genuine residents and eligible to treaty benefits:

- An individual;
- A person engaged in an active conduct of business in the State of residence;
- A company, the shares of which are traded in the State of residence on a substantial and regular basis on an officially recognized securities exchange or a company which is wholly owned, directly or indirectly, by another company that is resident of the State of residence and the shares of which are so traded;
- A not-for-profit organization that is generally exempt from income taxation in the State of residence, provided that more than half of the beneficiaries, members or participants, if any, in such organization are entitled to the benefits of the treaty; or
- A person that satisfies both of the following conditions:
 - More than 50 percent of the beneficial interest in such person or in a company, more than 50 percent of the number of shares of each class of the company’s shares, is owned directly or indirectly by persons entitled to the benefits of this treaty; and-
 - Not more than 50 percent of the gross income of such person is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to the benefits of this treaty.

C. Domestic Legal Framework

10. The concepts of “residency” and “source” are the main pillars of international tax policy. They allocate taxable income between countries. In the IDTA, residency also determines the scope of the tax liability.

Residency

11. The residency rule for individuals is unclear. The IDTA describes which persons are residents abroad and provides an exception based on (1) having an occupation in Iran, (2) living in Iran for more than 6 consecutive months in a year, or (3) staying abroad for mission, medical treatment etc. This definition relies on physical presence. Other countries also apply criteria, e.g., a permanent home or place where direct family members live, where bank accounts or investments are held, etc.

12. Residency for legal persons/entities is linked to registration under the Iranian Commercial Code, but this could be supplemented by other criteria. Iran would benefit from the possibility to deem legal persons resident based on the “place of effective management.” Factual circumstances, such as the location of annual shareholders’ meetings; where records are kept, or day-to-day management is exercised, or board members reside; can be used to determine this.

13. Iran should move from a citizen- to residence-based tax system. The scope of tax liability in Iran depends on whether the person is Iranian or foreign. Iranian persons resident in Iran are subject to tax on worldwide income, but all other persons are subject to tax on income derived in Iran. Iran could broaden the tax base to foreign nationals resident in Iran and subject them to same tax treatment as Iranian residents.

Income Derived in Iran (“Source”)

14. The law does not include a clear definition of what income is considered “derived in Iran.” For example, employment income is derived in Iran when the employment contract is concluded with an Iranian employer, rather than on whether the employment is in Iran. This establishes a legal linkage, rather than an economic linkage to its territory. Likewise, profit derived in Iran is defined by whether the business is registered in Iran. Typically, countries use a threshold for business activities before they start taxing profits as derived in their country. This threshold is set exclusively by qualitative criteria cumulating in a definition of “*permanent establishment*” (PE).

15. Clear source rules would strengthen the legal framework for international cooperation and should be in-line with the following principles:

- Simple to administer by taxpayers and tax administrators;
- Based on a substantial economic linkage between the income and the geographical area;

- The source country should not object to the rule if it were applied in the residence country (between-country neutrality);
- Introducing a specific source rule suggests the intention by the source country to tax income from that source, otherwise international loopholes are created;
- The definition of the source of income cannot be manipulated by the taxpayer. It can only be defined by the lawmakers.

Permanent Establishment

16. Non-Iranian persons (individuals and legal entities) conducting business activities in Iran are required to register under the Commercial Code. Under the IDTA, these businesses become liable to tax after registration. The law does not contain any threshold for imposing tax on businesses in Iran. This creates an incentive for businesses not to register. Most countries include the recognized international concept of “*permanent establishment*” (PE) in domestic legislation. This enables the tax administration to enforce tax collection, in the absence of formal registration, if there is sufficient evidence of business activity.

17. The domestic PE concept is usually transplanted into domestic legislation from double tax treaties (DTTs) to avoid differences. A PE definition is provided in the model conventions published by the OECD (OECD, 2014) and the UN (UN, 2011). The latter definition is broader, as it captures a services-PE. Creating a threshold for taxing business service activities in this way provides an alternative to a withholding tax (WHT) on services. A services-PE subjects the service provider’s net income to income tax by filing tax returns in Iran, whereas a WHT on services subjects the gross payment to tax if purchased by a business.

Taxing Cross-Border Payments

18. The IDTA provides for withholding tax on cross-border payments.⁶ Dividends and most interest paid abroad is exempt in Iran. Cross-border royalty payments and service fees are subject to very low effective tax rates. By applying the (CIT) rate of 25 percent on a reduced tax base (10–40 percent of total annual receipts), these taxes effectively mimic WHT of 2.5–7.5 percent (Box 3). Normally, WHTs are applied to interest and dividend income and expense payments that are prone to abuse (i.e., earnings stripping).

19. The effective WHT rates range from 0 (dividends) to 7.5 percent (certain service payments) and are low compared to the statutory CIT rate and WHT rates in other countries (Table 1). These rates are possibly too low to deter base erosion using interest payments, royalties, or service fees. Given the 25 percent CIT rate in Iran, the typical WHT rate of 5 percent effectively

⁶ Article 107 and the IDTA By-Law.

allows for 80 percent of these payments to be deducted from the tax base. Raising the WHT rate to 15 percent would reduce this deduction to 40 percent.

20. The multiple and differentiated WHT rates creates an administrative burden for both taxpayers and tax administrators, and causes arbitrage between the various payments. In

addition, the unconditional exemption for cross-border dividends makes Iran vulnerable to international tax planning where Iranian residents transfer their wealth, and subsequently their investment income, into low tax jurisdictions. A unified WHT rate of 15 percent for all kind of cross-border payments, including dividends would help minimize this risk.

Box 3. Domestic Taxes on Cross-Border Payments		
The following payments made to foreign persons are subject to tax in Iran		
	Reduced Tax Base (In Percent of Gross Receipts)	Effective WHT Rate (In Percent)
Dividends	-	0
Interest (intra-group)	20	5
Royalty:		
• Design of buildings (surveying, drawing, supervising, and technical calculations)	20	5
• Licensing and other rights		
• Manufacturing and mineral extraction	20	5
• Government contracts	20	5
• Other	30	7.5
• Cinematographic contracts	20	5
Services:		
• Contract-based activities and technical services		
• Construction (incl. infrastructure)	20	5
• Exploration, development, and upstream activities hydrocarbon	15	3.75
• Supply and equipment inclusive price	10	2.5
• Transportation		
• International rail and road	20	5
• Domestic rail, road, water, and air	18	4.5
• Education, training, and technical assistance	15	3.75
• Exploiting investments on economic activities	20	5
• Medical services	30	7.5
• Other services	30	7.5

Table 1. Corporate Income Tax and Withholding Tax Rates for Selected Economies

Country	CIT Rate	WHT Rates			
		Dividends		Interest	Royalty
		Investment	Participation		
Columbia	25	0	0	33	33
Egypt	22.5	10	5	20	20
Philippines ^{1/}	30	30/25	15	20/25	30/25
Poland	19	19	0	20	20
South Africa	28	15	15	15	15
Thailand	20	10	10	15	15
Turkey	20	15	15	0-18 ^{2/}	20

Source: International Bureau of Fiscal Documentation.

1/ The first percentage refers to recipients that are legal persons, whereas the second percentage refers to individuals;

2/ Turkey applies a number of different WHT rates for various types of interest depending on the status of the lender and/or the denomination of the loan.

D. Tax Treaty Network

21. DTTs eliminate double taxation to protect against tax avoidance. Double taxation arises if both the residence and source country claim tax rights over the same income. DTTs allocate income between the contracting countries, whereby the source country typically gives up (part of) its taxing rights to attract FDI. Iran is the source country with most of its treaty partners and should weigh the cost of lower WHT rates on income generated in Iran against the benefits it receives in return.

Existing Network

22. Iran has negotiated over 60 DTTs in the last two decades and has DTTs with its main trading partners, including the four main countries where its FDI investors reside.^{7 8} It has a special unit within the tax authority dealing with DTT negotiation that has gained extensive experience. Most DTTs follow the OECD Model Convention. Iran has not yet entered into Tax

⁷ China, South Africa, France, and Turkey. Iran is currently negotiating a DTT with the Netherlands.

⁸ Currently Iran has 43 DTTs in force, 9 DTTs are concluded but not yet in force, and 8 DTTs are under negotiation. Some DTTs were negotiated but did ultimately not result in the conclusion of a DTT.

Information Exchange Agreements (TIEAs) that could provide a good alternative to concluding full DTTs with potential partner countries, because TIEAs allow exchange of tax information without forgoing any revenue.

Allowable WHT Rates

23. Iran has reserved its right to levy WHTs on cross-border payments in most of its DTTs, except for cross-border service payments. The allowable WHT rates under DTTs are generally higher than the domestic WHT rates. Most DTTs allow WHT rates on dividends, interest, and royalties up to 10 or 15 percent. Both treaty partners have explicitly agreed that the source country is allowed to levy these WHTs and the resident country commits to credit these taxes against their own taxes.

24. Iran can better exploit the full potential of its DTTs by raising its domestic WHT rates to the allowable rates in its DTTs. This would not deter FDI or raise financing costs because the higher WHT rates would be fully absorbed by the treaty partner who provides a tax credit for taxes paid in Iran by its resident investor. The total tax cost of the cross-border investment does not increase, but tax revenue would be re-allocated between the treaty countries. Box 4 provides an example.

Box 4. Re-Allocation of Tax Cost		
A foreign investor invests 1,000,000 units in Iran, financed by a loan of 600,000 units taken up in the country of residence. The interest rate is 12 percent. Taxable interest income is 72,000 units. The CIT rate in the residence country is 25 percent. The DTT allows a maximum WHT rate of 10 percent.		
Iranian WHT rate on interest payments	3 percent	10 percent
Iranian WHT	2,160	7,200
Foreign CIT	18,000	18,000
Foreign tax credit	<u>2,160</u>	<u>7,200</u>
Foreign tax payable	15,840	10,800
Total Tax Cost	18,000	18,000

References

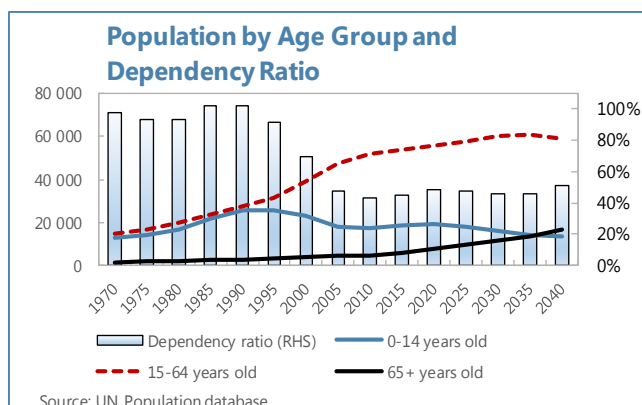
- Organisation of Economic Co-operation and Development, 2014, "Model Convention with Respect to Taxes on Income and Capital.", (Paris: OECD.)
- United Nations, 2011, "Model Double Taxation Convention between Developed and Developing Countries (Update)." United Nations Department of Economic & Social Affairs; (New York: United Nations.)

FOSTERING PRIVATE SECTOR JOB CREATION IN IRAN¹

- Designing appropriate job creation policies is essential if Iran is to harness the potential of its large working age population to boost productivity, growth and incomes.
- Fostering greater private sector job creation requires a comprehensive strategy that improves both demand and supply conditions in the labor market. A stable macroeconomic environment, policies that foster a level playing field among enterprises and reduce the role of the state in the economy, improved access to finance, and a lower regulatory burden would create space for private firms to grow and hire. Supply-side policies that help develop the skills needed in the private sector would make workers more productive and attractive to hire. Policies that facilitate workers mobility would help labor reallocation.
- Designing policies that ensure equal opportunities for women will help bring into the labor market a large portion of the population, in which Iran has invested in the form of higher educational attainment, but which currently remains mostly outside the labor force. In the medium to long term, bringing them into the labor market would foster economic activity, innovation and job creation, and ultimately lead to higher economic growth.

A. The Opportunities and Challenges in the Iranian Labor Market

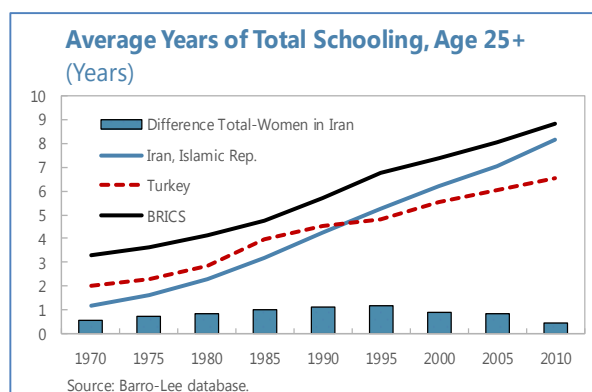
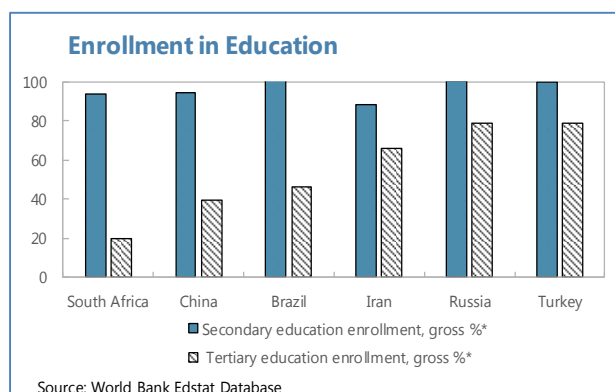
1. Iran has a large, well-educated, working age population. Iran benefits from relatively small age-dependency ratios through 2045, which could help boost productivity and economic growth.² It has a well-educated workforce thanks to improvements in accessibility to education that led to important increases in educational enrollment and years of education over several decades. This has been accompanied by significant reductions in the gender gap in education; women and men are now completing the same number of years of total education.³ By enhancing the allocation of resources in the economy, having a larger, educated labor force, including women, can help increase productivity and incomes. Employers can draw from a more diverse labor force, and entrepreneurship is boosted as more small enterprises are created and expanded (Cuberes and Teignier 2015; Elborgh-Woytek and others 2013).



¹ By Gaëlle Pierre

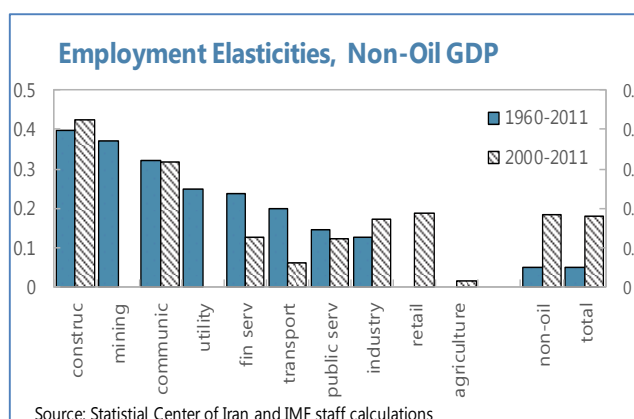
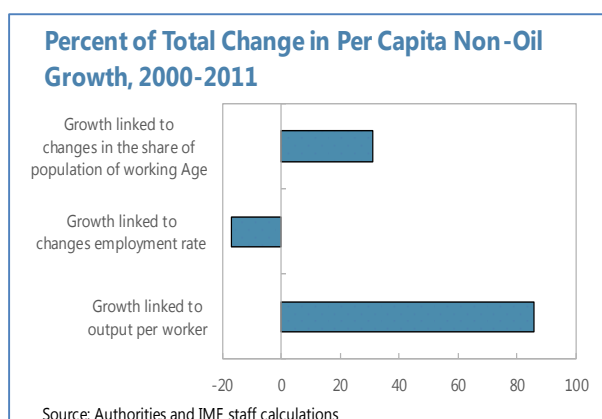
² Assaad and Roudifahi, 2007.

³ Despite some restrictions on certain fields of study, women represent 60 percent of university entrants, and about 70 percent of students in engineering and science, amounting to the largest cohort of female engineering and science students in the world.



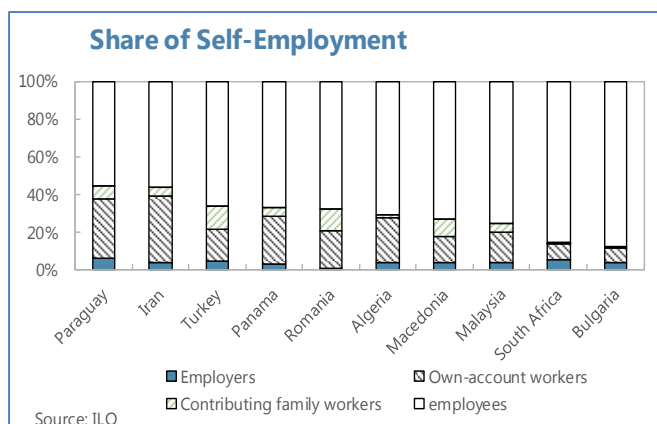
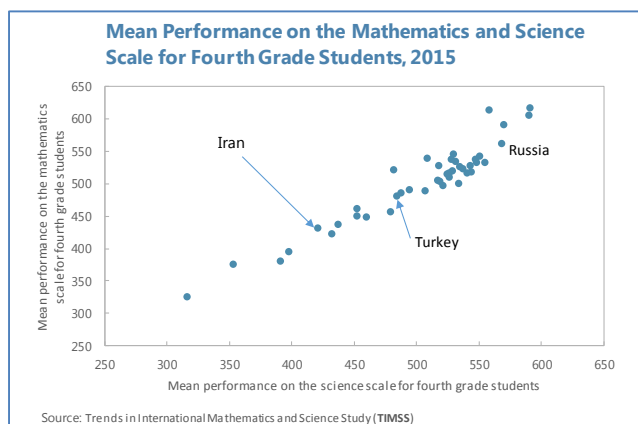
2. However, the formal private sector has not capitalized on this opportunity. Between 2000–11, increases in output per worker, and to a lesser extent the increase in the share of the working age population, drove non-oil growth. Despite average annual growth rate of real non-oil GDP of about 3.6 percent over the period 2005–2015, and the shrinking share of the oil sector in GDP, employment creation was not enough—while the working-age population increased by 15.8 million people between 2000 and 2011, employment increased by 3.3 million jobs. Previous analysis (Blotevogel, 2015) shows that the long-term elasticity of employment to growth, even using non-oil growth, is low by international standards. It also points to low total factor productivity (TFP) in the non-oil sector, especially after 2011. This means there are structural impediments to job creation and to the allocation of resources to their more productive use (Crivelli and others, 2012).

3. Labor market outcomes are weak. Unemployment has hovered around 11 percent over the past 30 years, with women's rates on average 8 percentage points higher than men's. Labor force participation (40 percent) is low by international standards due to very low female participation (17 percent). As could be expected given these high rates, youth unemployment is high at 30 percent, but a third of youth are not employed, in education, nor in training. Moreover, over a third of the unemployed have been out of work for over a year, and around 60 percent of unemployed women over 25 years old are long-term unemployed. There is a wide rural-urban gap. The agricultural sector constitutes about 50 percent of employment in rural areas, while services represent 60 percent of employment in urban areas. Under-employment rates are higher in rural areas than in urban areas, while unemployment rates are higher in the latter.



Yet there is evidence of skills mismatches. While Iran scores better than other countries in Middle East and North Africa (MENA) in international tests for mathematics and science, it is below other middle income countries such as Russia. In a labor market with oversupply of labor, employability becomes crucial, but graduates have high expectations and are not fully prepared for private sector employment. There is evidence that some types of jobs, such as manual work, experience labor shortages as most students prefer academic topics.

4. Private sector firms have little incentives to grow. Compared with other upper-middle income countries, the employment structure is more heavily tilted towards the agricultural, manufacturing, transportation and construction sectors, while to a lesser extent the service sector. Employment in the public sector is at the average at around 20 percent of total employment, but as in most MENA countries, when combined with semi-public sectors such employment dominates the economy. The private sector is relatively small, and private sector employment is disproportionately in self-employment, especially own-account workers (without employees). Informal employment has been rising in recent years, and women are more likely to work in the informal sector.



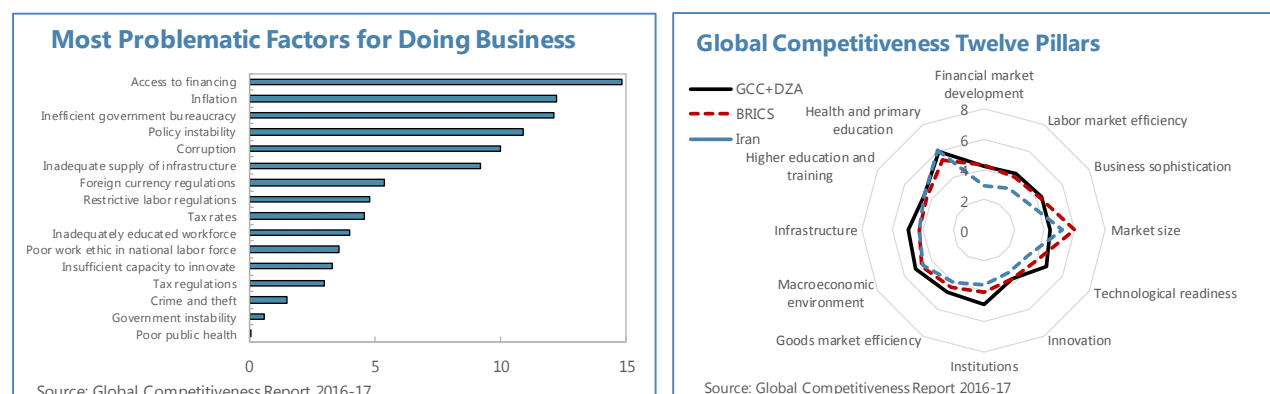
B. Key Elements of a Strategy to Foster Private Sector Employment

5. Fostering private sector employment requires coordinating actions on several fronts. A comprehensive strategy for job creation encompasses macroeconomic policies that provide a stable environment, regulations that are transparent and adequate, supply-side policies that empower the workforce, and policies that protect workers and help them move between jobs. Implementing such a strategy requires coordination among ministries that do not usually interact. In order to obtain the buy-in and to ultimately ensure the success of the strategy, consultations have to be carried out with other stakeholders, especially unions and employer representatives, and Civil Society Organizations (CSOs). Although some policy changes have been made and consultations with stakeholders have been held by some ministries, the implementation has not been systematic and efficient and has so far not translated into significant improvements neither in private sector job creation nor in productivity. The sixth National Development Plan (NDP) lays principles for fostering job creation and should lead to such a strategy.

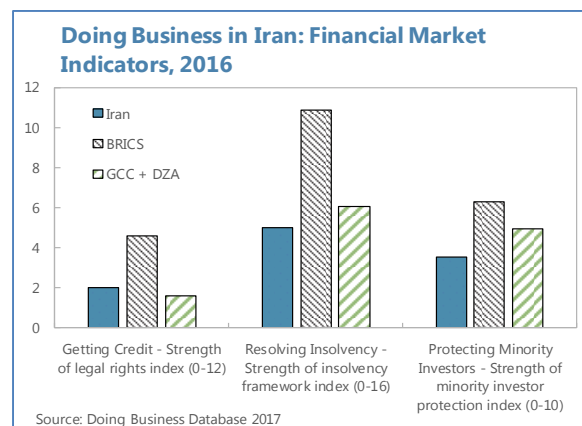
Implementing policies that bolster labor demand in Iran

6. Fostering job creation starts with addressing the lack of private sector labor demand.

International surveys of business leaders and of de jure regulations (Global Competitiveness Report (GCR) 2016-17, and Doing Business (DB) 2017) suggest the following priority reform areas.



- Maintaining macroeconomic stability was deemed among the most important constraints by business leaders interviewed for the GCR and those that the Iran Article IV team met with. While Iran does not appear to have significantly worse macroeconomic issues than comparator countries according to GCR indicators,⁴ inflation, until recently was in double digits, the exchange rate was volatile and sanctions created uncertainty that discouraged investment.
- Improving access to finance is the first priority for business leaders. Three of the four de-jure regulations indicators that are the furthest from the best performance are related to the financial sector—getting credit, protecting minority investors and resolving insolvency. In particular, Iran scores are weak in terms of the strength of legal rights, recovery rate during insolvency procedures and strength of insolvency framework. For example, investors' recovery rate on the dollar is 17.9 cents (versus 32 cents in BRICS and 31 cents in Gulf Cooperation Countries (GCC) and Algeria); it takes 38 years to resolve insolvency against 23 years in BRICS, and 25 years in GCC and Algeria.



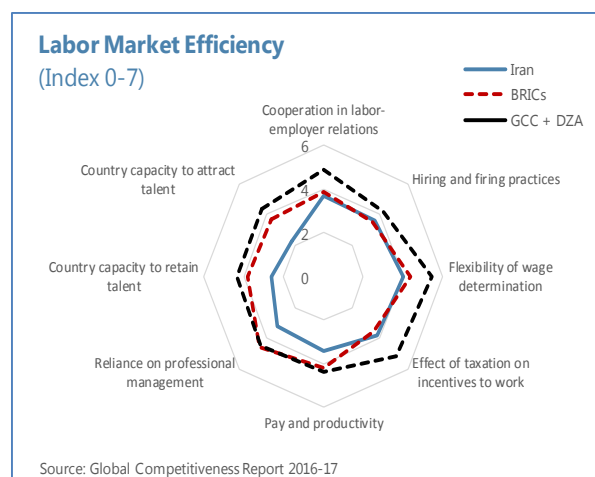
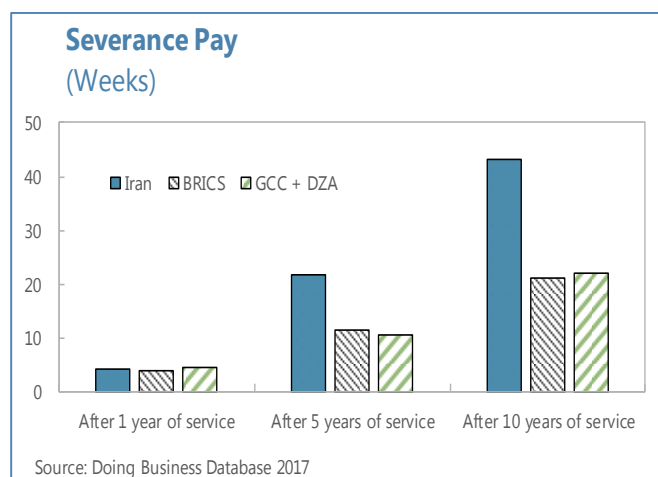
⁴ The GCR identifies twelve pillars: four basic pillars (institutions, infrastructure, macroeconomic environment, and health and primary education); six pillars relevant for efficiency enhancers (higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness and market size); and two pillars for innovation and sophistication (business sophistication, R&D innovation). Given its level of development, Iran is classified as an efficiency-driven economy.

- Inefficient government bureaucracy is the third area identified by business leaders closely followed by policy instability and corruption. This suggests a broad agenda for improving governance. This is consistent with the idea of reducing the role of the government to that of a facilitator of private sector activity rather than a direct actor, and of creating a level playing field that would help new entrants. In particular, the role of the government could include providing infrastructure investment, and removing excessive government-imposed constraints on the economy (e.g., red tape, liberalizing domestic prices). Leveling the playing field involves enhancing regulations as well as enforcement. Such steps include improving the commercial orientation of state-owned and quasi state firms; reviewing regulations to simplify and remove unnecessary exemptions; and increasing transparency of enforcement. The sixth NDP includes steps in this direction—for example, it makes it easier for the public sector to do business with the private sector.⁵

Designing regulations that accompany job creation

7. Reviewing labor regulations can help facilitate job creation and retain talent.⁶

Although labor regulations or an adequately educated labor force are not among the top constraints reported by business leaders, labor market efficiency—the country’s ability to allocate its resources efficiently—is weaker than in comparator countries. In particular, according to the GCR indicators, there is scope for Iran to better nurture and attract talent from within the country and from abroad. Moreover, the relation between pay and workers’ productivity is weaker than in comparator countries. DB indicators show that most Iranian labor market de jure regulations are within international averages, but dismissals are relatively difficult.



⁵ The NDP includes targeted measures, such as allowing public firms in social cultural or service sector to purchase goods and services from private firms, and Departments of Port and Shipping to give contracts to private companies.

⁶ Haltiwanger and others, 2014.

- **Dismissal procedures are restrictive.** Employers must obtain approval by a third-party in order to dismiss any worker—something that is done in only 20 percent of countries. Implementation maybe discretionary and therefore uneven, which, by increasing uncertainty, can create further costs for employers. Removing such an impediment to firing, especially in the case of small-scale dismissals, and ensuring there are transparent ways of dismissing unproductive or redundant workers would encourage the reallocation of labor.
- **The financial cost of dismissals is above world averages.** Severance pay is about twice the world's average for workers with 10-year tenure. In addition to its financial costs, severance pay linked to tenure provides little if any, benefits to workers with short employment spells. In reality because only a fraction of workers are covered by them—often the more educated ones—severance pay can be regressive. Weakening the link between severance pay and tenure, for instance, by imposing a maximum amount a worker can obtain, would reduce the bias that job security imposes against workers with less tenure. Iran could also consider reducing the generosity of payments to bring them more in line with international experience, and rely more on its unemployment benefits, which are the most efficient way to insure against the risk of unemployment (see Holzmann and Vodopivec 2012, on severance pay reforms).
- **Flexibility cannot come solely from temporary contracts.** Temporary contracts are allowed, which is a strength of a well-functioning labor market. But in the context of stringent regulations on permanent contracts relying on fixed-term contracts alone to increase flexibility may lead to increases in precarious employment.⁷ The review of regulations on all types of contracts, which is currently underway, is crucial.

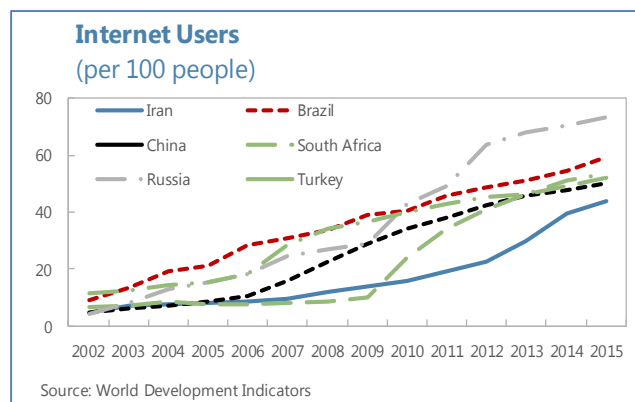
Empowering the labor force with adequate skills

8. Iran is seeking to make formal education more relevant to the private sector. The NDP allows more exchanges between the public and private education sectors. Moreover, the authorities are planning to equip school graduates with relevant skills, such as entrepreneurship skills. This is welcome, but there is a need to increase employability of graduates in general. Steps can be taken from organizing job market fairs to involving private sector professionals in curriculum design and teaching.

⁷ For example, Spain saw a dramatic increase in the share of temporary employment to 33 percent when it liberalized those while keeping regulations the same on other contracts in the mid-1980s. Workers with temporary contracts are less likely to be employed in firms that provide training, and to receive firm-provided training (Albert et al. 2005).

9. More generally, Iran can boost total factor productivity (TFP) in the non-oil sector by improving innovation and technology adoption.

Iran has a relatively weak technological readiness—including technology adoption and Information and Communications Technology (ICT) use. Many countries have been adopting new technologies and taking advantage of technological advances at a greater speed in the past decade, while Iran came only recently to the technological revolution. In this context, the NDP aims to foster research and technological development.



Protecting workers and facilitating matching

10. Increased flexibility must be accompanied by measures to help and protect workers.⁸

For this, Iran has a mix of passive and active policies that cater to the unemployed, the poor, and vulnerable groups. The social protection system includes programs that cover old age, sickness, and unemployment, as well as means-tested social assistance. It offers a number of targeted policies, that help training the unemployed and less developed regions, and gives incentives to employ more workers through temporary exemptions, for example of social security contributions. The extent to which these active and passive policies are monitored and evaluated in Iran is unclear, but this can help fine tune policies (Khandker et al., 2010).

- **Iran has a functioning unemployment benefit scheme, but coverage is low.** Iran has an unemployment insurance program with eligibility criteria and allowances that are broadly in line with best practices.⁹ However, the system has not really been tested so far, given the difficulties in firing workers. It currently provides unemployment benefits to 200,000 unemployed, covering only a fraction of the nearly 3 million unemployed. Labor market reforms that improve the mobility of workers will mean that the unemployment benefit system will likely come under greater demand.
- **Training programs have been a key element of Iran's activation strategy.** Training schemes are popular across the world. Their effectiveness varies, but international evidence suggests that well-targeted programs that provide skills that are relevant to employers, including soft skills, can improve beneficiaries' chances to find work. Iranian authorities have been looking into ways

⁸See Kuddo and others (2016) for guidelines on how to implement regulation that promote job creation; Card and others (2010, 2012) on international evidence on the impacts of ALMPs.

⁹ It is available to workers who become involuntarily unemployed and have contributed to social security for at least six months. The maximum duration of benefits is 50 months. The allowance is 55 percent of the insured's average earnings in the 90 days before unemployment began is paid plus 10 percent for each of the first four dependents—the minimum benefit is equal to the minimum wage of an unskilled laborer.

to improve the relevance of the skills provided through these schemes by increasing the involvement of the private sector in the design and provision of training, leaving the government the role of ensuring quality of providers.

- **Making the most of job intermediation services.** By disseminating information, job intermediation can improve the match between job seekers and jobs. It can for example leverage advances in information technology to establish basic services relatively cheaply. To be effective, job intermediation has to provide quality services that will attract both employers and job seekers. Iran can better leverage its provincial public employment services centers and bring employers into the process through providing them services such as candidate screening or vacancy management, in order to in turn better garner information on vacancies.
- **Iran relies on social security exemptions to foster employment in small firms.** Employment subsidies can help groups that may be priced out of the labor market, such as the long-term unemployed or the youth. Such subsidies should be temporary since they are meant to cover the initial cost of training new workers and making them fully productive. They need careful targeting since they suffer from deadweight losses—whereby beneficiaries would have found a job anyway—and substitution effects—whereby subsidized individuals are employed instead of unsubsidized ones. Iran has some of these subsidies—the government initially pays the social security contribution for new hires for small firms as long as they add to the total employment of the firm. Given that employer contributions (23 percent) are slightly above the average contributions among middle-income countries (20 percent) with similar social programs, such subsidies may indeed help employment, but the authorities could investigate their net impact and consider international evidence on key success criteria (Brown 2015). The NDP specifically provides a two-year exemption of the employer's share and unemployment insurance for employers who recruit young university graduates with at least BA/BS degree for internship programs.

Creating opportunities for all

11. Creating job opportunities for all benefits economic growth. It is crucial to look not only at headline GDP numbers, but also at how the benefits of growth are distributed and how growth affects people's lives. Improving opportunities, including enlarging the pool of talents available to employers by fostering participation, can also bring further economic development. For example, (Aguirre and others 2012) estimate that bringing the female employment rate to male levels could raise GDP in Japan by 9 percent, the United Arab Emirates by 12 percent, and Egypt by 34 percent. Under similar assumptions, we estimate the GDP boost in Iran would be around 40 percent.

12. Accounting for the impact of regulations on vulnerable groups can make policy design more inclusive. Some regulations create direct hurdles for vulnerable groups. There is evidence of gender discrimination in hiring and unequal remuneration for work of equal value (as in about 60 percent of countries); women do not get full wages while on maternity leave (while they do in 68 percent of countries). A few other indicators point to other hurdles—workers do not get five days of sick leave per year (70 percent of countries provide these days); and although night and overtime

work are allowed, the associated wage premium is high. Improving the flexibility of work hours, or providing leave benefits, for all workers, can improve female labor force participation, work-life balance, and job quality for all, as well as help employers face seasonal variations in production.

13. Designing economic and social policies that help vulnerable groups. Beyond the policies discussed so far, economic and social policies can also be used. For example, issues such as the availability of child or elderly care, explicit nondiscrimination laws, and greater flexibility on working arrangements and hours are of particular importance for Iranian women's participation in the labor market. Similarly, fiscal policies can be designed in order to minimize gender biases—for example through individual income taxation, tax credits or other benefits for low-wage earners. Social assistance policies, such as family allowances, can help parents reconcile work and family care; or pension reforms that address retirement age gaps between men and women can provide greater incentives for women to participate, and improve their income in old age.

References

- Aguirre, DeAnne, Leila Hoteit, Christine Rupp, and Karim Sabbagh, 2012, "Empowering the Third Billion Women and the World of Work in 2012," (Washington: Booz and Company)
- Albert, C., C. Garcia-Serrano, and V. Hernanz, 2005, "Firm-Provided Training and Temporary Contracts," *Spanish Economic Review* 7 Vol. (1), pp. 67–88.
- Assaad, R., and F. Roudifahimi, 2007, Youth in the Middle East and North Africa: Demographic Opportunity or Challenge?" (Washington: Population Reference Bureau)
- Blotevogel, R., 2015, "The Productivity Challenge in Iran," IMF Country Report No.15/350 (Washington: International Monetary Fund)
- Brown, A., 2015, "Can Hiring Subsidies Benefit The Unemployed?", *The IZA World of Labor*, <http://wol.iza.org/articles/can-hiring-subsidies-benefit-unemployed/long>.
- Card, D., J. Kluve, A. Weber, 2010, "Active Labor Market Policy Evaluations: A Meta-Analysis". NBER Working Paper No. 16173 (Cambridge: The National Bureau of National Economic Research)
- Card, D., J. Kluve, A. Weber, 2015, "What Works? A Meta-Analysis of Recent Active Labor Market Program Evaluations," NBER Working Paper No. 21431 (Cambridge: The National Bureau of National Economic Research)
- Crivelli, E., D. Furceri, and J. Toujas-Bernate, 2012, "Can Policies Affect Employment Intensity of Growth? A Cross-Country Analysis," IMF Working Paper 12/218 (Washington: International Monetary Fund)
- Cuberes, D., and M. Teigner, 2015a, "Aggregate Effects of Gender Gaps in the Labor Market: A Quantitative Estimate," *Journal of Human Capital* 10 Vol (1).
- Elborgh-Woytek, K., M. Newiak, K. Kochhar, S. Fabrizio, K. Kpodar, P. Wingender, B. Clements, and G. Schwartz, 2013, "Women, Work, and the Economy: Macroeconomic Gains from Gender Equity," IMF Staff Discussion Note No. 1310 (Washington: International Monetary Fund)
- Holzmann, R., M. Vodopivec, 2012, "Reforming Severance Pay" (Washington: The World Bank).
- Khandker, S., G. Koolwal, and Samad H., 2010, "Handbook on Impact Evaluation. Quantitative Methods and Practices," (Washington: The World Bank).
- Kuddo, A., D. Robalino, M. Weber, 2016, "Balancing Regulations to Promote Jobs. From employment Contracts to Unemployment Benefit" (Washington: World Bank Group.).
- Haltiwanger, J., S. Scarpetta, and H. Schweiger, 2014, "Cross country differences in job reallocation: The role of industry, firm size and regulations" *Labour Economics, Elsevier*, Vol. (26C), pp. 11-25