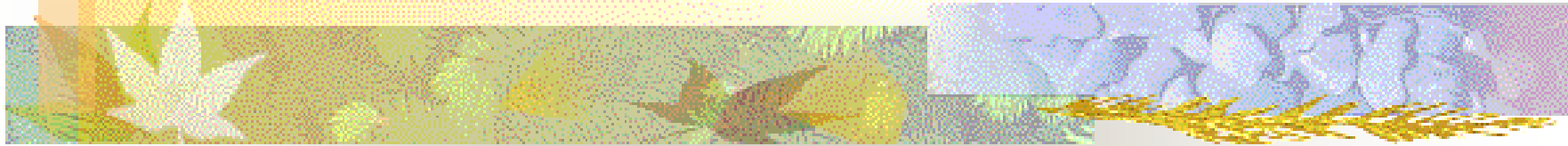




Iranian National Tax Administration

Tax Expenditures: An Iranian Perspective



Mohammadreza Abdi

Deputy President of Research, Planning & International Affairs
Iranian National Tax Administration (INTA)

dpi@intamedia.ir



Introduction

- One of the main functions of the governments, apart from resources allocation, stabilizing the economic fluctuations, redistribution of income and wealth in the society, is the provision of essential services and public goods. In regard with this, to ensure the public security and security of the country boundaries, provision of public health services and public education and the provision of public goods are among the most important functions of the governments.



Introduction (continued)

- A common approach to meet such commitments is to allocate the funds needed in the country's annual budget. Such an approach has already been labeled as "Direct Government Spending".
- As opposed to the above approach, there is another approach for the provision of essential public goods which has been entitled as "Off-budget or Tax Expenditures".
- Tax expenditures refer to (tax) revenue losses resulting from the grant of specific tax aids or supports to particular groups and enterprises in order to realize certain social goals.



Introduction (continued)

- In the tax laws and regulations of many countries, there are long lists of a large variety of tax subsidies and supports in the form of tax credits, allowances and other tax privileges are to be granted to specific groups or individuals aiming at special non-tax social objectives.
- In the Iranian tax laws, too, there are different types of tax supports and aids in the form of allowances, discounts, preferences, legal postponements, etc. aiming at a set of social goals in such areas as health and treatment, education, charity affairs, housing etc.



Introduction (continued)

- In Iran, like many other developing countries, there is no typical budgeting for tax expenditures. However, the Fifth Development Plan Act (2011-2015) has obliged the government to replace the existing tax exemptions with alternative tax credits in the annual budgets of the country as a first essential step towards transparency and targeting the tax subsidies.
- In the present paper, I will try to take a look at the literature on the topic, different approaches to the estimation of tax expenditures, some international developments, and more specifically, tax supports and aids stipulated in the Iranian Direct Taxes Act.



Definition & Goals of Tax Expenditures

- The definition of tax expenditures and making decisions on what items to be regarded as tax expenditure may vary from a country to another since it seems to be a subjective concept.
- The reason why such purposeful tax reliefs have already been labeled as “tax expenditures” is that they are basically classified as part of government spending programs whereby the government replaces direct spending with indirect supports through the taxation system. So, tax expenditures that are sometimes called as “out-of-budget expenditures” refer to revenue losses resulting from granting certain tax privileges that aim at specific public goals with the help of the tax system.



Definition & Goals of Tax Expenditures (continued)

- Such expenditures are considerably similar to the ordinary government expenditure programs that aim to achieve public policies which are not attainable or too hard to be attained through equal and fair collection of tax revenues.
- A major difference between the tax expenditure and the government ordinary spending is that at the first approach, the government can barter the taxes with the services provided by persons or the private sector. As an example, the government can either fund the costs of the construction of an electricity plant by a direct spending procedure or rather by granting tax expenditures to the companies involved in the construction operations through allowing them to decrease their due taxes as exactly equal to their claims.



Definition & Goals of Tax Expenditures (continued)

- Theoretically, it does not make a difference for the government to choose one of these two methods with the only difference that in the tax expenditures method, the government will no longer be engaged in administrative bureaucracy needed for funding the projects in question, and is not obliged to respond to monitoring authorities.
- In any case, for the government, the tax expenditures are taken as revenue losses while for the taxpayers, they are assumed as tax obligations.
- In many OECD countries, tax expenditures are currently recognized as reductions, subsidies, or tax aids (Schick, 2007).
- Nevertheless, tax expenditures are less tangible than various typical direct expenditures of the governments and that's possibly why they are so difficult for policy makers and the public to assess and measure.



Definition & Goals of Tax Expenditures (continued)

- In general, through the policy tax expenditures, governments can follow the following three goals:
 - 1) income redistribution;
 - 2) precise measurement of (the lost) taxable income;
 - 3) development of certain social activities (including educational activities, public health services, charitable affairs, housing etc.)




Definition & Goals of Tax Expenditures (continued)

- Finding the most desirable way to organize tax expenditures depends on the purposes for which the government follows the tax expenditures approach. On this basis, the following items should be taken into account in designing a tax expenditure plan:
 - 1) in a program with income redistribution purposes, first of all, it is required to identify the target households. More specifically, in this respect, only refundable tax credits could help the people in the lowest income classes.
 - 2) in a program aimed at a precise measurement of tax revenues, the deductions should be itemized.
 - 3) in a program with social activity development purposes (including educational activities, public health services, charitable affairs, housing, etc.) or a program with the aim of motivating particular behaviors, there should be a focus on the sensitivity or responsiveness of the intended target groups.



Global Trends of Tax Incentives & Reasons for Moving towards the Tax Expenditures Approach

- Surrey believes tax incentives are generally less desirable than direct subsidies aimed at certain social goals. He argues that tax incentives are not efficient from the viewpoint of justice since they are typically in favor of high income individuals and since it is administratively difficult to develop and manage such incentives. Moreover, tax incentives are developed and managed by tax authorities who are not that much expert in the area of non-tax social policy.
- A major question posed by Surrey is: Are tax incentives an efficient instrument for the implementation of certain social policies as opposed to direct government expenditure, granting loan interest subsidies or guaranteeing the loans?



Global Trends of Tax Incentives & Reasons for Moving towards Tax Expenditures Approach (continued)

- According to the research literature, tax incentives are implemented by most countries in different forms. Research literature shows also that in developing countries, tax incentives are typically untargeted and inefficient.
- Different countries have already been classified in three groups on the basis of their levels of development. 15 countries have been selected from each group to form a sample consisting of 45 countries. The classification has been based on the World Economic Forum under the title “Global Competitiveness Report, 2012-2013”. According to that report, the countries have been classified as follows: “Phase 1”, “Phase 2” and “Phase 3”. The classification has regarded two criteria: “GDP” and “Share of Mineral and Raw Materials in the Export of Goods & Services”.



Experience of Countries which are in Phase 1 of Development (1996-2012)

- The following observations can be listed with regard to tax incentives in countries of the *first phase of development*:
 - 1) Small Proportions of “Permanent Tax Incentives”: Only three countries, i.e. Azerbaijan, Pakistan and Ghana have permanent tax incentives where Azerbaijan grants them for all agricultural activities, Pakistan for electricity generation projects and Ghana for cacao cultivation. In essence, the range of permanent tax incentives in Azerbaijan is very wide and can significantly be effective on tax revenues of that country (of course, such permanent tax incentives are to be effective up to the end of 2013).



Experience of Countries which are in Phase 1 of Development (1996-2012) (continued)

- **2) Lack of Comprehensive or Targeted Tax Holidays:** The countries in question either do not grant tax holidays or they grant them partially, i.e. the incentives are not granted to all industries but rather, they target specific industries in certain regions.
- **3) Replacement of Tax Holidays with Other Types of Incentives:** Some countries under study have already removed or decreased tax holidays (in the period 1996-2012). In contrast, other types of tax incentives including “reduced tax rates”, “investment credits” and “tax credits” have been increasingly introduced.

Table (1): A Summary of Tax Incentives in 15 “Phase 1 Countries”

Country	Permanent Exemption	Tax Holiday	Reduced Rate	Investment Credit	Tax Credit	Other Incentives
Azerbaijan	*		*			*
Bolivia		*				*
Pakistan	*		*		*	
Zimbabwe		*	*			
Senegal			*			*
Saudi Arabia					*	*
Ghana	*	*	*			
Philippines		*	*		*	*
Kenya		*	*	*		
Kuwait		*				
Egypt						
Nigeria		*	*	*		
Venezuela					*	
Vietnam		*	*			
India		*		*		



Experience of Countries which are in Phase 2 of Development (1996-2012)

- The following observations can be listed with regard to tax incentives in in countries of the ***second phase of development***.
 - 1) ***Small Proportions of “Permanent Tax Incentives”***: Only two countries, i.e. China and Morocco have permanent tax incentives which in both countries are granted to the agricultural sector. In practice, the range of permanent tax incentives both in China and Morocco is very wide and can significantly be effective on tax revenues of the two countries (As for Morocco, such permanent tax incentives are to be effective up to the end of 2013).



Experience of Countries which are in Phase 2 of Development (1996-2012) (Continued)

- **2) Lack of Comprehensive or Targeted Tax Holidays:** the countries in question either do not grant tax holidays or they grant them partially. Only 4 countries in the second phase of development grant tax holidays.
- **3) Decrease of Tax Holidays:** In the countries in question, the general trend has been a descending decrease of tax holidays (in the period 1996-2012). The average level of tax holidays in the 15 countries classified in the Phase 2 of Development has decreased from 2.6 years in 1996 down to 1.8 years in 2012. Moreover, the average length of tax holidays in these countries has been significantly less than that of countries in the Phase 1.

Table (2): A Summary of Tax Incentives in 15 “Phase 2 Countries”

Country	Permanent Exemption	Tax Holiday	Reduced Rate	Investment Credit	Tax Credit	Other Incentives
Jordan						
Indonesia		*	*	*		*
Argentina						*
South Africa				*		
Brazil						*
Bulgaria						*
Thailand		*	*			*
Turkey			*			*
China	*	*	*		*	
Russia			*			*
Romania					*	*
Kazakhstan			*	*		
Poland					*	
Malaysia			*	*		
Morocco	*	*	*			



Experience of Countries which are in Phase 3 of Development (1996-2012)

- The following observations can be listed with regard to tax incentives in countries of the ***third phase of development***.
 - **1) Lack of “Permanent Tax Incentives”**: None of these countries have permanent tax incentives. It is worth mentioning that both in the countries of phases 1 and 2 we observe a small proportion of such incentives.
 - **2) Lack of Comprehensive or Targeted Tax Holidays**: The countries in question either do not grant tax holidays or they grant them partially. In Singapore, for example, tax holidays are granted to pioneering companies engaged in manufacturing hi-tech products, provision of certain services and international trade for a period of 5-15 years. In South Korea, as another example, foreign companies investing on certain activities in the area of hi-tech industries can take benefit from a tax holiday of 5 years.



Experience of Countries which are in Phase 3 of Development (1996-2012) (continued)

- **3) Decrease of Tax Holidays:** In the countries in question, the general trend has again been a descending decrease of tax holidays (in the period 1996-2012). As an instance, in Taiwan, the tax holiday for companies engaged in developing, important or strategic sectors was removed in 2005 or in South Korea, as another example, the length of tax holiday to be granted to foreign investments has decreased from 7 to 5 years. In general, the average level of tax holidays in the 15 countries classified in the Phase 3 of Development has decreased from 1.8 years in 1996 down to 1.3 years in 2012.

Table (3): A Summary of Tax Incentives in 15 “Phase 3 Countries”

Country	Permanent Exemption	Tax Holiday	Reduced Rate	Investment Credit	Tax Credit	Other Incentives
Austria				*		
Australia			*	*	*	
Great Britain			*	*		
Germany					*	*
U.S.A.					*	
Taiwan					*	*
Denmark				*		
Japan			*	*		*
Singapore		*	*	*		
France			*		*	
Finland					*	
Canada			*		*	
South Korea		*			*	
Norway						
Netherlands			*	*		



Tax Incentives in Iran in Terms of Items Mentioned in Tables 1, 2 & 3

- In the Iranian tax system, as it will be discussed later, all types of incentives mentioned above including permanent exemptions, tax holidays, reduced tax (rates), investment credits, and some other incentives are currently granted to taxpayers.
- We have, however, decided to remove or minimize permanent exemptions and tax holidays. We have already proposed, in a Bill Amending the Iranian Direct Taxes Act recently submitted to the Parliament minimizing these incentives.



Advantages & Disadvantages of Tax Expenditures

- In general, tax expenditures have two advantages over direct government spending and that is why the tax expenditure approach has increasingly been growing:
 - 1) The first advantage is what has been labeled as “**Political bias**”. It refers to the political orientations towards making use of this method. From the standpoint of the legislators, it is a very attractive situation when they see, for example, that the government has decreased the tax obligations of a company which is involved in the construction of an electricity plant.
 - 2) The second advantage is what has been labeled as “**Procedural Biases**”. They refer to the fact that the tax expenditures, in contrast to many other government cost plans, is a free of cost program for which the government has no constraints in terms of permitted amounts to spend and, moreover, there is typically no monitoring over such an approach.



Advantages & Disadvantages of Tax Expenditures (continued)

- So, the two political and procedural biases are regarded as an important factor encouraging the legislators to use the tax expenditures approach.
- Nevertheless, this approach may be criticized in that it can be **costly** due to the ***lack of monitoring and oversight***.
- In general, some of the most important positive aspects or consequences of the tax expenditures approach can be listed as follows:
 - Encouraging the private sector to participate in the government's social and economical activities;
 - Promoting the process of decision-making by the private sector instead of the government's decision-making;
 - Minimizing the necessity for severe government monitoring over such expenditures.



Advantages & Disadvantages of Tax Expenditures (continued)

- In spite of significant positive impacts, however, the tax expenditures may have negative aspects as well, among them we may mention the following:
 - **Ineffectiveness:** some tax expenditures are not sufficient to overcome economic pressures or they are required to be compensated for by internal and external tax supports.
 - **Inefficiency:** Many tax expenditure plans do not address real needs but rather, they can be regarded as replies to specific beneficiary groups. In such cases, they may result in the decrease of efficiency of certain sectors and, at the same time, they may have negative impacts on the profitability of certain projects and on the total investing rate.
 - **Tax Inequity:** The tax expenditures approach may deviate from tax inequity at both horizontal and vertical levels.



Advantages & Disadvantages of Tax Expenditures (continued)

- ***Tax Base Erosion:*** This approach may limit, in its own right, the impact of decreased tax rates.
- ***Increase of Complexity of Tax Laws:*** Due to the increase of administrative costs and ease of seeking for illegal privileges.
- ***Increase in the Ambiguity of the Size of Government:*** Since the tax expenditures usually replace the government direct spending, the achievement of objectives typically expected from direct spending plans can result in an apparent decrease of the size of government.



Types of Tax Expenditures

- Tax expenditures have different forms. Some of them are in the form of legal tax postponements, specific exceptions, reliefs and exemptions, deductions and allowances while others directly affect the after-tax income of households or enterprises through granting tax incentives (including tax credits, reduced tax rates, etc.) for certain activities. Some of the most important types of tax expenditures are as follows:
 - 1) **Allowances**: amounts deducted from taxpayers' total income in order to calculate the taxable income base;
 - 2) **Exemptions**: amounts deducted from the taxable income base;
 - 3) **Tax Rate Reductions**: decrease of tax rates for specific groups of taxpayers or transactions liable to tax;
 - 4) **Tax postponements**: legal delays in the payment of taxes;
 - 5) **Tax Credits**: amounts deducted from taxpayers' tax debts;



Types of Tax Expenditures (continued)

- Some important types of tax expenditures in different countries are as follows:
 - ***Professional/Vocational Spending***: such as the costs of meals, entertainments, etc.;
 - ***Allowances for Housing Loans Interests***: including tax credits for repayment of mortgage loans and specific allowances for interests;
 - ***Allowances for Deposit Accounts Interests*** (up to particular thresholds);
 - ***Deductions Allowed for Companies' Investments/Reinvestments***;
 - ***Tax Subsidies for Taking Care of Children***;
 - ***Reduced Income Tax Rates for Small and Medium Enterprises***;
 - ***Tax Credits for Retirement Pensions***;
 - ***Tax Credits for Charitable Contributions***;
 - ***Deductions Allowed for Using Clean Energies***; and
 - ***Employers' Contributions to Employees' Health Care Costs***.



Tax Expenditures Budget & Methods of Tax Expenditures Estimation

- Tax expenditures budget refers to the estimation of tax losses accrued from various tax concessions, discounts, exemptions, preferences, non-refundable tax credits or legal tax postponements granted by the tax law to individuals or enterprises.
- Such tax aids or supports are intended to reduce tax obligations/tax debts of individuals or companies involved in certain activities. As an instance, in Iran like many other countries, taxpayers who contribute to charity institutions are allowed to deduct the same from their taxable income. In such cases, tax expenditures budget aims at forecasting and estimating the cost of such contributions.
- Some countries specify a certain threshold for such tax expenditures in order to restrict the government's costs including direct costs and the costs of tax expenditures. Many other countries, however, do not follow such restrictions.



Methods of Measurement of Tax Expenditures

- As a matter of fact, such measurements are a main component of any reports on tax expenditures which, in many developing countries, function as a tool of financial transparency and efficient allocation of resources. I'm not going to get into details, but it would be worth mentioning that in some countries, reporting tax expenditures is a legal requirement while in others including Iran, there is no legal obligation in that respect.
- In general, there are three major methods for estimating tax expenditures: “*revenue forgone method*”, “*revenue gain method*” and “*outlay equivalent method*”. In all these methods, tax expenditures are estimated on a *cash* basis or rather, on an *accrual* basis.



Methods of Measurement of Tax Expenditures (continued)

- **1) Revenue forgone method:** This method calculates the government's revenue losses in the past. It does not focus on the taxpayers' behavioral responses. As an example, the cost of a tax credit is exactly equal to the amount of that tax credit. In the same way, the cost of a tax allowance is computed as the product of the total deductions multiplied by the final tax rate.
- **2) Revenue gain method:** This method calculates the government's revenues to be gained in future as a result of the cancellation of tax costs. In this method, the taxpayers' behavioral responses are taken into consideration. Using this method requires a proper understanding of taxpayers' behavior and having the information and knowledge of tax elasticity.



Methods of Measurement of Tax Expenditures (continued)

- **3) Outlay equivalent method:** In this method, the direct expenditures which are supposed to have the same pre-tax/post-tax impacts on the taxpayer's income are also regarded as tax expenditures providing that they are appropriate to the tax treatment of the tax subsidy or the tax transfer granted to the recipient.



A Typology of Tax Expenditures in Iran

- In Iran, like many other countries, there is a long list of a large variety of tax concessions to be granted to certain groups, individuals or enterprises aiming at certain social objectives.
- With regards to revenue losses, tax expenditures cover a considerable amount of tax revenues. Informal estimations indicate that more than **15%** of the country's GDP are tax exempted as result of granting a large variety of tax privileges to different groups and individuals. If we multiply the average tax rate in Iran which is approximately **20%** by the above percentage, we will observe that the value of tax expenditures in Iran will amount to **3%** of the GDP.
- Table (4) provides a typology of tax privileges which account for tax expenditures in the Iranian taxation system:

Table (4): Major Tax Expenditures in the Iranian Tax System

	Tax Category	Description	Type of Expenditures	Objective
1	Inheritance Tax	<ul style="list-style-type: none"> • An allowance of IRR 30,000,000; • An exemption of 80% of the decedent's participation bonds and his bank deposits; • An exemption of 50% of the value of the decedent's shares in the companies listed in the Stock Exchange; • An exemption of 40% of the value of the decedent's shares or partnership share in other corporations; • An exemption of 40% of the net value of the decedent's assets in producing, industrial, mining and agricultural enterprises. 	Allowance & Exemption	Distribution & Allocation
2	Real Estate Income Tax	<p>1) Exemption from taxation up to a total area of 150 square meters of useful built area for the residential units in Tehran and up to 200 square meters in other places;</p> <p>2) The annual taxable rental income of individuals with no other source of income shall be exempted from taxation up to the level of tax exemption of salary income.</p>	<p>1) Exemption</p> <p>2) Allowance</p>	<p>1) Distribution & Allocation</p> <p>2) Distribution</p>
3	Tax on Income from Agriculture	An exemption of 100% for all activities in the field of agriculture; animal rearing; stockbreeding; fish farming, etc.	Exemption	Distribution & Allocation
4	Tax on Salary / Individual Business Income	<p>1) An annual allowance of IRR 100,000,000;</p> <p>2) A rebate of 50% of the salary tax of the employees working in less developed regions.</p>	<p>1) Allowance</p> <p>2) Reduced Tax (Rate)</p>	<p>1) Distribution</p> <p>2) Distribution & Allocation</p>

Table (4): Major Tax Expenditures in the Iranian Tax System (continued)

	Tax Category	Description	Type of Expenditures	Objective
5	Taxes on Income	An exemption of 100% of the income of charity institutions from cash and non-cash aids and gifts received by them.	Exemption	Distribution
6	Corporate Tax	An exemption of 80% of the income from producing and mining activities for 10 years and an exemption of 100% of such income derived in the less developed regions for 4 years.	Tax Holiday	Distribution & Allocation
7	Corporate Tax	Any part of the declared profit of private and cooperative companies that is used for development, reconstruction, renovation or completion of existing industrial or mining units of those companies, or for setting up of new industrial or mining units, shall be exempt from 50% of the applicable corporate tax.	Tax Credit	Allocation
8	Corporate Tax /Tax on Individual Business Income	1) An exemption of 100% of the income of publishing, journalistic, cultural and artistic activities; 2) All enterprises for internal and international tourism shall enjoy an annual exemption with regard to 50% of their applicable taxes.	1) Exemption 2) Reduced Tax (Rate)	Distribution & Allocation

Table (4): Major Tax Expenditures in the Iranian Tax System (continued)

	Tax Category	Description	Type of Expenditures	Objective
9	VAT/Corporate Tax /Tax on Individual Business Income	An exemption of 100% of income/value added of the exportation of goods and products from income tax and VAT.	Exemption	Allocation
10	Corporate Tax /Tax on Individual Business Income	An exemption of 100% of the income of hand-woven carpet workshops and handicrafts.	Exemption	Distribution & Allocation
11	Corporate Tax	1) An exemption of 100% of the income derived by rural, tribal, agricultural, fishers, workers, employees, university and school students' cooperative companies; 2) A reduction of 25% of the applicable corporate tax rate for conventional cooperative unions and public joint stock cooperative companies.	1) Exemption 2) Reduced Tax (Rate)	1) Distribution 2) Allocation
12	Taxes on Income	An exemption of 100% of interest or bonuses accrued to saving accounts and various deposits held by the Iranian banks, credit institutions as well as interest of deposits related to pension contributions.	Allowance	Distribution & Allocation

Table (4): Major Tax Expenditures in the Iranian Tax System (continued)

	Tax Category	Description	Type of Expenditures	Objective
13	Taxes on Income	A deduction of 100% from the taxable income for the funds contributed by taxpayers to the repair, mobilization, construction or completion of schools, universities, centers of higher education, health and therapy centers, training camps, etc.	Deduction	Distribution & Allocation
14	Corporate Tax	The rebate of 10% of the Tax on Corporate Income derived from the selling of commodities accepted and sold in the Commodity Stocks, and 10% of the Tax on Profits of companies listed in the domestic or foreign stock Exchanges.	Reduced Tax	Distribution
15	VAT	An exemption of 100% of the value added derived from selling or supplying unprocessed agricultural products, essential commodities, books, notebooks and all types of printing papers, immovable property, all types of medicine and medical services, banking and credit services, public transportation services, educational and research services.	Exemption	Distribution

**THANK YOU FOR YOUR
LISTENING & YOUR
PATIENCE**

