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Report on Public Financial Management, Procurement, and Expenditure Systems in Iran

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FISCAL YEAR OF BUDGET
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1 USD (2004) = 8719 IRR

ABBREVIATIONS AND ACRONYMS

ABC	Activity Based Costing
ASOSAI	Asian Organization of Supreme Audit Institutions
AO	Audit Organization
BMJ	Bonyad Mostazafan va Janbazan
BMJII	Bank Markazi Jomhori Islami Iran
CBI	Central Bank of Iran
CEM	Country Economic Memorandum
CFAA	Country Financial Accountability Assessment
CSRO	Civil Service Retirement Organization
CPAR	Country Procurement Assessment Report
DIO	Defense Industry Organization
DTE	Department of the Treasury & Expenditure
EBF	Extra Budgetary Funds
EC	Expediency Council
ECSPS	Europe and Central Asia Operations Policy and Services
FC	Financial Controller
FMIS	Financial Management Information System
FPI	For Profit Institutes
FSAP	Financial Sector Assessment Program
FY	Fiscal Year
GC	Guardian Council
GDP	Gross Domestic Product
GFMIS	Government Financial Management Information System
GFS	Government Finance Statistics
GNI	Gross National Income
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IKEC	Imam Khomeini's Emdad Committee
IMF	International Monetary Fund
INIO	Iran National Industries Organization
INTOSAI	International Organization of Supreme Audit Institutions
IRIB	Islamic Republic of Iran Broadcasting
IRNA	Islamic Republic News Agency

IRPD	Institute for Research in Planning and Development
MENA	Middle East and North Africa
MEAF	Ministry of Economic Affairs and Finance
M&E	Monitoring and Evaluation
MNAFM	Middle East and North Africa Region Financial Management
MNSED	Middle East and North Africa Region Social and Economic Development Group
MNSIF	Middle East and North Africa Region Finance, Private Sector & Infrastructure Group
MP	Member of Parliament
MPO	Management and Planning Organization
MRC	Majlis Research Center
MTEF	Medium-Term Expenditure Framework
NIN	National Identification Number
NPO	Not-for-Profit Organizations
OECD	Organization for Economic Council and Development
OIETAI	Organization for Investment, Economic and Technical Assistance of Iran
OPCP	Office of Protection of Consumers & Producers
OPCFM	Operational Policy and Country Services; Financial Management
OSF	Oil Stabilization Fund
PAL	Public Accounts Law
PEM	Public Expenditure Management
PER	Public Expenditure Review
PRMPS	Poverty Reduction and Economic Management Public Sector Governance
P&S	Ports & Shipping
QFAs	Quasi Fiscal Activities
ROSC	Report on Observance of Standards and Codes
SAC	Supreme Audit Court
SOE	State Owned Enterprise
SSO	Social Security Organization
SWO	State Welfare Organization
TFYDP	Third Five Year Development Plan
TSE	Tehran Stock Exchange
VAT	Value Added Tax

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EXECUTIVE SUMMARY

What is the purpose of this report?

1. This report has been prepared in the context of the World Bank's continuing work with all borrowing countries examining and documenting their public expenditure management systems, as part of the Bank management's fiduciary responsibility to the Board of Executive Directors. This is the first such report prepared by the Bank on Iran in over two decades.[1]

2. Accordingly, this review aims to describe, and to the extent possible, analyze public expenditure management systems in Iran, including those involved in budget formulation and execution, financial management, procurement, and oversight (but not the management of the civil service). As such, it contains elements of a Public Expenditure Review (PER), a Country Financial Accountability Assessment (CFAA), and a Country Procurement Assessment Report (CPAR). The team that prepared this document included staff competent in all three areas.

3. The report has also been prepared as part of the World Bank's effort to establish a multiyear program of collaborative public expenditure work with the Government of the Islamic Republic of Iran with a strong emphasis on knowledge sharing in both directions. The Iranian authorities are in the process of modernizing their budget management, increasing the focus on performance and including much greater attention to monitoring and evaluation at all levels. In particular, they are keen to learn best practices worldwide to enhance the design and implementation of their reforms. Thus, this report represents the Bank's initial effort to formulate a baseline understanding of Iran's rapidly evolving systems so that it will be better placed to work with the government in helping it acquire this knowledge. As such, this report represents the first activity in a mutually-agreed, multiyear program of collaborative public expenditure work. The broad outlines of this work have been formalized in a memorandum of understanding.[2]

[1] The IMF has recently published its ROSC on fiscal transparency in Iran. The main conclusions of this study and that study are similar. See IMF Country Report No. 02/267 Islamic Republic of Iran: Report on the Observance of Standards and Codes – Fiscal Transparency Module.

[2] This memorandum identifies priority areas of knowledge work, including a series of joint analytical pieces and a series of capacity building initiatives and training courses organized in Iran mainly for budget and financial management staff - both in central agencies (MEAF, MPO, etc.) and line agencies - on issues such as: monitoring and evaluation systems (theory, choice of indicators, institutional arrangements, evaluation criteria, etc.) for programs financed by public funds; public finance issues related to decentralization and local financial management; a comprehensive review of current public expenditure analysis and management issues (introducing a medium-term framework for budgeting, performance-oriented budgeting, the design and costing of sector strategies and programs); and other possible training areas such as financial controls and auditing, procurement, and anticorruption.

What is the public sector in Iran?

4. ***Large, complex public sector.*** Given the importance of oil, the production and export of which is controlled by the Iranian government, and a legacy of state-dominated approaches to development both before and after the Islamic Revolution of 1979, it is not surprising that Iran has an extensive, sophisticated, and complicated public sector. Vestiges of multiple historical and other influences – including power sharing arrangements between the Supreme Leader and the elected government and bureaucracy, are evident in the way its current public expenditure management institutions are structured and function.

5. ***Definition of the public sector in Iran.*** For the purposes of this report, the public sector is defined in terms of the control of public funds and assets, as mandated by the national Parliament and managed by the national executive through well articulated and generally transparent processes. This definition includes the general central government agencies (which include ministries as well as several independent public institutes), as well as the 28 provincial governments that are administrative arms of the central government. These management bodies are fully funded by the budget.

6. Total central government spending is estimated to have averaged as much as 42 percent of GDP during the 1990s and was equivalent to $45 billion in 2002/03 once implicit revenues and expenditures are made explicit and extra budgetary funds are included, stemming from subsidies arising from a dual exchange rate that was only recently unified to the market rate and from nonmarket (i.e., subsidized) transfer pricing of petroleum products for domestic consumption) are made explicit and extra budgetary funds are included. However, the budget of the central government is relatively modest. It typically has been only about 25 percent of GDP, though it rose to 33 percent of GDP in 2002/03 mainly because of efforts at making exchange rate and petroleum subsidies explicit. While the great bulk of explicit public revenues transit through the budget, there are several extra budgetary funds. The largest of these is the recently created Oil Stabilization Fund (OSF), which includes certain funds linked to foreign borrowing, employment creation, and similar issues. Finally, there are two main public pension funds. With the exception of the OSF and the pension funds, data on extra budgetary funds are limited. The roughly 800 municipal governments are funded locally, and have not been included in this report. However, their expenditures are relatively minor compared to those of the central government budget.

7. ***Many public enterprises.*** Roughly 1000 state owned enterprises (SOEs) and state-owned banks, which account for over 85 percent of banking assets, could technically be included in the definition of the public sector, as they are majority government owned, either directly or as assets of other government-owned SOEs. In principle, these are expected to follow government procurement regulations. The projected summary accounts for about 500 of the largest are annexed to the government budget, although only tax and dividend payments are legally binding. Some of these are sometimes directed, through notes in the budget, to finance quasi-fiscal activities, which may contribute to contingent government liabilities if they cause SOE net assets to

deteriorate. Some 300 SOEs receive budgetary transfers and are considered spending entities in the budget as a result. In 2002/03, budgetary transfers to these SOEs totaled about 6 percent of the central government budget (although 5/6ths of these transfers were in the form of interest free loans requiring eventual repayment). Moreover, many SOEs, and public institutes benefit from preferential access to government contracts. Thus, they may become tools in both executing budget policies and in bypassing budgetary controls within the government. However, SOEs are not primarily financed through the budget, and they have a different governance and auditing structure than government entities. In addition, there exist nearly 1000 other SOEs that are controlled by banks (as a result of Islamic banking rules that substitute equity stakes for interest payments) or foundations (as a result of the disposition of certain nationalized assets after the Revolution). These are outside of the definition of the public sector used herein.

8. ***The particularities of the bonyads***. To round out the discussion of what defines the public sector, one must add the foundations, or bonyads. Bonyads are non-government public institutions distinct from the private sector and SOEs and are often considered a distinguishing feature of Iran. Of the many bonyads, four have a quasi-public status, inasmuch as they hold substantial assets derived from nationalizations on which they earn substantial revenues. From these revenues, as well as from charitable contributions, they both finance and deliver a wide array of public social services, especially for the poor. Other bonyads are privately funded, although some of the largest receive funds from budget transfers. Direct central government budget transfers to all bonyads account for less than 1 percent of total central government spending, whether on or off budget. They may receive additional public funding via outsourcing arrangements with some ministries and departments. Those receiving budgetary transfers appear as government spending agencies in the budget, and these transfers are subject to audit by the central government. Because the functioning of the bonyads is distinct from both the budget and government assets, and because they are supervised solely by the Supreme Leader, they are excluded from the definition of public sector as used in this report.

9. ***Modest tax receipts***. This sizeable government is financed by only modest domestic tax receipts (6 percent of GDP and about a fifth of total revenues), since most revenues come from oil, as in most oil-rich economies. So long as oil prices remain above about $20 per barrel, crude oil exports are not unduly absorbed by the heavily subsidized domestic consumption of oil. The volatility of oil revenues is satisfactorily addressed through reserves in the OSF. The immediate challenge for the public sector is therefore not so much to diversify revenues as to manage expenditures more effectively. Thus, more effective management of expenditures is the central focus of this review. Nonetheless, the government is instituting measures to diversify revenues, including the introduction of a value added tax, while at the same time attempting to rationalize the tax system (such as substituting import tariffs for quotas and lowering high marginal income tax rates).

10. ***Complex political and institutional environment for public sector.*** In terms of political structures, the country is characterized by a rather unique power sharing arrangement between a Supreme Leader (and the various offices, including the judiciary,

attached to him) and an elected Parliament and executive together with an extensive government bureaucracy. The “public sector” in Iran typically is defined in terms of the parliamentary and executive branches, together with public assets (mainly SOEs) that operate independently from the executive. However, the Supreme Leader also controls assets of a public nature, receives public funds, mostly but not only through the government budget although it is primarily financed through private funds, and performs services that are public in nature. In addition, the Supreme Leader exercises direct and indirect influence over the size and activities of the traditionally defined public sector. Consequently, the definition of the public sector is complex, and even with best intentions to improve transparency and accountability in public finance, the sheer institutional complexity of the Iranian public sector renders such a task more difficult. The Office of the Supreme Leader is funded almost entirely from charitable contributions (which may be highly institutionalized but are not mandated by Parliament or the government), as well as from earnings of the various foundations and the state-owned enterprises they control.

Use of public resources

11. ***Respect for fiscal discipline***. The government has made a serious and successful effort to restore and sustain fiscal discipline. Since the borrowing binge of the 1980s, it has shored up its fiscal stance and its reserves. While a wide array of distortionary economic policies limited growth to modest levels in the 1990s (3.5 percent a year), conservative fiscal management has achieved some successes. As of 2002, Iran maintained relatively low inflation (less than 15 percent a year), low explicit government debt (5 percent of GDP, both foreign and domestic, although implicit debts and contingent liabilities are believed to be significant and there is some borrowing from the Central Bank), and substantial foreign reserves (some US$23 billion, or nearly a year’s worth of imports).

12. In Iran, budget management systems themselves are designed in part to help protect fiscal discipline by matching cash releases to available resources and by assuring that commitments are within budget envelopes (through an organization of financial controllers in the Ministry of Finance). Partly as a result of fiscal stability, the country has achieved reasonably good and improving macroeconomic performance, generally exceeding targets in its Third Five-Year Plan with the average annual growth rate during the Plan (2000-2005) reaching 5.2 percent. However, spending increased substantially in 2002/03, driven mostly by the shift from implicit to explicit financing of subsidies. This has raised the fiscal deficit to over 5 percent of GDP, requiring exceptional transfers from the OSF and increasing inflationary pressures.

13. ***Priority given to social spending***. A substantial share of central government budget spending is allocated to social sectors (health, education, safety nets, subsidization of basic goods), consonant with the objectives of the Revolution. The share of the budget given to social spending would be even larger if implicit spending on subsidies was included. The government has sought, through a variety of governmental and non-governmental spending mechanisms, to improve social conditions. It has had

considerable success, as the improvement in poverty and social indicators testify. Over time, the priority to social spending has been systematically protected against cuts. Some social spending, like that in education, is mildly progressive. However, much of this spending, especially that on consumer subsidies that are least transparent, as those on energy, benefits the more affluent, not the poor.[3]

14. ***Modest spending on personnel***. Central government employment makes only a modest call on government resources, amounting to about 39 and 26 percent of current and total budgeted spending, respectively. The shares would be substantially smaller if implicit revenues and expenditures were also included in the budget. The government wage bill is only 6 percent of GDP, well below the 11 percent average for MENA countries and noticeably below the 9 percent average for other lower middle income countries.

15. ***Average spending on capital*** *(development activities)*. Capital spending, which is about a fourth of total budgetary spending, ranged from 5 to 7 percent of GDP in the late 1990s, and the early 2000s.

16. ***Moderate defense spending***. Defense spending, as reported in the budget, amounts to about 3 percent of GDP. This is below the average for all developing countries, well below the average for other countries in the region, and below the levels defense spending in some OECD countries (e.g., the US spends 4 percent of its GDP on the military). However, the share allocated to defense has been gradually rising at the expense mainly of infrastructure (roads and transport).

What are the key public financial management institutions in Iran?

17. By nature, most public expenditure management systems are complex. The one in Iran seems especially so. Overall responsibilities are shared, in a well articulated if changeable fashion, between the religious authorities and the government's executive and legislative branches. In addition, an elected Parliament debates and approves budgetary policy.

18. ***Strong, centralized executive role***. Executive power over public expenditures is divided between a Management and Plan Organization (MPO)[4], under the Presidency, which prepares and manages the overall budget process, and the Ministry of Economic Affairs and Finance, (MEAF) which largely handles back-office spending and accounting functions as well as tax collection. While there are substantial and repeated discussions between the MPO, line ministries, and the Cabinet, budget formulation is controlled, in both process and content, by MPO. MPO also effectively exercises influence over procurement through a variety of channels (see below).

19. The executive branch of government is composed of about 90 executive departments and public institutes (which this report labels as "executive agencies"), that

[3] World Bank, Poverty in Iran – Trends and Structure, 1986-1998, 2003.
[4] Equivalent to the Office of Management and Budget in the US, for example

receive appropriated funds. Budget execution itself is managed through some 550 separate spending entities, plus several SOEs that receive budget funds and a few bonyads that are outside of government as defined here. The spending agencies each have one or more bank accounts (summing to some 2000 separate accounts in total) for the budgetary appropriations they receive and manage directly. A Central Allocation Committee, chaired by MPO, assures that the funds released to spending entities do not exceed available resources. The commitment and liquidation process within spending entities is overseen by financial controllers acting on behalf of the Ministry of Finance to assure that obligations remain within the resource envelope.

20. Budgetary expenditures that are technically subject to formal procurement rules (that is, the purchase of goods and services and capital spending) now amount to about 30 percent of the budget, or roughly 9-10 percent of GDP. This is about two-thirds the level of public procurement in OECD countries.[5] However, there is insufficient information to ascertain what portion of this has been, in fact, spent in compliance with the procurement rules, as there are substantial exceptions and the mission had virtually no contact with line agencies or public contractors.

21. ***Active Parliament***. Parliament is an active partner in budgetary debates through an array of committees mandated to examine the executive's budget proposal over a period of 2-3 months. Its own independent research center prepares its own extensive budget analyses. However, the net impact of Parliament on the budget is typically to increase spending through new capital projects and directing, through detailed notes to the budget, various government and public sector agencies to carry out specific policies, sometimes of a quasi-fiscal nature. Parliament also receives the audit reports of external auditors, but there is little evidence that these inform its debates to any degree.

22. ***Independent external auditors***. Three separate fiduciary oversight bodies function in Iran with differing mandates. One deals with government agencies, one deals with SOEs, and one deals with quasi-public bonyads that report to the Supreme Leader. Their mandates do not generally overlap. The municipalities[6] have their own budgets and are accountable to local parliamentary bodies, although the MPO does perform a review of their budgets.

What are some of the salient characteristics of the public financial management system in Iran?

23. ***Well structured annual budget formulation process within the framework of five-year development plans.*** Much of Iran's budget preparation is guided by the framework and targets of its five-year development plans. This framework projects macroeconomic aggregates, establishes overall revenue and spending targets and broad sector spending priorities, and sets the direction of expenditure management policies

[5] For 2002/3 and 2003/04. Although comparable data classified by GFS categories are not available for years before 2002/03, it appears that the "procurement percentage" has increased substantially from the level in the 1990s.

[6] Oversight for municipalities rest with the Ministry of Interior

(including quasi-fiscal issues such as directed credit and earmarked resources). The five-year plan is used as a constant point of reference in preparing and justifying budget proposals, and deviations from plan targets are monitored and reported to Parliament. The five-year plans are not prepared on a rolling basis, but the macroeconomic framework is updated annually. Nonetheless, annual budget formulation remains, for the most part, incrementally based, especially within the spending units. One axis of the government's budget reform program aims to increase the focus on strategic policy directions, specific costing of policies, and performance as a basis for budget preparation.

24. ***Substantial but not total budget transparency and information***. There is a surprising degree of budget transparency and information in Iran. At the same time, however, the complexity of the budgetary system and the overall public sector increases the difficulty of deciphering, and hence understanding and debating the budget. Budget documents are extensive, detailed, and public. They are even available on the government's website while still in draft. But there is no document that brings together, in a summary form accessible to external groups and general readers, relevant information on the macro-fiscal position, the government's budget priorities, and planned proposals for spending in the following year.

25. Beginning with 2002/2003, the government presented the budget according to the GFS format for the economic classification of expenditures. Thus, the budget document distinguishes seven categories each for current and capital spending, in each program, in each of the approximately 90 executive agencies that receive appropriated funds. In line with GFS standards, the budget also presents changes in capital and financial assets for each executive body, which appear in a detailed annex. Other annexes provide summary accounts for approximately 500 SOEs and budgets for each of the 28 provinces. The data presented cover the proposed year, the current year (as approved), and the previous year (as executed). In addition, a series of notes carefully detail various exceptions, exemptions, and earmarking for spending agencies. In total, the document is over 1500 pages. It is available in draft form on the government's website and bookstore, and on compact disc as well, when approved.

26. At the same time, there is relatively little information on off budget or implicit revenues and spending, loan guarantees and other contingent liabilities, and quasi-fiscal obligations. Likewise, there is little information on the process of budgetary execution, including a lack of periodic reporting on the status of budgetary execution during the year itself, although the budget document contains actual out-turns for previous years (a welcome contrast to many countries). In addition, many budget execution decisions are both non-transparent and non-public, including contract awards for public procurement.

27. ***Substantial legislative consultation***. Parliament is substantially involved in budgetary discussions. The draft budget, in full detail, is distributed and discussed over a period of several weeks through a series of committees in Parliament. Technical support is provided by the Parliamentary Research Center. Parliament may eliminate or add activities, or change allocations, provided that overall fiscal discipline is respected. In practice, however, parliamentary changes are typically small, driven by local

constituencies, and inevitably tend to increase spending over the executive's proposals. Parliamentary budgetary deliberations are televised, and the Parliamentary Research Center analyses are published.

28. ***Centralized budget allocation and deconcentrated budget execution***. There is a centralized system of periodic (monthly and quarterly for current and capital spending, respectively) cash releases (or expenditure allotments) to the approximately 2000 bank accounts maintained by the units receiving budgetary funds and SOEs. These cash releases are based on the overall availability of government revenues and, in principle if not always in practice, on the units' use of previous funds. The process gives priority to fully funding salaries, interest charges, and transfers (subsidies). The actual management of these funds is highly deconcentrated, with each spending unit having its own bank accounts, cash management and financial control arrangements, and financial management information system.

29. ***Relatively wide margins for budgetary flexibility for spending units***. Spending units can revise budgetary allocations during the fiscal year with no prior parliamentary approval within margins of 10-30 percent, depending on the level of aggregation and type of expenditure. However, there can be no shifts between current and capital budgets. The flexibility margin is unlimited for public institutes, which receive about 6 percent of the budget, essentially in the form of block grants. Although there is no internal approval process for changes in the approved budget, the various revisions are submitted for *ex post* parliamentary approval near the end of the year. When revisions reflect fluctuations in revenue, they are typically tailored by the central Allocation Committee to specific programs as part of the detailed periodic allotment process, rather than being across-the-board. However, certain trends emerge from these revisions; education, social security and defense spending is systematically higher than initial allocations, while that of infrastructure is lower. Recurrent spending exceeds allocations, while capital spending remains below budget despite the strictures on shifting between these two categories.

30. ***Generally sound system of spending regulations and internal financial controls.*** Procurement regulations stipulate competitive bidding above fairly modest thresholds. However, in practice, partly because of the limited capacity of spending entities, these regulations are not uniformly enforced nor do they fully conform to international standards of competitiveness and transparency. Decisions about civil service staffing and payroll management are centralized, in principle, in the MPO. Expenditure controls, accounting, and reporting in spending units are the responsibility of an independent financial controller (FC). The position of the FC was inspired originally by the French model of public finance. While institutionally part of the MEAF (and not the spending unit) and overseen by the SAC, the FC is, in fact, functionally responsible to each spending unit. The FC assures that all transactions, including procurement activities, within a spending unit comply *ex ante* with applicable regulations. The FC also manages the actual payment processes, maintains internal accounts (on a cash basis) and a registry of physical property, and reports financial information to both the MEAF and the independent external audit organization (SAC). This lack of separation between the functions of accounting for, approving, and processing payments (which is most marked

in smaller spending agencies) increases the risk of collusion, financial irregularity and improper use of budgetary resources, and is contrary to international standards of internal control.

31. ***Weak internal audit function***. While charged with the independent financial control of the spending agency, the FC typically plays the role of accountant and member of the procurement committee in the spending agency, a practice maintained since 1980. Operational imperatives mean that the FCs focus on supporting, rather than overseeing, the financial management activities of the spending agency. Consequently, as noted above, there a lack of separation between the functions of internal controls over spending. Also, Iran has lacked an independent internal audit capability, which is recognized in international norms as an important safeguard of the fiduciary integrity of the expenditure process, since the transfer of SAC from the MEAF to an independent status in 1980. Such an institution could be established either as a centralized unit based in the MEAF or as separate units in each of the spending entities working under regulations and the general supervision of the MEAF.

32. ***Extended commitment periods complicate financial controls.*** Since 2000/01, the Parliament has authorized both commitments and payments to be made after the end of the fiscal year, for a period of one and four months for current and capital spending, respectively. In addition, some independent agencies have a much longer complementary period for making new commitments. This complementary period not only extends the reporting deadlines, but also complicates financial management and accountability and threatens transparency. On the other hand, the possibility of having an extended commitment period may help avoid the wasteful spending surges that often occur at the end of fiscal years in countries where no budget carry forward is allowed.

33. ***Emphasis on compliance, rather than performance***. Budgetary management systems are also designed to assure a notional compliance with rules and regulations. In Iran, there is a deep respect for process, even in disputes between the Supreme Leader and the legislative or executive branches. This respect for process carries over into budget management. Iranian authorities have adopted an elaborate management system, drawn from public finance traditions of developed countries, and they accord an importance to respecting these rules and institutions, even if exceptions to respecting financial management rules are accepted and documented. *Ex post* evaluation is carried out by three separate audit agencies. While mandated, independent, and public, this evaluation appears limited in scope and impact, and, as in most countries, focuses on compliance rather than the efficient and effective delivery of public services.

34. ***Limited performance monitoring and evaluation but recognition of the need for it***. While respecting rules and institutions is an important asset, it in no way guarantees that public spending is as effective as it could be in Iran. As in all countries, policy choices permeate spending patterns, and such choices are often motivated by concerns other than efficacy. The heavy past reliance on implicit revenues and spending, and on some off-budget funds, has undoubtedly hampered informed debate on the merits of such spending. And some clear policy choices, such as the heavy subsidization of energy,

have led to sub-optimal and unsustainable development results. Thus, serious budget management does not mean that the budget has become a strategic policy tool or that the performance of public spending is a key criteria in allocation.

35. With respect to actual performance, the MPO is responsible for monitoring the effectiveness of spending units, even though it is also intimately involved in the design and approval of agency programs and budgets in the first place. However, the emphasis on performance *per se* remains rudimentary, reflecting the incremental, rather than policy- or results-oriented, basis for budget preparation. There is a general tendency to equate performance with regulatory conformity. Thus, there is no well-developed, independent monitoring and evaluation system in place. However, the government's budget reform program aims squarely at instigating results-based management, and it has initiated pilots to launch the reform effort. One of the government's priorities for training and knowledge transfer is in the area of monitoring and evaluation.

36. ***Competitive procurement principles but with extensive exceptions that reduce transparency and efficiency***. Budgetary expenditures that are technically subject to formal procurement rules (that is, the purchase of goods and services and capital spending) now amount to about 30 percent of the budget, or roughly 9-10 percent of GDP – about two-thirds the level of public procurement, for example, in OECD countries.[7] Previous procurement regulations, dating from 1971 and covering the main government agencies, enshrine competitive procurement as the preferred public procurement method. However, so many exceptions are possible that competitive bidding is not, in fact, the primary procurement system for spending entities. These exceptions include the widespread use of sole-source procurement and restrictive, rather than open, tendering; preferential, cost-plus, procurement from SOEs; informal rationing of works and services among registered contractors and engineering and other consulting firms; and systematic recourse to change orders after bid awards. In addition, the lack of standardized bidding documents (despite sensible guidelines on tender requirements) and centralized oversight creates further possibilities for non-competitive procurement. Importantly, awards are not published. Some of the exceptions to procurement rules may reflect both a search for needed flexibility (where rules and regulations may have morphed from a check on bad behavior to a check on sensible, efficient management) and a way of sidestepping fiduciary restrictions meant to curb personal or institutional gain. In either case, they reduce transparency and shift many spending decisions to entities where such financial controls are more limited and where alternative mechanisms to assure accountability and effectiveness are also less developed. The new procurement law attempts to address these deficiencies and corrects some but not all.

37. ***Highly decentralized procurement process but with substantial, often indirect centralized (MPO) influence***. Each spending agency is responsible for its own procurement. However, MPO has substantial influence over procurement decisions dealing with public works and related consultancies through the formulation of shortlists

[7] For 2002/3 and 2003/04. Although comparable data classified by GFS categories are not available for years before 2002/03, it appears that the "procurement percentage" has increased substantially from the level in the 1990s.

(for construction contractors and consultants), informal rationing of contracts among national (typically state-owned) firms, *ex ante* approval of all foreign consultants, and decisions on exceptions to public works contracts. By contrast, there appears to be little MPO influence over suppliers of goods contracted by spending agencies, beyond mandating a schedule of prices that suppliers are expected to honor.

38. ***Absence of a comprehensive public procurement legislation coupled with an independent national procurement policy and oversight entity***. Existing legislation on procurement remains piecemeal, and no single autonomous agency exists to assure it is implemented with fairness, transparency, and efficiency. Instead, various agencies, including the MPO and individual spending agencies, have prepared different procurement guidelines. Despite the absence of internal oversight mechanisms, channels for recourse are limited for bidders, and external oversight limited mainly to verifying compliance with the budgetary and financial approval process rather than any issues related to fairness or transparency. While a step in the right direction, proposed legislation deals narrowly with the bidding process, not procurement overall. Countries with sound procurement systems typically have a comprehensive and consistent framework of procurement laws, regulations, and implementation directives, including standardized bidding documents, to assure a uniformly transparent and competitive procurement process in spending agencies. These countries also establish an independent national public procurement regulatory entity to develop public procurement policy and related reforms, to guide and oversee consistent applications of procurement regulations by spending agencies, and to assure appropriate training of staff involved in public procurement. Indeed, sound financial management requires the development of strong human resource capacity with requisite procurement knowledge and skills. This is especially important where procurement is highly decentralized and where the environment is becoming more complicated and competitive, as procurement from the private sector, both national and international, increases with more privatization and openness.

39. ***Relatively weak financial reporting***. In Iran, although there is monthly reconciliation between spending, the budget and bank statements at the level of the spending entities by the FCs (and eventually the SAC), there are no consolidated monthly fiscal reports to central agencies, the Central Bank, the Parliament or the public. In addition, there is no published comprehensive semi-annual report on budget implementation, although Parliament can request such information on an *ad hoc* basis. Further, there is insufficient reconciliation of MEAF and Central Bank data. Finally, certified accounts are submitted to Parliament with a lag that may reach up to three years, compared to an international norm of about twelve months. As a result, budget formulation and approval in Iran does not benefit from information on budget execution in the current year.

40. ***Fragmented financial management information system***. Each spending unit maintains its own cash-based accounts and submits them monthly to the MEAF. In turn, the MEAF must then enter the data into its own system. There is no unified, real-time computerized financial management information system and no unified government

accounting reporting except through *ex post* manual consolidation of the accounts of spending units. The fact that there are so many spending units, so many separate bank accounts, and so many separate information systems make real-time, centralized accounting, reporting and consolidation difficult other than at the agency level. The high degree of budget deconcentration renders the absence of a computerized FMIS system even more costly. In light of this, the government budget reform program envisages the development of such a system in the coming years.

41. ***Comprehensive, independent, public external audit structure, but limited to fiduciary compliance.*** The SAC, reporting directly to Parliament and the public, assures comprehensive external fiduciary oversight of all the funds allocated through the national budget in principle. However, its oversight is limited to ensuring that the individuals who are vested or involved with the receipt, payment and custody of the public funds comply with government regulations on public expenditure. The SAC does not conduct systems-based audits and thus makes no recommendations about systemic weaknesses in the overall control environment. In the past, budget liquidation reports by SAC to Parliament have lagged by at least three years. This lag has recently been reduced to one year. However, there is little information suggesting Parliament uses these reports in its budget oversight role. There is no equivalent external oversight mechanism focusing on actual performance of spending agencies. In addition, the internal but relatively autonomous Audit Organization audits SOEs and banks annually (and reports to all concerned agencies on time). A separate audit agency under the Supreme Leader, audits the spending of the Supreme Leader and the bonyads, but these reports are not made public.

How is the Iranian budget system evolving?

42. ***Budget reform is an agreed priority***. Beginning with the Third Five-Year Plan, adopted in 2000 under the strong leadership of MPO, there is wide acceptance of the view that Iran must manage its public resources more effectively. This is, driven primarily by the challenge to increase the competitive foundation of the Iranian economy. Consequently, the government has launched a budget modernization reform program that aims to enhance accountability for performance, starting with changes in budget presentation and formulation to increase comprehensiveness, transparency, and clarity, and continuing with future efforts to progressively introduce better expenditure management and the key elements of a performance based budgeting system inspired by the most modern management methods. The classification of both revenues and expenditures now conforms to GFS standards, which improves the readability and analytical content of the massive budget document. Revenues and expenditures that were previously implicit are being made increasingly transparent and explicit in the budget, including foreign exchange subsidies and, to some extent, oil revenues and subsidies. There are initial efforts to introduce activity-based costing to strengthen the basis for budget formulation, for all ministries and agencies for the budget that is being formulated for the coming year.

What are the limitations of this report?

43. ***Partial treatment of some public expenditure management issues.*** Although the focus of this report is on expenditure management systems, the mission was unable to explore all issues in equal depth. In particular, revenue policy in general and tax policies and systems in particular are not covered. There is no analysis of the government's personnel management and payroll system. There is little discussion of debt management systems, and there is a relatively limited review of human resource issues within the public expenditure management system itself. Finally, there is limited understanding and discussion of efficiency and effectiveness in the delivery of key public services such as health and education and of the management systems and organizational arrangements in the agencies that are responsible for these programs.

44. ***Limited attention to expenditure policy***. This review does not purport to analyze Iran's public expenditure policies, although it does provide key facts about the size, content, and trends in revenue and spending. Other Bank reports, including the recent Country Economic Memorandum (CEM), the Poverty Assessment, the Financial Sector Assessment Paper (FSAP), and a review of the housing sector, provide some additional information and analysis on public expenditure policies.[8]

45. ***Substantial information available, but relatively limited interaction with operational staff***. For the most part, the Iranian authorities were highly cooperative with the Bank team, and they shared an impressive array of publicly available Iranian documents on budget management and content. Nonetheless, this review remains based on a relatively limited set of meetings with key officials and on relatively limited translations of written material, most of which is available only in Farsi. As a first step, the team focused on comprehending the system as it is supposed to work. Unfortunately, there is limited information on deviations from the formal system in practice, and it is often difficult to access. Therefore, there were few opportunities at this stage to discuss the actual application of policies and systems with those in charge of day-to-day activities, such as accountants and line agency managers and personnel.

What are the next steps?

46. ***Priority given to understanding, not recommending.*** Accordingly, the report stops short of recommending additional or different reforms or action programs, pending further collaborative work within the agreed multiyear program. This report presents a baseline of understanding, bolstered by selected analytical and comparative diagnoses, on which the Bank can begin to tailor its work with Iran in the area of public financial management. The main chapters of the report thus summarize the size, structure, and functioning of the Iranian budget system. The final chapter contains a framework for assessing public financial risk in Iran, which summarizes the salient risk characteristics of

[8]Iran – Medium Term Framework for Transition – Converting Oil Wealth to Development, World Bank, April 2003; Poverty in Iran – Trends and Structure, 1986-1998, World Bank, 2003; Financial Sector Assessment Program, FSAP, Vol. II, Main report, Iran, World Bank and IMF, July 2000; Iran Housing Sector Strategy, sector note, World Bank, June 2002.

the Iranian system and efforts to attenuate them. This framework could provide an agenda for future discussions on follow-up work.

47. ***The value of deepening the risk assessment***. A risk assessment framework, based on the major processes of budget formulation and execution, is one way of assessing ongoing or needed reforms. The key areas for a risk assessment include the overall legal framework, budget formulation (strategic priority setting, realism, comprehensiveness, classification, and approval), budget execution (revenue forecasting and implementation, cash and treasury management, expenditure management, procurement, internal controls and audit, and financial reporting and reconciliation), external oversight and transparency (external audits, parliamentary oversight, public disclosure and debate), and budgetary impact (performance assessment). Most of the key risks are endogenous to the system itself. While the mission did not formally assess risks, it did seek to highlight areas in the Iranian system that contribute to and mitigate risks in the use of public funds and to recognize where aspects of its reform program might provide tools to better manage many of these risks. The government is cognizant of these risks in many, if not all, areas. Many of its reform efforts respond to risks, but it has not carried out a comprehensive risk assessment.

48. ***Defining a multiyear work program for public expenditure analysis and support***. The Bank and Iran have decided to implement a multiyear framework of collaborative work on public expenditure management to help support the government's own budget reform program. In terms of substance, the follow-up work may cover a broad range of public expenditure management and policy issues, although there is likely to be a focus on public procurement, internal and external auditing, multi-annual and performance-oriented budget formulation and execution, and monitoring and evaluation. In terms of process, the implementation will focus particularly on building a trusted working relationship between the Bank and Iran. This will include a range of specific activities that are being finalized. They are likely to include the following:

- Formulation of a public expenditure and analysis support strategy to guide the World Bank county assistance strategy in this area over the next few years,
- Creation of a joint World Bank–Iran working group on public financial management to guide and manage our assistance in this area,
- Joint formulation of a more detailed multiyear capacity building, training, and knowledge sharing program,
- Conduct of several capacity strengthening workshops and courses on a range of public financial management topics, notably monitoring and evaluation, activity based costing, risk assessments, and related topics,
- Joint preparation of selected analytical notes exploring issues of mutual interest in this area, especially in the range of areas dealing with risk management, and,
- Provision of focused advice on specific topics to Iran on a "demand" basis.

CHAPTER I: MACROECONOMIC AND FISCAL DEVELOPMENTS SINCE THE REVOLUTION

Overview

1.1 The Islamic Republic of Iran is a country with a population of 67 million (2004) and a GNI per capita of $2,300 which, while higher than the regional average of $2,000 places Iran among lower middle-income countries. Poverty has declined in Iran, with 20.9 percent of the population living below the poverty line in 1998 compared to 27.3 percent in 1986[1], and social indicators are on the rise. Iran has the third largest oil reserves in the world and the second highest gas reserves[2]. The gross export value of oil and gas account for 80 percent of Iran's exports, which is just under 20 percent of GDP. The service sector constitutes 48 percent of GDP, while industry (including oil) and agriculture account for 41 and 11 percent respectively. Although Iran's GDP growth rate is around 6 percent, its real GDP per capita is growing at around 5 percent. Gross domestic investment is around 37 percent of GDP, while gross domestic savings is around 37 percent of GDP and total debt is 8.2 percent of GDP.

Macroeconomic Developments in Iran (1970 – 2004)

1.2 After the turbulence of the Islamic Revolution in 1979 and the Iran-Iraq War between 1980 and 1989, economic activity began to recover gradually in the 1990s (see Chart 1.3). It has only now reached the level of the mid-1970s. In particular, real GDP caught up with the GDP just before the Revolution, in 1991 after the war with Iraq (1980-89), and in the middle of the First Five-Year Plan. Since then, real GDP growth has been higher. In the 1990s, growth rose to almost 5 percent from near zero in the 1980s. However, in the last three years, growth increased to 6 percent on average.

The Islamic Revolution and the Iran-Iraq War

1.3 The uncertainties of Revolution initiated a decline in real GDP, while the war with Iraq exacerbated it. Although the importance of the oil sector had begun to recede in the mid-1970s, oil production declined sharply from 1977 to 1981. The steepest reduction occurred during 1980-81 at the start of the war with Iraq. By 1981, the oil sector's contribution to GDP had fallen to less to less than 10 percent, from around 50 percent in the early 1970s. In addition, the non-oil sector suffered during this time period, with the steepest decline being towards the end of the war.

The Plan Period

1.4 In the 1990s, the Iranian government initiated reforms within framework of five-year development plans in order to spur economic activity. These development plans

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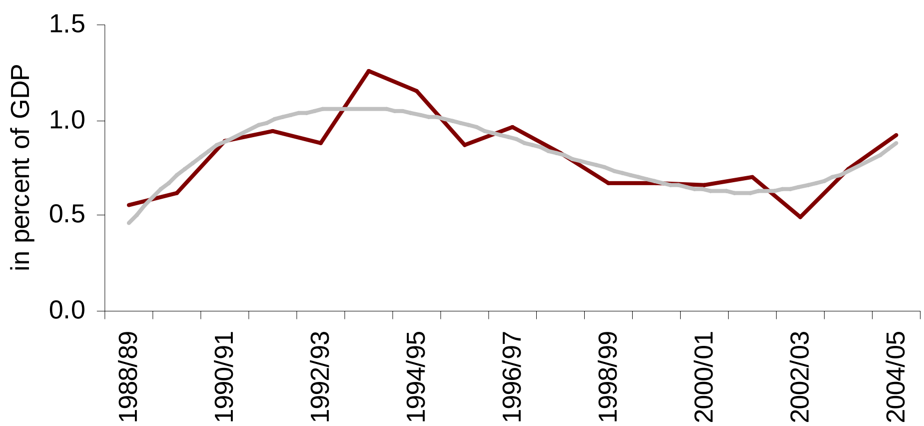
[1] Poverty in Iran, Trends and Structures, 1986-1998. World Bank, 2003.
[2] Iran's oil reserves are next only to those of Saudi Arabia and Iraq, and its natural gas are next to those of Russia.

established a relatively coherent framework based on consensus among ministries and Parliament on key economic issues.

The First Five-Year Plan Period: 1989-1994

1.5 The First Five-Year Plan (1989/90–1994/95) focused on growth mainly as a response to low per capita incomes and a fall in living standards that had resulted from weak economic performance due to the war and high population growth[3]. Reforms focused on measures that would rejuvenate the private sector, including a gradual elimination of multiple exchange rates, the removal of non-tariff barriers, decontrolling domestic prices, eliminating bank credit ceilings, and privatization. The Plan also attempted to reach higher growth rates via expansionary public investment programs[4] focused mainly on infrastructure (see Chart 1.1). These programs were financed by Central Bank deficit financing and short-term external borrowing. The boom in oil exports, as a result of Iraq's invasion of Kuwait in 1991, also led to a revision of the Plan targets in a move towards achieving ambitious growth rates and expanding new projects. However, this could not be sustained[5]. The increase in expenditures resulted in large fiscal deficits, which by 1993-94 had reached 7.2 percent of GDP (see figure 8 in Chart 1.3). Due partly to these policies, the exchange rate appreciated and interest rates turned significantly negative. Initially, growth and employment picked up, but soon stalled.

Chart 1.1: Infrastructure Investment[6]

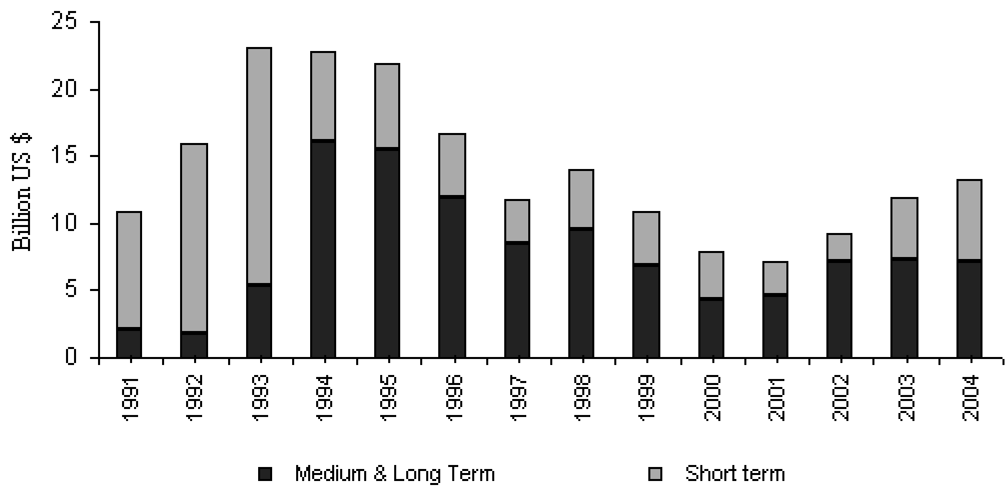


Source: Management and Plan Organization, Iran, Islamic Republic and Annual Budgets

[3] Growth rates during the first 10 years of the revolution, while fluctuating, were mainly negative, averaging –1.5 percent. GDP at market prices fell from 13,255 billion rials in 1977/78, just before the Revolution, to 10,594 billion rials in 1988/1989.
[4] The ratio of total investment to GDP had declined sharply in the pre-Plan period.
[5] Many new investment projects were undertaken during the Plan, leading to excess capacity that could not be utilized. The public sector, for example, added 11,000 new hospital beds between 1989 to 1992, while occupancy rates of these hospital beds decreased from 248 days to 240 days per year. At the same time, the private sector 25,000 new hospital beds. The number of initiated projects exceeded planned targets, leading to delays and rising costs.
[6] This includes roads and transportation. There can be other definitions of infrastructure, including capital spending on water, which is on average 0.4 percent of GDP in Iran.

1.6 By the end of the First Plan period, inflation surged and Iran began to face serious balance of payments difficulties, including strained relations with external creditors. The current account deteriorated mainly due to a large growth in imports resulting from reconstruction and pent-up consumption demand that could not be met during the war years. After the surge in 1991, oil prices fell. External debt in 1993 reached 50 percent of GDP ($23 billion), with short-term debt making up 76 percent of this total (see Chart 1.2). In an effort to contain a default on foreign debt, the government reversed many of the reforms it had undertaken. Noteworthy among these reversals was the reintroduction of the system of multiple exchange rates and administratively allocated foreign exchange for imports.

Chart 1.2: Total External Debt Stock (1991-2004)
(Billion of U.S. Dollars)



Source: World Bank Data

The Second Five-Year Plan Period: 1995-1999

1.7 The Second Five-Year Plan (1995/96-1999/2000) aimed to reverse the macroeconomic imbalances created by the First Plan. The Plan focused on normalizing relations with external creditors, placing runaway external debt dynamics on a sustainable path, and curbing inflation. However, in an effort to control debt dynamics, Iran severely compressed its imports and, with soft oil prices, growth failed to pick up. Growth averaged 2.7 percent per year, falling short of projected rates of 5.1 percent per year, while inflation, which averaged at 26 percent per year during the Plan period, was more than double its targeted level. Economic and financial sanctions, including the Iran-Libya Sanction Act passed by the U.S. Congress in 1996, dampened business confidence, intensified downward pressures on the exchange rate (inducing a 50 percent depreciation in the market exchange rate), and sparked a run on consumption goods (causing inflation to spike at 50 percent). As the decade came to a close, the government implemented a number of sectoral reforms in the financial and external trade regimes but could not fully

implement all the reforms envisaged. As with the First Plan, the Second Plan saw some reversals after implementation had commenced.

The Third Five-Year Plan Period: 2000 - 2005

1.8 Under the current Third Five Year Plan, a broad reform program is envisaged and, unlike the Second Plan, specific measures that need to be undertaken to fulfill Plan objectives are laid out within the Plan. As will be discussed below, the main challenge facing planners has been the rising unemployment rate, which is estimated at around 11 percent in 2004. However, the macro framework is relatively stable in Iran compared to the past, while oil prices have recovered and are projected to continue at the current level.

1.9 In the first two years of the Plan, reforms, including unification of the exchange rate (March 2002) and the licensing of private banks, have laid the groundwork for further liberalization of the economy. In addition to adopting a managed floating exchange rate, corporate and personal income tax rates have been lowered and simplified, a national tax organization and a large taxpayer unit have been established, nontariff barriers have been reduced, licensing procedures have been streamlined to the extent that most import items need licensing only by the Ministry of Commerce for recording purposes, a draft law on VAT has been submitted to the Cabinet for approval, and a law on foreign investment providing incentives and protection to foreign investors has been ratified. The average annual growth rate of GDP during the first three years of the Third Plan (2000-2003) has been 5.2 percent. Inflation has followed a declining trend, but remains around 15 percent. External debt has been reduced, and international reserves have increased. Reflecting these positive developments, Iran successfully issued its first Eurobond since the Revolution in 2002.

The Oil Sector

1.10 The oil sector, which in the 1970s represented above 40 percent of GDP, shrank to 10 percent of GDP following the Revolution. Since then, the oil sector has recovered somewhat. Although its position in the economy has been eroded, the oil sector still contributes around 15 percent of GDP, approximately 50 percent of government revenues, and 70 percent of exports[7]. Increasingly, agriculture and services have emerged as the more vibrant sectors. Since 2002, when the exchange rate was unified, the exchange rate has appreciated in real terms. This is largely because Iran's inflation has been higher than that of its trading partners and has not been offset by nominal depreciation. In nominal terms, the exchange rate has depreciated since the beginning of 2002, belying the suspected effects of Dutch disease due to higher oil prices (see chart 1.4).

[7] For a more detailed discussion of oil and non-oil revenues, see chapter 3, paras 3.2-3.4

Chart 1.3 Iran: Macroeconomic Developments, 1970/71-2003/04.

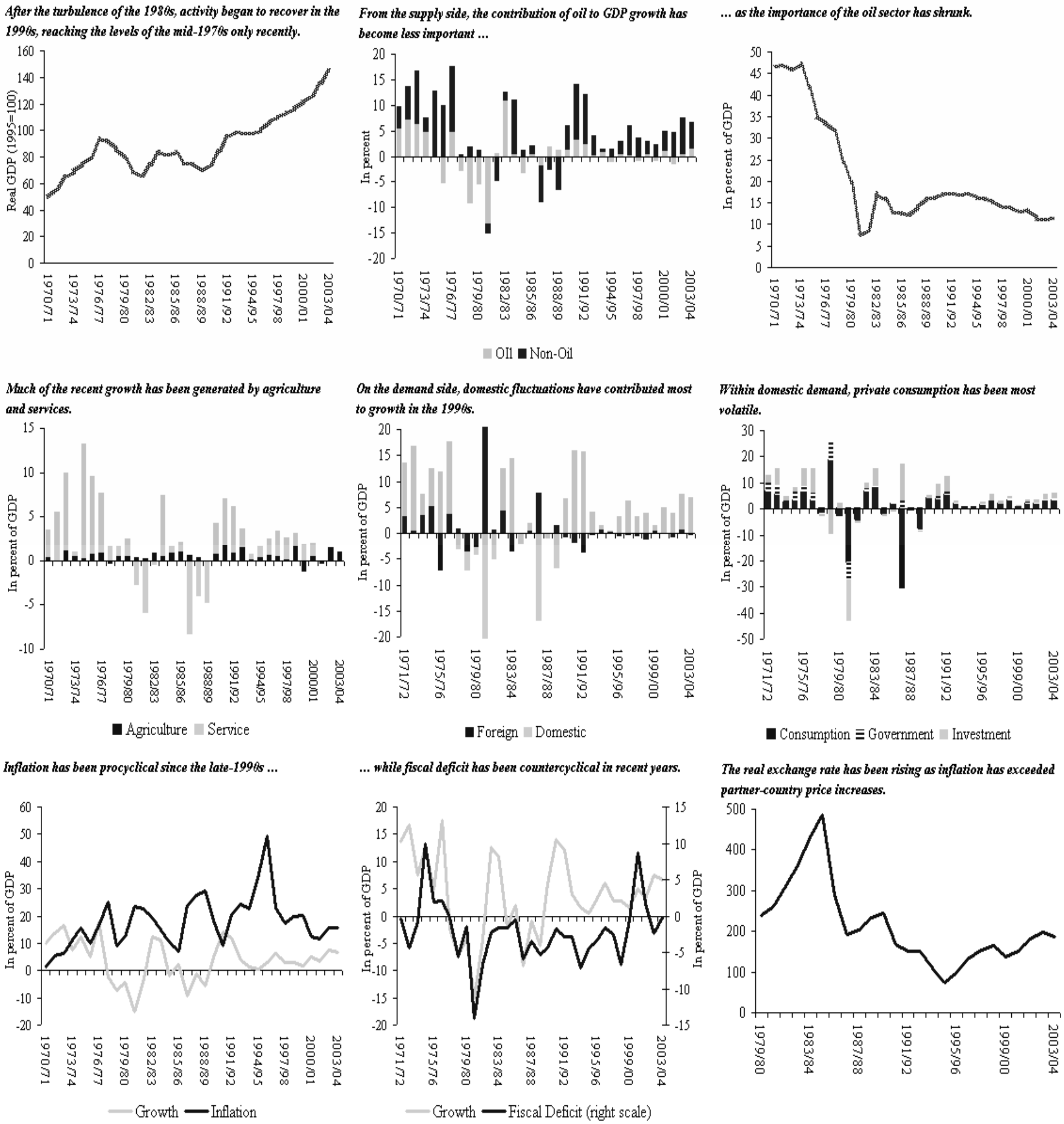
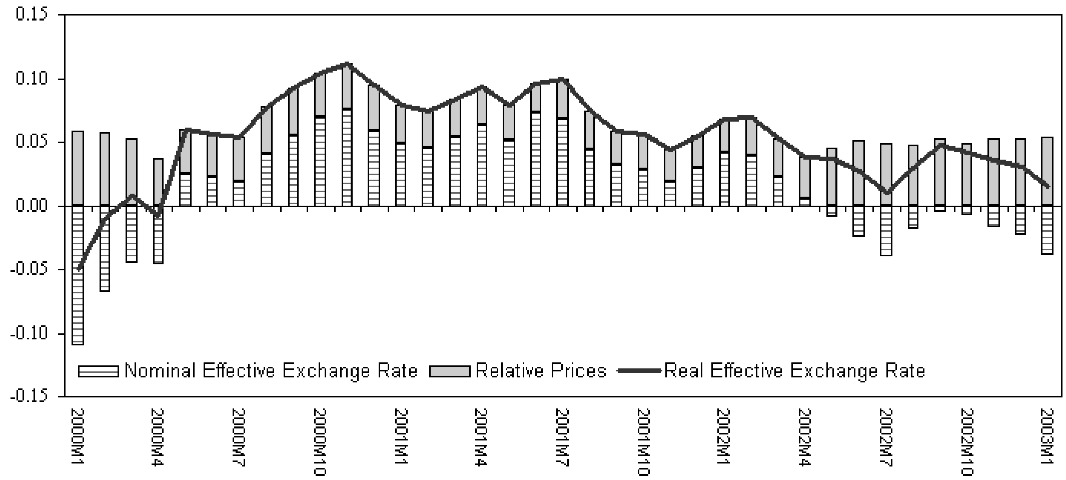


Chart 1.4: Exchange Rate Developments (2000-2003)



Source: The IMF

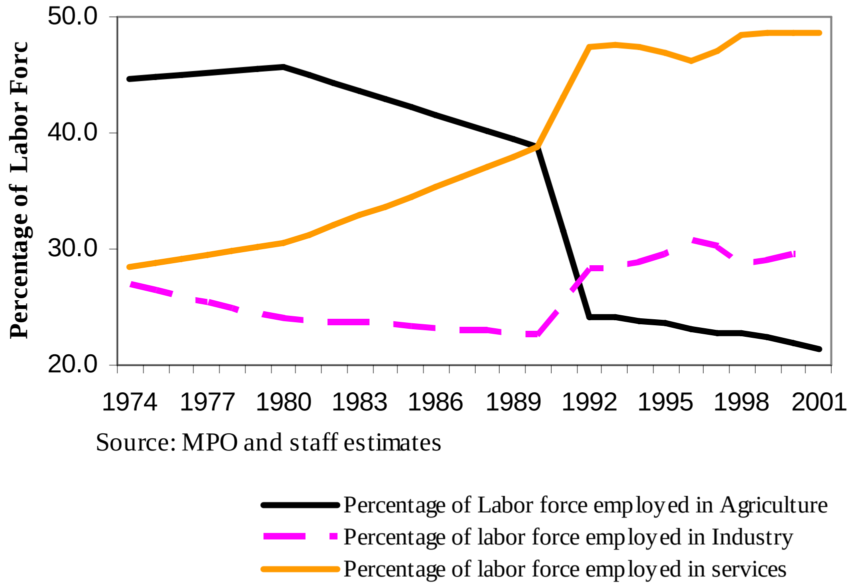
The Non-Oil Sector

1.11 Public sector dominance of the economy, together with the lack of a competitive business environment and remaining restrictive trade policies, reduce competitiveness in general. The public sector is protected (as will be discussed in Chapter 2) via subsidies and preferential treatment from the banking sector. This has encouraged monopolies and reduced competitiveness, while hampering the level playing field that would encourage the private sector. State-owned enterprises often receive transfers from the public budget and benefit from preferential procurement practices. Thus, they may not have sufficient incentives to operate efficiently. Non-oil exports account for 5 percent of GDP (2003) and grew by an average of 5.1 percent per year in the 1990s. This compares unfavorably to middle-income countries, where non-oil exports grew at 9.4 percent per year. The debt crisis compressed imports and caused the government to reverse policies. As a result, non-oil exports in 1997 fell to the level witnessed in the early 1990s. As a result of reforms and higher oil prices since 2000, non-oil exports have seen a recovery. There has been a marked change in the composition of Iranian exports, and non-oil exports have doubled their growth rate.

1.12 High unemployment is one of Iran's most pressing problems. Non-oil manufacturing, while the most natural sector to absorb Iran's growing labor force, has not expanded at a pace adequate enough to generate sufficient employment. While unemployment receded slightly in the first half of the 1990s, unemployment has again begun to increase due to weak job creation. At present, the unemployment rate is close to 11 percent despite a female participation rate of just 15 percent, one of the lowest in the MENA region.

Chart 1.5: Iran--Trends in Sectoral Employment (1974-2001)

Whereas agriculture employed the bulk of the labor force in 1974 - 45 percent - it now employs only 21 percent with the service sector increasing its share to 49 precent from 28 percent while the industrial sector's share has fluctuated .



Fiscal Developments

1.13 While the overall fiscal balance[8] has generally remained in deficit (see Chart 1.3[9]), there were some signs of improvement in the 1990s on the back of high oil prices and rising revenues, both oil and non-oil. During the First Plan, the fiscal deficit averaged around 4.4 percent of GDP, which improved during the Second Plan to 3.5 percent[10]. Beginning with 2002/03, there has been a tendency for the budget to be expansionary and spending has gone up. The budget deficit for the year 2004/05 is estimated to be 1.4 percent. The government's response to the pressing problem of high unemployment has been to effectively increase both current and capital expenditures. Capital spending in 2002/03 increased by 5.6 percent over the previous year in order to enable job creation projects to be completed expeditiously in sectors such as water, energy, agriculture, urban and rural development, industry, education and healthcare. Current expenditures increased by 13.2 percent in real terms, adding to the deficit.

[8] This discussion of the fiscal policy and revenues looks at the budget data over time. However, it should be noted that several subsidies were implicit in the budget until 2002. Including them affects the numbers we are looking at, as does the presence of a large number of off-budget expenditures. These will be discussed in detail in Chapter 2.

[9] Chart 1.3 is based on data provided by the Management and Planning Organization and staff estimates.

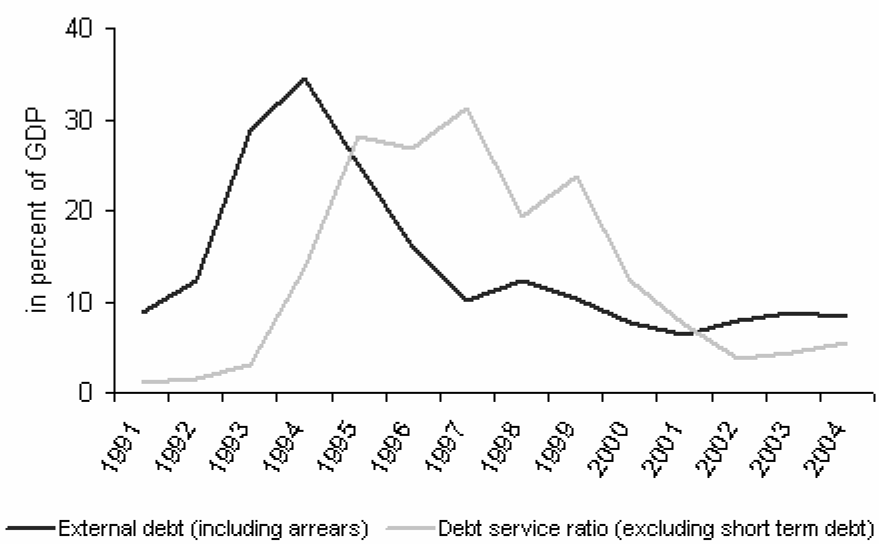
[10] This improvement in the fiscal deficit during the Second Plan took place in spite of the effect of low oil prices in 1998, which increased the fiscal deficit to 6.7 percent of GDP for that year.

Table 1.1: Fiscal Data in Percent of GDP (1992-2004)

	1992/93	1997/98	2001/02	2002/03	2003/04	2004/05 proj.
Expenditure	19.7	27.9	25.5	29.3	27.2	28.5
Revenue	18.5	25.4	27.3	26.9	27.0	27.0
Budget Balance	-1.2	-2.4	1.8	-2.4	-0.2	-1.4
Primary Balance	-1.2	-2.1	1.5	-		
External Debt	12.2	14.4	6.3	8.0	8.7	8.4

Source: IMF article IV and Budget Law

Chart 1.6: Iran Debt Ratio (1991-2004)



Source: World Bank Data

Medium Term Outlook

1.14 Under current projections, real GDP is expected to grow at 6 percent, and external debt is the lowest it has been (see Chart 1.6). A look at the macro indicators for the last two years and the current year indicate that, for the most part, Plan targets are being consistently met or exceeded (see Table 1.2). Employment, however, is a pressing problem. Measures to address it are being taken, including reforms aimed at encouraging private sector growth. Although growth projections appear to be robust, the distortionary effects of the high energy subsidy encourage capital intensive industries, which have low employment potential. Among other constraints to private sector growth are the continued protection of the dominant public sector[11], and firing restrictions regulated by the Labor Law. In addition the private sector is unable to penetrate the service sector even though it employs nearly 50 percent of the labor force (see Chart 1.5).

[11] This will be discussed in detail in chapter 2.

Table 1.2: Macro Economic Indicators[12] (1999-2003)
(in billion Rials)
Growth Rates in percentages

	1999/00	2000/01	Average Growth	Growth 2000/01		Growth 2001/02		Growth 2002/03		Growth 2003/04	
	Actual	Actual	1997/98-2000/01	3rd plan	Actual	3rd plan	Actual	3rd plan	Actual	3rd plan	Actual
GDP at factor cost	48915	51816	4.1	4.5	5.9	5.5	3.3	6.5	7.5	6.7	6.7
Agriculture	8091	8395	1.7	4.3	3.7	5.3	-2.3	4.9	11.4	5.5	5.3
Industry and minning	9823	10694	5.8	7.5	8.8	8.6	10.2	8.2	12.3	8.7	11.0
Construction and housing	2410	2620	4.9	8.7	8.7	9.8	4.9	9.6	17.4	10.1	—
Oil sector	3884	4261	2.1	-3.3	9.6	-3.6	-11.1	0.5	3.6	0.5	8.4
Services	27439	28818	4.6	6.1	5.0	7.2	5.7	6.4	5.5	6.9	4.8
Fixed capital formation	12739	13808	5.9	6.0	8.4	6.9	8.8	7.3	12.0	7.8	8.5
private sector	8556	9393	7.9	6.1	9.8	9.5	8.0	9.7	12.4	9.6	14.9
public sector	4183	4416	2.0	5.6	5.5	2.8	7.4	3.3	11.1	4.7	-5.2
Private sector consumption	29008	30216	4.8	3.3	4.2	3.4	3.4	3.5	7.8	3.6	10.6
Public sector consumption	5767	5827	1.8	6.1	1.1	-0.3	6.7	1.5	4.8	3.5	2.4
Government general revenue (current)	94572	107029	18.0	21.3	13.2	16.8	13.6	18.7	62.9	20.0	16.2
Budget deficit (current) billion rials	-640	-1287	…	-940	-1287	-1245	-616	-1490	-17195	-1850	-27478
Export of goods and services, $ million	18152	18414	15.5	1.4	34.4	5.9	—	8.1	8.5	—	2.8
Non oil export, $ million	3908	4119	…	17.2	5.4	29.8	-1.0	20.9	32.4	—	16.5
Import of goods and services, $ million	16990	19726	2.5	16.1	-3.7	-12.6	16.3	6.8	28.9	—	12.4
National liabilities, $ million	10357	7953	-13.1	21.5	-23.3	—	-9.3	—	28.0	—	31.0
Liduidity	192689	249111	22.9	20.8	29.3	18.0	—	15.7	30.1	14.2	26.1
Inflation rate (%)	20.1	12.6	—	19.9	12.6	17.4	12.0	15.3	15.8	14.0	15.6
Unemployment rate (%)	13.5	14.3	—	15.3	14.3	—	14.7	—	12.2	14-15	11.2

Source: Bank Markazi Jomhori Islami Iran and Management and Planning Organization: TFYDP projections

[12] Table from Macro Report of the Proposed Budget 1381 (2002/03) to the Budget Consolidation Committee prepared by MPO. GNP growth is based on an import forecast of 17 billion dollars. Inflation and investment growth rates were forecast using the Macro Bureau's model. Estimated actuals for 1380 are from the Central Bank. Plan forecast: MPO, Statistics Division.

CHAPTER II: THE STRUCTURE AND SIZE OF THE PUBLIC SECTOR

2.1 This chapter discusses the organizational features of the institutions that constitute the public sector, as well as its scope and size. It looks at the decision-making structure, with its dual centers of authority, focusing on the power of each over public funds. The role of the public sector and the institutions that assist in discharging this role are discussed. The Central Government's budget constitutes the most important part of the public sector. While the allocations in the budget shed considerable light on the activities of the public sector, the large number of implicit expenditures and the presence of a sizeable amount of quasi-fiscals and spending outside of the budget also need to be taken into account. Lastly, this chapter looks at SOEs as well as *bonyads*, which, although not directly part of the public sector, are important in the larger structure of the state.

Organizational Structure of the Public Sector

The Decision-Making Structure

2.2 Under the provisions of the post-1979 Constitution, the Government of The Islamic Republic of Iran is structured to have two sources of power: the executive, headed by an independently-elected President, and the Supreme Leader, who guides the country and has supreme religious and judicial power. The President prepares the budget and presents it to the Majlis[1], which approves and oversees the budget. The Supreme Leader, however, wields considerable economic power as well, since he controls several institutions and agencies including bonyads (foundations that themselves own hundreds of enterprises and industrial companies with significant market shares in major sectors of the economy). More importantly, the Constitution also gives the Supreme Leader the right to delineate general policies and supervise their implementation. In addition, the Guardian Council, which checks all legislation for compatibility with the Constitution and Islamic law, and the Expediency Council, which intervenes in the case of a dispute between the Majlis and the Guardian Council, are important actors in the decision-making process. While there are competing sources of power, institutional mechanisms and procedures have been set up to resolve disputes.

2.3 The highest authority in the country is the Supreme Leader, who exercises supreme political and religious power according to Article 5 of the Constitution. The Supreme Leader also oversees several institutions and agencies, which are not accountable to other branches of government, through his representatives. These include the bonyads (which are discussed in detail later) and agencies such as the Supreme Council of Cultural Revolution and the Islamic Propaganda Organization. The Supreme Leader's financing comes from private sources, including charitable institutions and

[1] *Majlis-e Shora-ye Islami*, or the Islamic Consultative Council, is the official name for the Iranian Parliament.

khoms[2]. The government budget does provide transfers to some committees under the Supreme Leader (such as the Committee of the Leader's Representatives in Universities) and to some bonyads. Although the President lacks a crucial veto power[3] over the budget, the relationship in general between the legislature and the executive branch is subject to constitutionally-provided, mutual checks and balances[4].

2.4 The Supreme Leader can influence all economic matters using the powers vested in him by the Constitution. Among these powers are:

- the prerogative to delineate the general policies of the country;
- the prerogative to supervise the proper execution of these policies;
- the power to issue decrees for national referenda; and,
- control over the Judiciary, the Guardian Council and the Expediency Council.

2.5 Next to the Supreme Leader, the President is the highest authority in the country. Among other responsibilities, the President signs and supervises the implementation of laws passed by the Majlis, as well as supervising the implementation of the budget and development plans ratified by the Majlis. The President heads the Cabinet, according to the Constitution, and appoints and dismisses ministers with the consent of the Majlis. The Cabinet consists of 22 ministers in charge of the various ministries. The Majlis has the power to impeach individual ministers and the Council of Ministers collectively as per Article 89 of the Constitution. The President's Office consists of the Secretariat, advisors, and deputies to the President. The President also has seven aides in charge of institutions administered by the President, including the Management and Planning Organization.

2.6 The legislature consists of the Islamic Consultative Assembly or Parliament (Majlis) and the Guardian Council of the Constitution. All legislation must first be approved by the Majlis[5] and then ratified by the Guardian Council according to Article 94 of the Constitution. The Majlis votes on the outlines of the budget after the details have been reviewed by the various committees (see Chapter 4 for a detailed discussion of

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[2] *Khoms* are religious alms like the *zakat* tax, and amount to 2.5 percent of certain items. Whereas zakat is an annual redistributive tax amounting to one-fourth of increase in assets, khoms are voluntary donations to a (Marja-e-Taqlid) religious leader by his followers.

[3] See Article 52 of the Iranian Constitution, which states that the annual budget of the country will be drawn up by the Government in the manner specified by law and submitted to the Parliament for discussion and approval. Any change in the figures contained in the budget will be in accordance with the procedure prescribed by law. Article 123, in addition, states that the President is obliged to sign legislation approved by the Assembly or that results from a referendum, after the legal procedures have been completed and it has been communicated to him. After signing, he must forward it to the responsible authorities for implementation.

[4] Article 75 of the Constitution, which requires that members' bills and proposals and amendments to government bills proposed by members that entail the reduction of the public income or the increase of public expenditure be introduced in the Majlis only if the means for compensating for the decrease in income or for meeting the new expenditure are also specified.

[5] Resolutions normally become laws when passed by a simple majority of those attending, unless otherwise required by law. Quorum is reached by attendance of two-thirds of the Members of Parliament. These rules change for emergency situations.

the budget process). The process is analogous to the one for all legislation whereby at the first reading of a bill (which has already been passed by the committee concerned), the bill's generalities are voted upon and, upon passage, are passed forwarded to the committees concerned for a review of the details[6]. Once the budget bill has been passed by the Majlis, it goes to the Guardian Council for ratification. Under the provisions of Article 69 of the Constitution, all deliberations of the Majlis must be open and a full report of these broadcast by radio and published verbatim by the Official Gazette.

2.7 The Guardian Council[7] checks all laws passed by the Majlis, including the budget law, for compatibility with Islamic law and the Constitution[8]. The Guardian Council's role is, in effect, like that of an upper house of Parliament that can vote out the lower house's resolution. In the case of a disagreement, the Majlis can send the relevant bill back to the Guardian Council for a second reading. The options open to the Majlis if it still disagrees are either to accept the ruling of the Guardian Council or refer it to the Expediency Council (see Box 2.1 on the resolution of the 1380 (2002/03) budget dispute).

2.8 The Expediency Council was first established on a temporary basis in February 1988 to resolve any disputes that arose between the Majlis and Guardian Council. Article 112 of the 1989 amended Constitution made the Expediency Council a permanent institution and added to its duties an advisory role to the Supreme Leader and the power to select the Supreme Leader. This structure has resulted in an economic policymaking and implementation environment whereby decisions reflect a dynamic flex of competing interests since, in practice, no institution wields absolute power.

[6] It is at this stage that members may propose their related amendments, which together with the details are either accepted or rejected. The concerned committee may also invite outside experts to take part in its proceedings and discussions. Bills then go on for a second reading in the House and MPs whose amendments have not been accepted in committee can put them forward to the whole House to be voted on. Once the bill has been passed in its second reading, it is forwarded to the Guardian Council for ratification.

[7] The Guardian Council itself has twelve members, six of whom are clerical Islamic jurists appointed by the Supreme Leader, with the power to rule on the compatibility of all legislation with Islamic principles via simple majority of these six. The other six are elected by the Majlis from among jurists whose candidature is put forward by the Supreme Judicial Council. Compatibility with the Constitution is decided by a majority of the whole Council.

[8] According to Articles 91 and 94 of the Constitution.

Box 2.1: The Parliament's Right to Scrutiny: The Ruling of the Supreme Leader

In June 2002, the Majlis decided to hold a debate on the need for enquiring into the performance of the IRIB. This was in response to a Member's request for an inquiry into whether the IRIB was complying with procedures for registering its purchases with the Ministry of Commerce. The Guardian Council intervened at this stage, pointing out that IRIB operated directly under the Office of the Supreme Leader and therefore could not be scrutinized, as per the ruling of the Expediency Council. Furthermore, the Guardian Council stated that this ruling could be revised only if the Supreme Leader provided his consent. Although several MPs argued that the Majlis had the right to hold an institution to which it allocated funds accountable, the debate was dropped from the agenda of the Majlis by the Speaker on procedural grounds. The Speaker pointed out that the relevant Majlis by-law (Article 198 of its procedures, passed in 1999) prohibited the Majlis from scrutinizing institutions under the Supreme Leader and that this ruling, as mentioned above, had been ratified by the Expediency Council.

The Speaker of the Majlis then forwarded a letter to the Supreme Leader, Ayatollah Seyed Ali Khameini, seeking his views on the revision of Article 198 and referring to the fact that the performance of several organizations, government offices and foundations under his purview had been reviewed in the past by auditing commissions appointed by the Majlis. Specifically, the Speaker pointed out that the IRIB and BMJ had been audited by commissions appointed by the Fourth Majlis and the result of these audits had been made public. He requested the Supreme Leader to permit the Majlis to revise Article 198 of its own Internal Affairs Code, so that its constitutional right to survey into "every national affair" would be duly guaranteed, in particular the right of the Majlis to audit the performance of foundations that are run under the Supreme Leader's direct supervision.

The Supreme Leader replied that the auditing right of the Majlis "in every national affair" was among the most appropriate methods of ensuring the sound performance of the country's national institutes. He stressed that the existence of such an article in the country's Constitution was one of its strengths and that the IRIB would benefit from this oversight. The Supreme Leader then authorized the Expediency Council's revision of its own ratification and permitted the Guardian Council to revise the law entrusting the right to probe with the Supreme Leader.

In July, the Expediency Council agreed to revise the code prohibiting the Parliament from scrutinizing organizations under the Supreme Leader and set up a special commission to study the case on which it based its recommendations. Thus, the power of the Majlis to scrutinize the affairs of all organizations receiving government funds was ensured.

The Public Sector

2.9 The scope of the public sector expanded following the Islamic Revolution in 1979. This increase was due to a restructuring of the public sector meant to fulfil the objectives of the Revolution and the difficult economic conditions resulting from the war with Iraq from 1980 to 1988. With monopoly rights over oil production and distribution, significant financial resources are controlled by the Iranian state, over and above the constitutional powers provided by Articles 44 and 45 of the Constitution. Given the redistributive nature of the state as enshrined in the Constitution, these resources are distributed to the population in the form of direct and indirect subsidies as well as by the creation of new economic activities. Despite some economic liberalization during 1993/94, including a removal of price controls imposed during the war, the public sector in Iran continues to dominate the economy. The first real attempts at reforming the public sector began with the Third Five-Year Plan (1999-2004). Most of these reforms

focus on increasing transparency and improving the functioning of the public sector. Some attempts have been made to rationalize its size and limit its role in the economy.

Role of the Public Sector

2.10 The role of the public sector is defined in Articles 44, 45 and 43 of the Constitution of The Islamic Republic of Iran[9].

- Article 44 of the Constitution states that "the economic system of the Islamic Republic is based on public, cooperative and private sectors, with proper and regulated planning." It then defines the public sector to include "all large-scale industries, mother industries, foreign trade, large mines, banking, insurance, provision of power, dams and large irrigation channels, radio and television, post, telegraph and telephone, aviation, shipping, roads, railways and the like, which are public ownership and at the disposal of the government". The cooperative sector is defined as one that "includes cooperative production and distribution companies and institutions established in cities and villages on the basis of Islamic principles" while the private sector includes "that part of agriculture, animal husbandry, industry, trade and services which complements public and cooperative economic activities". Thus, the private sector is given only a residual role in the economy. However, article 44 has recently been reinterpreted by the Parliament in response to a directive from the Supreme Leader. With the exception of downstream oil and gas industries all other areas of the economy including banking, insurance, export, energy, transportation and telecom are open to both the private and cooperative sectors.
- Article 45 of the Constitution reinforces the primacy of the public sector by explicitly stating that "public wealth such as barren or deserted lands, mines, passes, woods, reed beds, natural groves, unbounded pastures, legacy without heirs, property whose owner is unknown and public property taken from usurpers is at the disposal of the Islamic Government to be dispensed with according to public interests." It also states that the details and the manner of utilization of each one of them will be determined by law."
- In addition, Article 43 of the Constitution, with its delineation of the objectives of economic activity, influences the role that the Iranian state envisages for itself. It defines the basis for the economy as one that includes the satisfaction of basic needs for all. Basic needs, as laid out in this article, include housing, nutrition, clothing, health, medical treatment, education, and necessary conditions for the setting up of a family[10]. In addition, this section of the Constitution also proposes

[9] Adopted in 1979 and subsequently amended in 1989.

[10] Article 36 of the Third Five-Year Plan clarifies this further, stating: "In implementing Principle Twenty-Nine of the Constitution and in order to promote social justice, the System of Social Security, with the goal of supporting different classes of society against economic, social and natural events, and its byproducts from the point of view of retirement, unemployment, age, disabilities, being without a caretaker, wayfarer, physical, mental and emotional disabilities resulting from accidents and acts of nature, and the need for health and medical care services and medical attention in the form of insurance and the like (support and relief), is a public right, and the Government is authorized, based on regulations, to secure the above

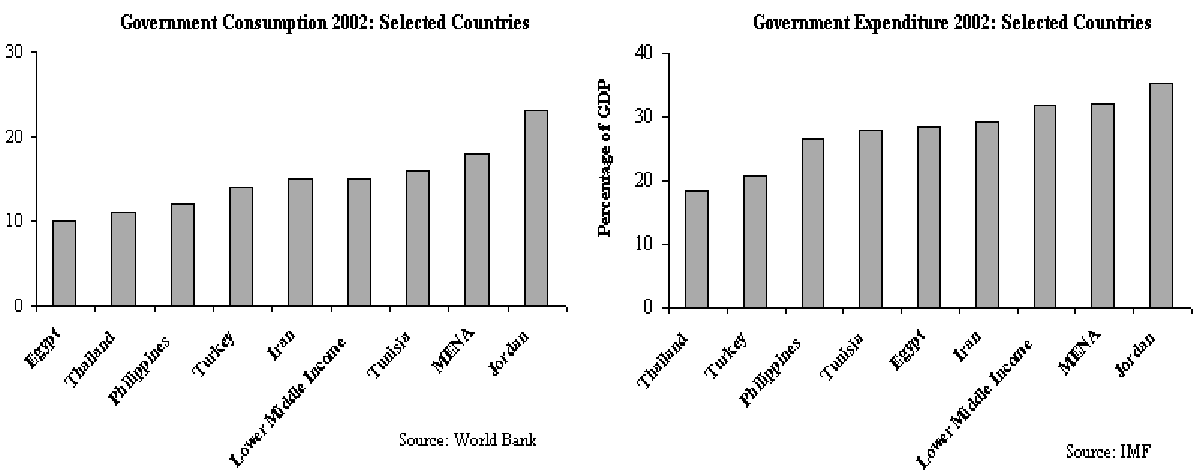
the creation of work conditions and opportunities for all for the purpose of achieving full employment or providing opportunities for work[11].

Coverage and Size of the Public Sector

Central Government

2.11 The explicit size of the central government is comparable to other developing countries with similar income levels. Total budgeted expenditures in 2000, in percent of GDP, were the same as those of Egypt, a country of similar income level and size in the region and higher than those of Thailand and Turkey, two countries at the same level of income and size outside the region (see chart 2.1). Government consumption levels were also lower than in Jordan and Tunisia, the two other countries in the region that we used as comparators.

Chart 2.1: Government Consumption and Expenditures: Selected Countries, 2000



2.12 However, the effective size of the public sector is difficult to estimate precisely. Apart from the Central Government's budget, various implicit revenues and subsidies, extra-budgetary funds, quasi-fiscal activities, contingent liabilities of the Central Government[12] and alternative service delivery institutions make up the larger public sector. Information on these activities is difficult to come by.

services and financial supports for each single member of the country from the source of public revenues and revenues acquired by the participation of people."

[11] Directives in the budget to provide banking facilities to the private and cooperative sectors is done partially with a view toward creating employment opportunities.

[12] Ideally, the costs of tax expenditures need to be included in the size of central government as well, but many countries, including Iran, do not calculate or present this information. Income tax exemptions for the police and the military, customs tax exemptions for some sectors or, as in the case of Iran, for income earned from agricultural, husbandry, forestry, low and medium cost housing, exports of finished industrial goods and agricultural products are some examples of tax expenditures.

2.13 The budget covers a major share of the expenditure and revenues of the Central Government only, including transfers made to entities such as state-owned enterprises (SOEs), pension funds and bonyads,[13] all of which fall outside the purview of the Central Government. General government includes the entire central government plus the pension funds and municipalities. The public sector includes the general government plus the SOEs and banks.

2.14 Central government budget expenditures stabilized at around 24 percent of GDP by the end of the 1990s. Several implicit subsidies and revenues, however, were not included in the budget until 2002/03. Current reforms aimed at increasing transparency of the system include making these implicit subsidies explicit over time. As table 2.1 indicates, the estimated size of the central government increases to 42 percent of GDP if the implicit revenues and subsidies and major quasi-fiscal activities are taken into account. In addition, quasi-fiscal activities typically involve implicit interest rate subsidies to public sector borrowers, achieved by imposing controls on banks and other financial institutions to hold down interest rates, rather than through explicit or implicit government spending.

Table 2.1: Implicit Central Government Budget
(Averages over 1991-2000, in percent of GDP)[14]

	Budget	**Adjusted**
Total Revenue	**23.5**	**42.4**
Oil and gas	13.4	34.7
Tax and non-tax	10.1	7.7
Total Expenditure	**23.7**	**42.4**
Budgeted Expenditures	23.7	18.0[15]
Off-budget Expenditures		24.4
-Implicit Energy Subsidy		11.1
-Exchange rate and other Subsidies[16]		13.3

Source: Iranian authorities and staff estimates

13 Bonyads are non- governmental public organizations or foundations created after the Islamic Revolution. In 1979 at the same time that the Provisional Revolutionary Government nationalized banks, insurance companies and manufacturing enterprises, the Revolutionary Islamic Courts confiscated the assets of those who had left. These were consolidated into bonyads under the oversight of the Supreme Leader.

14 Iran, Country Economic Memorandum, World Bank 2003. The table excludes the major extra-budgetary funds, including the share of oil revenues accruing to the Oil Stabilization Fund set up in 2000 and the contributions to and distributions from the Social Security Fund. The methodology of deriving these estimates is described in the CEM.

15 The valuation of the implicit subsidies is based on computing domestic oil at market prices. While this increases off-budget expenditures, GDP is also raised. Consequently, budgeted expenditures and tax revenues fall as a percent of GDP.

16 Other subsidies consist of mainly the exchange rate subsidy.

2.15 The main implicit subsidies that were not taken into account in the 2002/2003 budget and constitute the better part of off-budget spending are the following:

- *Exchange rate subsidies provided to imports of essential items*. Until 2002/03 foreign exchange was allocated for the import of selected items at about 20 percent of the market exchange rate (1750 Rials per dollar relative to the open market rate of 8000 Rials per dollar). Among the selected items were imports of cereal and food items, pharmaceuticals, military equipment, fertilizer and certain capital equipment. Exchange rate subsidies constitute the bulk of "other implicit subsidies", which total 13 percent of GDP.

- *Fuel subsidies, financed by selling crude oil to domestic users at a price that is considerably lower than the border price that foreign buyers would be willing to pay*. The energy subsidy, whereby almost no proceeds from the domestic sale of fuel accrues to the budget as a result of the selling price of fuel covering only the operating costs[17] of the SOEs in this sector, is equivalent to around 11 percent of GDP[18].

2.16 As part of reforms that are being undertaken currently, the exchange rate has now been unified and the subsidy provided on exchange rate transactions removed. However, for open letters of credit that pre-date the unification of the exchange rate, the commitments are being honoured by the government. The exchange rate subsidy will continue to be shown as an explicit item in the budget until these commitments expire. Fuel subsidies too are being gradually made more explicit.

Types of Public Entities

Executive Agencies

2.17 In the budget itself, the main center of attention is what is called an executive agency (*dastgah*). Although executive agencies are not all in the same category and can include such diverse entities as ministries, institutions, foundations, non-profit organizations, municipalities or even libraries, the nomenclature used in the budget to describe them is the same. Some executive agencies are fully funded; some are partially funded through the budget and can use their own revenues or charge user fees as the case maybe. Regardless of the significance of the amount transferred to the executive agency, as long as they receive a positive amount from the budget, they are mentioned in it. The budget for the year 1381 contains 91 organs or entities and one miscellaneous category. Each managerial body type is subject to a different governance regime and hence to different budgetary, financial management, and employment regulations, which will be discussed in Chapter 4. Table two of the budget bill shows the allocation of central government General Budget Expenditure to 91 executive agencies, a line item for the

[17] Including a modest replacement cost.
[18] The implicit energy subsidy is calculated by using market prices based on the average international price of oil that prevailed in the 1990s.

ownership of capital assets for the provinces, and miscellaneous line items, as shown in table 5.1. A significant share of expenditures (13 percent) is classified under the broad category of miscellaneous. Table 2.2 sheds light on the organizational units in the budget.

Table 2.2: Budget Coverage

Level and Type of Spending Entity	Financing from the Central Government Budget	Other financing
1. Supreme Leader and affiliated organizations of which Bonyads		1. The office of the Supreme Leader, and all its affiliated Organizations, 2. The Judiciary and all its affiliated organizations
2. Legislative and similar organizations	1. The Constitutional Assembly, 2. The Legislative, 2. The Council of Guardians, 3. The Expediency Council 4. The SAC	
3. Executive Agencies	1. Executive Agencies, including affiliated government organizations. 2. Government-owned companies and Bonyads included in the Government General Expenditure	
4. Other public organizations	1. Public companies, for-profit organizations affiliated to the government, and the banks, all shown as a separate classification (Art.4, PAL -87).	1. Public non-governmental organizations, Bonyads and other entities (Subject of Art.5,PAL-87)

Ministries

2.18 At the core of the various organizational units that constitute the central government are the ministries. There are different types of organs or entities under each ministry. Some of these are directly under the ministries, while others are supervised by the ministries or are nominally controlled by them. These include departments, public institutes, SOEs, for-profit organizations, state banks, social security organizations and extra-budgetary funds[19].

2.19 Two separate central agencies manage the budget process: the Management and Planning Organization (MPO) and the Ministry of Economic Affairs and Finance (MEAF). The MPO was formed by the merger of two key organizations, the Plan and Budget Organization and the State Organization for Administrative and Employment Affairs. It is responsible for planning, budget formulation, monitoring and evaluation,

[19] Since the Constitution decrees that the President and his Cabinet ministers collectively and individually are held accountable to the Majlis, all other government organizations must be affiliated with one of the ministries or the Office of the President, unless they are under the Supreme Leader.

and personnel regulations, and is attached to the Presidency. The MEAF is responsible for budget execution, treasury functions and tax collection[20].

Departments

2.20 Departments are the principal executive divisions of ministries. They have three different sources of revenue: a specific allocation from the general budget; allocation of credits from unallocated funds via the budget notes; and a portion of their user fees referred to as earmarked funds in the budget. All of these are outlined in the budget document. The allocation and spending of departments are subject to the general budgetary regulations, while their accounts are controlled by the MEAF and audited by the SAC. While the MPO approves all new employment for any department, senior executives are approved by the Parliament. Wages and salaries of all department employees are subject to the uniform rules of remunerations to government employees.

Provincial Administration

2.21 In effect, provinces receive block grants from the central government's general budget, which includes revenues from taxes allocated to them (but collected by the central government) as well as funds from general government resources[21]. The grant is proportional to tax revenues raised in that province combined with a ratio (known as the deprivation index) inversely proportional to their level of development. These funds are allocated to the departments of the central government present in the provinces. These provincial unit budgets are included in the general budget, while an annex to the general budget provides the detailed breakdown of allocations to each department of the central government present in the provinces. Provincial governments are in charge of departments that are largely responsive to central government ministries but operate in a deconcentrated framework. In each province, there is a planning and development council that allocates the approved capital budget to different projects and that, beginning in 2003/04, is responsible for allocating all expenditures to the various provincial units of central ministerial departments. Provincial spending is subject to the same regulations as that of departments.

[20] The organization charts of the MPO and MEAF are presented in Annex 1.
[21] Of the total 45 trillion rial budget for provinces in 2002/03 (of which 18 is their own revenue), 9 trillion rial is for capital development and the remainder is for current expenditure.

Chart 2.2: Organization of the Public Sector

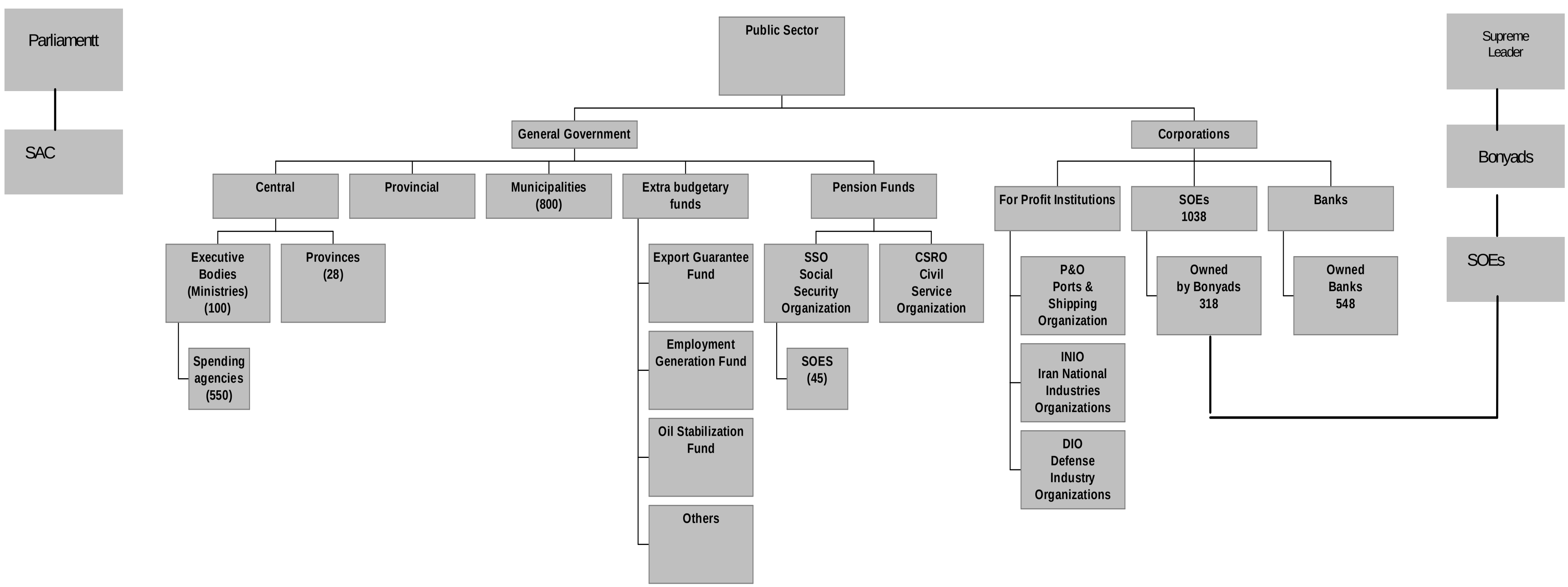
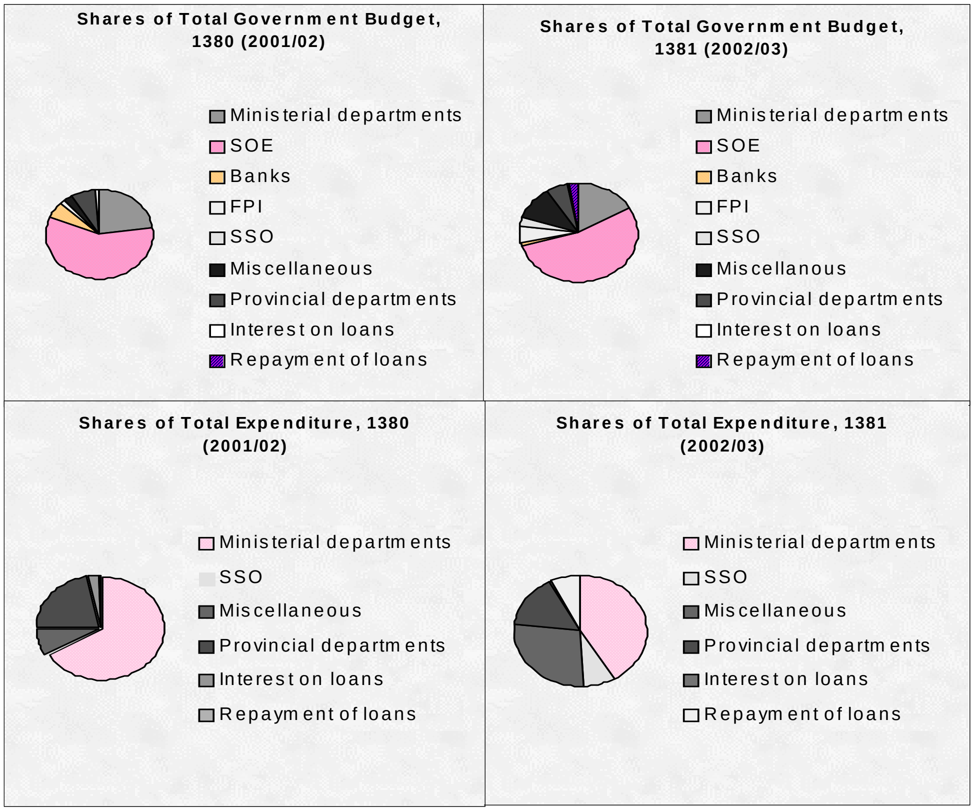


Chart 2.3: Share of expenditures and budget to different entities



Source: Budget law 1380 and 1381
Figures for 1381 are approved and 1380 are the actuals[22].

Public Institutes

2.22 Public institutes are semi-independent bodies affiliated with ministries that have been established to fulfill a specific purpose. Although they are financed mainly by their own revenues and have a special line in the budget, they are subject to the same budgetary regulations as departments[23]. However, they have more flexibility in regard to personnel management and pay scale[24]. Transfers to public institutes from the budget were to the tune of 5.8% of total expenditures in 2002/03.

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[22] Miscellaneous expenditure increased in 1381, due in part to making the exchange rate subsidy explicit and including this in the category of miscellaneous expenditure. See chapter 4, para 4.38 for a description of what is included in the category of miscellaneous expenditures. Approximately 98 percent of the approved expenditure for the SSO in 1381 is from earmarked revenues that provide social insurance to workers. The share of ministerial department expenditure to total general public expenditure was reduced by about 40 percent in 1381.

[23] The process followed involves transferring the revenues of the public institute to the Treasury and applying the same budget regulations that are mandated for the general revenues. They are also subject to same procurement rules as departments.

[24] While this flexibility in pay scale and management practices allows the institutes to attract and retain high quality staff, it also allows for institutes to be used as conduits for providing second jobs for those who cannot be awarded jobs effectively via the standardized structure followed by departments.

State Owned Enterprises

2.23 In Iran, state-owned enterprises are companies with a minimum of 50 percent of their shares belonging to the Government[25]. These SOEs send their budget to a General Assembly chaired by their parent minister. The technical, financial and economic evaluation of SOE programs and projects are discussed in this General Assembly. The Audit Organization attached to the MEAF audits SOEs. In addition, SOE operations funded by the budget fall under the jurisdiction of the Supreme Audit Court.

Table 2.3: Ownership of State Owned Entities

Ownership Status	Number of companies in 1999/2000 (share of total)	Number of companies in 2000/2001 (share of total)
State owned	997 (53%)	1038 (53%)
Bonyad owned	528 (28%)	548 (28%)
Bank owned	326 (17%)	318 (17%)
Other	31 (2%)	45 (2%)
Total	1882	1949

Source: Audit Organization

2.24 The first generation of SOEs (around 150) pre-dates the Islamic Revolution. The second generation of SOEs, around 500 in number, was established after the Islamic Revolution by the first generation of SOEs. An additional 350 SOEs were subsequently set up by the first and second generation SOEs, bringing the total number of SOEs close to 1000 by 2002. The budget includes projected summary accounts of around 500 of the largest SOEs, which in turn include the profit and loss statements of their subsidiaries. The 500 SOEs that are in the budget are being reorganized so as to be held under the umbrella of 85 holding companies. Already, 10 of these have been approved. Total transfers from the budget to SOEs amounted to 1.6 percent of GDP in 2002/03. Of these, the 12 largest SOEs (see Annex XI) account for 44 percent of the SOE revenue, pay 60 percent of the taxes paid by SOEs, earn 68 percent of the SOE profits, and receive 5.4 percent of transfers from public resources to SOEs. Of the 12 largest SOEs, Iran Air Airlines is the only one that ran a loss for the year 2002/2003.

2.25 SOEs dominate the wholesale import and distribution network for essential items. Out of 1949 SOES, 384 took losses in 2000/2001, which amounted to around 25 percent of their revenues. Over the years, public enterprises in water and electricity, both of which have price controls imposed by the Government, have tended to run some of the highest ratio of losses, as have SOEs related to art and culture. Losses in the water and electricity sectors were reduced in 2001/02 by raising tariffs. However, those in the

[25] Article 4 of the General Auditing Law, approved in 1987, lays out the following criteria for determining an SOE: (i) It is legally established as a company that according to a court or according to the law, has been nationalized or expropriated with more than 50% of its assets owned by the Government; or (ii) it has been established by another SOE with more than 50% of its share belonging to the SOE that established it.

cultural sector still account for most of the losses[26]. As part of the move towards privatization of SOEs, 1038 SOEs were restructured or converted into public companies using a variety of instruments, including auctions and negotiations, sales of shares in the stock market, dissolutions, and mergers, in the 1998/99 to 2000/01 period [27]. Taking the revenues and expenditures of SOEs into account, the size of the wider public sector ranges from 50 to 55 percent of GDP.

2.26 Capital transfers to SOEs from the general budget, while subject to repayment, are treated as interest free loans with no stated period of repayment[28]. Although the MPO is supposed to evaluate the capital projects of SOEs, it rarely does. The Government may finance some of the SOEs' operating budgets from the general public revenue and it guarantees their borrowing. The net borrowing of the SOEs, banks and for-profit organizations went up on average by 2.1 percent of GDP over the 1991-2000 period. The expenditures and revenues of the main SOEs and banks are displayed in the budget. Those that are not in the budget submit their financial statements separately. The central government conducts various quasi-fiscal operations via SOEs and banks. Some of these are funded partially by the budget, and others are financed directly by SOEs and banks.

State Banks

2.27 In June 1979, with the establishment of the Islamic Republic in Iran, all banks were nationalized and banking regulations changed with the approval of the Islamic Banking Law. The banking system in the country is dominated by 10 state-owned banks, six of which are general commercial banks in that they take deposits from the public and make loans to both the public and private sector[29]. Four other banks are specialized by sector: Maskan for housing, Keshavarzi for agriculture, Sanat O Madan for industry and mining, and the Export Development Bank. Their loanable funds come mainly from the commercial banks, BMJII and other public sources. During 2001, two private banks were licensed under new legislation. These, together with the four near-bank[30] private "credit institutions" licensed the previous year, account for a little more than 1 percent of the total banking system in terms of assets.

[26] The four largest loss making enterprises in 2000/01 were IRIB (Islamic Republic of Iran Broadcasting), IRNA (Islamic Republic News Agency), the Youth Training Center, and the enterprise devoted to maintenance and supplying equipment to sports facilities. IRIB also received the largest amount of transfers from the budget in 2002/03.

[27] 500 SOEs have been privatized by handing them over to the CSRO to cover part of its arrears with the Fund. The Pension System in Iran, Report, World Bank Sept 2003.

[28] Repayment was actually imposed beginning in the mid 1990s and repayments are now shown in the budget.

[29] 20 percent of the total financing of the 6 state-owned commercial Banks (Melli, Saderat, Tejarat, Mellat, Sepah, and Refah Kargaram) goes to the public sector (SOEs and bonyads included) at special rates. Bank Saderat is in the process of being transferred to the SSO in lieu of arrears owned by the Government.

[30] These near-bank institutions are bonyads. One of these bonyads is owned by Bonyad-e-Mostazafan va Janbazan. Almost a quarter of its loans go to companies that form part of BMJ.

Table 2.4: Annual Budget for Public Enterprises, Banks and for-Profit Public Organizations

(In trillions of Rials)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Revenues	14.20	21.65	29.96	42.80	59.82	82.40	113.98	127.61	187.17	226.94	312.64
Operational revenues	13.13	20.36	28.31	33.87	51.35	73.03	97.36	112.13	167.42	191.61	252.85
Other receipts	1.07	1.28	1.66	8.92	8.46	9.36	16.61	15.48	19.75	35.33	59.80
Expenditure	16.62	33.49	41.28	54.97	74.20	103.09	132.38	152.51	204.33	256.32	372.55
Current expenditure	12.20	21.94	28.69	39.62	52.26	70.42	93.94	108.36	145.28	164.56	236.42
Transfer to general revenue	0.01	0.01	0.01	---	---	---	0.22	---	---	---	---
Tax	0.35	0.80	0.60	0.77	1.47	2.62	2.87	2.78	1.15	1.11	5.82
Dividend	0.03	0.13	0.14	0.13	0.35	0.72	0.87	1.06	2.24	0.87	1.17
Other accounts related to dividends	0.09	0.01	0.01	0.03	0.02	0.12	0.07	0.03	0.10	0.04	0.04
Capital expenditure	4.42	11.47	13.15	16.98	24.32	34.72	40.51	47.72	65.35	102.12	166.94
Depreciation	-0.48	-0.86	-1.33	-2.55	-4.21	-5.51	-6.09	-7.44	-9.79	-12.37	-37.83
Budget deficit	-2.42	-11.84	-11.32	-12.17	-14.38	-20.69	-18.40	-24.91	-17.15	-29.38	-59.90
Sources for financing deficit	2.42	11.84	11.32	12.17	14.38	20.69	18.40	24.91	17.15	29.38	59.90
Transfers from budget	1.13	5.52	5.85	8.86	11.14	11.71	13.86	16.50	7.25	8.72	15.98
Net domestic loans	1.11	4.02	3.46	2.77	3.08	4.75	3.77	5.38	-0.11	-3.69	-0.62
Net external loans	0.00	1.11	0.00	-0.66	-1.90	0.65	1.05	4.04	7.90	25.07	41.50
Net use of current assets	0.18	1.19	2.00	1.21	2.06	3.59	-0.27	-1.01	2.10	-0.70	3.05
Net Borrowing	1.11	5.14	3.46	2.11	1.18	5.40	4.82	9.42	7.80	21.37	40.87
(Net Borrowing in percent of GDP)	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Source: MPO and staff estimates

2.28 The Government also intervenes in setting interest rates. Borrowing and lending rates are different for different borrowers and lenders, and the private sector borrows at a higher interest rate than the public sector. Banks are obliged to make loans under directives provided in the annual budget[31]. These have decreased over the years and now account for less than a quarter of the balance sheet. However, these loans are government guaranteed and benefit from the interest discussed in the section on implicit subsidies. In addition, a large number of the largest borrowers from the banks are SOEs and, as discussed above, the risk to banks is reduced by the MPO or government guarantees on these loans. Insofar as these loans are government guaranteed, they represent a potential liability to the budget. The rest of the loans are directed to comply with sectoral credit targets[32], with priority needs for the rest being more important criteria than prudential purposes. These numbers are hard to estimate since some of the loans are provided to SOEs. Instead, we looked at the loans provided to SOEs from different sources to get a better estimate of potential government liabilities. The Central Bank's claims on the Government amounted to 11 percent of GDP in 2000/2001, while its claims on SOEs in the same year amounted to 2 percent of GDP[33]. State banks are directed to give loans to SOEs and to businesses and households in different sectors at low interest rates. In addition, the ability of the borrowers to repay is guaranteed either by the MPO or by a government-issued letter of guarantee[34]. The debt exposure of SOEs and banks is a contingent liability of the central government. There appears to be no systematic accounting or monitoring of either the impact of the quasi-fiscal activities on the balance sheets of the entities involved or number and amount of government loan guarantees. Based on the profit and loss accounts of the SOEs, banks, and for-profit organizations, the quasi-fiscal deficit averaged around 2 percent of GDP over 1992-2002.

For-Profit Organizations

2.29 Defense Industry Organization (DIO), Ports and Shipping (P&O) and Iran National Industries Organization (INIO) are the only three for-profit organizations indicated in the budget. They follow exactly the same procedure as SOEs and are similar to SOEs in nature.

Extra Budgetary Funds

2.30 There are several extra budgetary funds (EBFs). There are no clear criteria for establishing an EBF. They are generally governed by multi-ministerial boards, which are chaired by a parent minister. The most important one is the Oil Stabilization Fund (see box 2.2).

[31] Each year the budget notes provide specific directives approved by the Parliament regarding banking facilities provided to special groups or for special needs.
[32] Banks are forced to lend certain proportions of their credit portfolios to designated sectors of the economy (FSAP).
[33] Economic Report and Balance Sheet, 1370-79, BMJII (Central Bank of Iran).
[34] Iran FSAP, World Bank/ IMF 2000 and staff discussions with MPO.

2.31 Whereas transfers to some EBFs, such as the Employment Generation Fund and the Export Guarantee Fund, and transfers from some EBFs. such as the Oil Stabilization Fund[35], are included in the budget, a comprehensive account of EBF operations, or even a list of all EBFs, was not available. A number of EBFs were included in the budget in 2002/03 as part of the move towards increased transparency. However, the Employment Fund, the Oil Stabilization Fund, the Export Guarantee Fund, the SSO, and the CSRO are among the EBFs not included in the budget. The financial statements of EBFs are submitted to the Cabinet but not to the Parliament. They are not subject to regular audit by the SAC. The SAC audits them only by special request of the Parliament.

Table 2.5: The Larger Public Sector

Type of Executive Agency	Relation with Central Government Budget	Relation to Central Government
Ministries, Departments, Provincial Administration, Public institutes	Their expenditures and revenues are in the budget	
Implicit Fuel subsidies:	Off budget	Direct expenditures
Exchange rate subsidies to essential imports	Previously off-budget. Currently most are included in the budget after exchange rate unification in 2002.	Direct expenditures
Extra-budgetary funds	Typically none, except OSF can finance budget if needed.	Direct expenditures
Pension Funds	Budget includes payment for civil servants to CSRO	Give rise to contingent (actuarial) liabilities
Municipalities	Have their own budgets.	Implicit liability
State Owned Enterprises	Summary budgets of 505 of some 2000 are included in the government budget. Some receive transfers from the budget in principle as loans.	All debt is a potential liability; some is explicitly guaranteed.
State Banks	Budget notes identify the interest rate subsidies and targets for sectoral credit allocation.	Deposit guarantee is a potential liability and QFAs create further contingent liabilities
Bonyads	Budget includes transfers to some Bonyads.	

[35] They were to the tune of 4.6 billion Rials, in 2002/03.

Box 2.2: Oil Stabilization Fund

The Oil Stabilization Fund (OSF) was established in 2000[1] with two stated objectives:- the stabilization of oil revenues by building up reserves and the support of investments in the private sector to increase employment and non-oil exports. According to Article 60 of the Plan that provided the basis for the establishment of the Fund, foreign exchange revenues from crude oil exports that are in excess of the projected figures in Table 2 of the Third Five-Year Plan are deposited into the OSF. The following table shows the projected figures within the Plan, as well as the actual allocations to the budget at the beginning of the year and supplemental transfers from the OSF.

Withdrawals from OSF for Government Budget (in Million of dollars)

Year/Description	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	Total
Budget Allocation In TFYDP	10951.5	11731	12684	11058	11579	12082.8	70265.5
Allocated for budget (Total)		13385	12864	12800	15446		54495
Supplemental transfers		1654	0	1742	3867		7263

The OSF is managed by a Board of Trustees chaired by the Minister of Economic Affairs and Finance. The Board includes the Ministers of Petroleum, Mines and Metals, and Commerce; the Head of MPO; the Governor of the Central Bank of Iran (CBI), and an advisor to the President. The Board supervises all affairs related to the OSF, including the setting of priorities for project selection; the formulation of the modes of calculating the interest rate of the facilities to be granted, pursuant to a proposal to be forwarded by the CBI; setting the repayment period of the facilities granted; identification of the process of the collection of the claims; determining a framework for the conclusion of contracts between the MPO and the operating banks[2]; and specifying the operating banks' charges and commissions.

According to the by-laws of the OSF, the CBI is bound to make quarterly payments, in foreign currency, of the interest to the OSF. The interest rate is determined by the Monetary and Credit Council of the CBI with due regard to the mutual commitments made. Around half of the Fund is put aside for offsetting low oil prices, while the remaining can be used for various projects in the private sector. Withdrawals by the Government have been permitted several times, so far. The first time was six months after the formation of the Fund, when the Government was authorized to withdraw $1.25 billion for payment of bonuses to the retired, fighting drought, and completing projects. The second time, in 2002, the Government was allowed to withdraw $2.1 billion to make up the budget deficit and $2.5 billion to cover payments made by the CBI to repay guaranteed debt. Since then, several other withdrawals have been made mainly to fund the budget deficit. Up to 50 percent of the Fund can be used for loans to the private sector in order to increase employment opportunities, expand production, and boost non-oil exports. These are subject to guidelines laid out in the by-laws of the Fund[3]. The interest rate for these loans is low compared to commercial interest rates, varying between 6.5 to 7 percent[4].

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[1] The Cabinet approved its by-laws in November 2000.

[2] Upon approval of the CBI, all of Iran's state-owned banks (the commercial banks and the specialized banks) have signed contracts with the MPO as operating banks for these loans.

[3] These include guidelines for project evaluation and a review of their technical, financial and economic feasibility, which need to be carried out by operating banks in conformity with the criteria approved by the Board of Trustees. In addition, the period of utilization of bank facilities granted for investment as well as tentative exploration of the projects cannot exceed three years. Furthermore, the repayment period of such facilities can, at the maximum, be extended for five years after the above period.

[4] According to the by-laws, the projects should not only have economic and technical justifications but should be profitable enough to repay the loan installments with interest. The loans granted are available to grantees in dollars, and the grantees, as well as the managing banks, are obliged to pay the installments with interest in dollars.

Social Insurance Funds

2.32 The largest pension fund in Iran is the Social Security Organization (SSO), covering workers in the formal private sector and contractual workers of the government, with 6 million contributors and 1.14 million individuals receiving old-age, disability, or survivor pensions. The Civil Service Retirement Organization (CSRO) covers approximately 1.5 million civil servants and pays benefits to 662,786 pensioners. In addition, 18 public companies[36] have put in place defined-benefits systems for their employees. Unofficial estimates put the number of employees covered by them at around 1.8 to 2 million. The above contributory regimes cover around 50 percent of the labor force while non-contributory schemes cover a large portion of the low-income population.

2.33 The pension branch of the SSO is unsustainable over the long term as currently structured[37]. The net present value of resources the government would need to transfer to SSO today in order to guarantee that promises to current retirees and contributors are met over 2002–2070 is estimated at around 115-140 percent of current GDP. If the system remains open to new entrants, these liabilities are estimated to range from 150 percent to 400 percent of current GDP. The present value of unfunded liabilities of the CSRO is estimated at 30 percent to 55 percent of current GDP. If CSRO were closed to new entrants, the additional resources necessary to honor the pensions of today and future retirees would fall to around 20 percent of GDP. In addition, the financial condition of the pension funds remains fragile[38]. The Government has accumulated considerable debt with regard to pension funds, which is being repaid by transferring SOEs to the funds.

Municipalities

2.34 According to the Law of Formation of the Municipalities, any place with a population of at least 5,000 people is entitled to have a municipality. In cases when there is a need for the existence of a municipality but the population criteria cannot be attained, the Ministry of Interior can order the establishment of a municipality. There are currently 800 municipalities in Iran.

2.35 The Municipalities Law states that the budget of each municipality is set by the administrative department of the municipality with the acknowledgement of the Islamic City Council. The budget of each municipality becomes operative upon the approval of the Ministry of Interior.

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[36] These companies are in sectors such as telecommunications, transports, oil, metals, finances (including the CBI), and defense.

[37] Data are from *The Pension System in Iran*, Report, World Bank September 2003.

[38] Although CSRO has accumulated reserves amounting to 3.3 percent of GDP, 70 percent of these are in the form of government arrears. This government debt generates negative real rates of return of around 2 percent after applying interest and penalties. As the number of retirees continues to increase relative to the number of contributors, expenditures are growing faster than revenues. CSRO is expected to generate an operational deficit within the next 2 to 3 years, while the SSO will likely show an operational deficit within the next 20 years. *The Pension System in Iran*, Report, World Bank September 2003.

2.36 The Ministry of Interior issues guidelines to all municipalities regarding the level of duties and local charges. The income of the municipalities according to the municipalities law consists of the following 7 categories:

- Periodically receivable income (permanent or repeating part of income) earned by levying various types of duties and local government-type taxes.
- Receipts from specific duties levied from time to time.
- Fees and charges received by profit-making organizations of the municipalities.
- Income from assets and properties belonging to the municipalities.
- Grants from the central government, government organizations, or executive bodies[39].
- Donations received from the general public, private institutions, or any other body.
- Occasional or unexpected receipts.

2.37 Tehran municipality, the largest municipality, is listed as an executive agency in the budget, as are a few other municipalities. The grants paid to the municipalities not listed as executive agencies are in the allocations made to the Ministry of Interior. Whereas, in principle the consolidated budget of various municipalities has to be published by the Statistical Center of Iran, none have been published for the last six years. The Ministry of Interior receives a budget to supervise the municipalities. A uniform accounting system is used for all municipalities.

Bonyads

2.38 Bonyads are non-government public institutions established by Articles 45 and 49 of the Constitution and overseen by the Supreme Leader. Bonyads are conglomerates that comprise hundreds of private and state-owned companies, farms, hotels, theaters, newspapers and other properties, and they are active in almost all sectors of the economy. Specifically, these foundations are responsible for certain public activities.

2.39 Bonyads are of two kinds: (i) state sponsored or supported by the state (and therefore public), which are involved in both productive activities and delivering social services; and (ii) privately funded ones, which are mainly for non-profit ideological and religious and cultural use, although they too provide charitable services[40]. In total, there now exist 10 large bonyads and several smaller bonyads.

2.40 Bonyads are distinct from the private sector and SOEs in several respects:

- They are accountable only to the Rahbar or Supreme Leader.
- They are audited separately from government agencies or SOEs.

[39] These appear in the budget of the Ministry of Interior.

[40] It should be noted, however, that even those bonyads that are privately funded benefit from certain special prerogatives and direct subsidies.

- They are able to carryover the budget received as a transfer from the government budget.
- They can invest their carried over transfers and revenues (unlike other public sector agencies).
- They are not subject to either the regulations governing state agencies or SOEs in terms of employment and other regulations, or those governing the private sector, such as the labor law.
- Their losses do not present a contingent liability to the Government since, unlike the SOEs, they do not receive any explicit guarantees from the Government. However, they are likely to constitute an implicit liability to the Government because of their ownership of certain SOEs.

2.41 The boundary between the Government and bonyads is fluid. Over the years, several bonyads have tended to replicate functions that were formally assigned to the central government that were eventually absorbed by ministries or evolved into independent agencies[41].

2.42 The bonyads are responsible for a variety of economic and social functions in the economy. Bonyads, are conglomerates that comprise hundreds of enterprises and industrial companies and are active in almost all sectors of the economy. Their activities were tax exempt until 2002 and they are major beneficiaries of the implicit foreign exchange subsidies and directed credit. They also receive transfers through the budget, usually linked to the provision of specific public services.

2.43 Among state-supported bonyads, there are bonyads that wield considerable economic power and receive transfers from the government budget (see Table 2.6). Of these, Bonyad Mostazafan va Janbazan[42] (BMJ - the Foundation of the Oppressed and the Disabled), which was established in March 1979, is the largest with an annual turnover of around 28000 billion Rials ($US 3.5 billion). In 2002/03, this amounted to almost 10 percent of the central government budget for the same year. With more than 65000 employees, the economic section of the BMJ manages more than 400 companies and factories. It is a major player in major economic sectors such as construction, industry and mining, tourism, agriculture, transportation and commerce[43] BMJ owns around 70 percent of the shares of these companies, on average, and the remaining

[41] An example is the Bonyad-e Omur Mohajerin-e Tahmili (Foundation for the Affairs of Imposed War Refugees), which was eventually subsumed by the Ministry of Labor. Similarly the Housing Bonyad which was state supported and helped provide housing to the poor eventually became a full fledged government ministry with the Bonyad's mandate being accorded independent status within the ministry. In addition, the Jehad-e Sazandegi (Reconstruction Crusade), which also channeled resources to villages and rural areas successfully was also turned into a ministry in 1984.

[42] According to BMJ's web site (http://www.iran-bonyad.org) they are active in the most outstanding industrial and business sectors: Food and beverage, chemicals, cellulose items, metals, petrochemicals, construction materials, dams, lowers, civil development, farming, horticulture, animal husbandry, tourism, transportation, five-star hotels, commercial services, financing, joint ventures, etc.

[43] 100 of these were involved in the agriculture sector, another 100 in industrial and mining activities, 60 in the services sector, 100 in construction and housing while the remaining 40 companies dealt with trade and commerce.

belongs to the public and private sector. While a majority of BMJ's transactions are with the private sector (especially in agriculture and services sectors), less than 10 percent is within the affiliated companies. Five major economic organizations owned by BMJ manage and supervise the activities of the affiliated companies. The activities of the BMJ and the affiliated companies of the BMJ that are financed from the budget are audited by the Audit Organization. The audit report is available to the Parliament and the public. The rest of BMJ's activities are audited by an independent company, Mofid Rahbar, which reports directly to Supreme Leader. The Fourth Majlis requested a special report on the activities of the BMJ, which was presented to the Majlis and discussed by the Parliamentarians.

Table 2.6: Transfers to Bonyads[44]
(in billion rials)

	2001/02 Est.	2002/03 Est.
Imam Khomeini Emdad Komiteh	3,509	4,452
Bonyad Mostazafan va janbazan	1,144	698
Bonyad Shahid	212	305
Bonyad Maskan	29	35
Total	**4,893**	**5,489**
In percentages:		
% of GDP	0.7	0.6
% of total Expenditure	3.2	1.9

Source: Budget law different years

2.44 As part of the economic reform agenda, the BMJ is obliged to privatize a majority of its holding companies directly to the public or through Tehran Stock Exchange (TSE). The goal is to reduce and downsize the number of companies to about 100 by the end of the reform period.

2.45 The Janbazan section (social services for veterans) of BMJ covers veterans from the Iran-Iraq War and looks after the welfare of those injured in the war. Part of its services are financed by government funds, with 15 different programs in the 2002/03 budget ranging from welfare services to employment and training services for war veterans. The total budget of the Janbazan section for 2002/03 amounts to 1800 billion rials, with an additional 1000 billion rials in the form of bank facilities and subsidized loans for housing, vehicle purchase, low fare tickets, and subsidized utilities for veterans. In addition to the interest rate subsidy, these loans have longer repayment periods[45]. In the event of special requirements, the Janbazan section[46] is authorized to raise funds from

[44] The table shows transfers to bonyads listed under categories (i) and (ii).
[45] Usually 20 years.
[46] In addition to the budget transfers discussed in section 2.43, part of Janbazan's activities were financed through transfers from the economic section of BMJ, amounting to 1000 billion rials in 2002. These were mostly used to provide housing for war veterans. This brings the total budget fpr Janbazan up to 3800 billion rials: 650 billion rials are provided by the current general budget, 10 billion rials are from the development expenditure, around 1140 billion rials are from the provincial budget. 1000 billion rials are in form of banking facilities and low interest loans.

the President's budget with the approval of the President. The Janbazan section prepares its own budget for the transfers it requests from the central budget and submits this to the Management and Planning Organization (MPO). In doing so, it follows the procedures of ministerial budget preparation. Most of Janbazan's activities are in accordance with the rules and regulations of the related ministries. Purchases of drugs and medicine, housing, and construction are done following the Ministry of Health and Ministry of Housing rules respectively.

2.46 Bonyad Shahid, or the Foundation of the Martyrs, was established in March 1980 to manage veterans' affairs and to provide support for the families of martyrs and the disabled. In 1991, Bonyad Shahid owned 150 companies in agriculture, mining, construction, and trade with over 160 billion rials in annual sales. This foundation is in the process of being merged with the Janbazan section of BMJ.

2.47 Bonyad Maskan (the Housing Foundation) was set up in June 1979 as a non-profit, semi-public organization to house the poor, especially in rural areas. It has more than 2000 branches in the provinces. Its financial resources come from a variety of sources, including the central government's development budget for rural housing, which in 2002/03 amounted to 34.5 billion rials, private resources, and borrowing from the banking system.

2.48 The Imam Khomeini's Emdad Committee (discussed in detail in Chapter 3) provides various forms of support to the poor.

2.49 There are many bonyads in the third privately supported category. Six of them are among the better known and largest. They are the 15 Khordad Foundation, the Resalat (or Prophetic Mission) Foundation, the Islamic Propaganda Organization, the Islamic Propagation Office, the Imam Khomeini Institute for Education and Research, and Bonyad-e Astan-e Quds. The 15 Khordad Foundation was founded in 1981 and provides support for religious causes as well as charity activities. The Resalat Foundation acts as a conservative Islamic think-tank connected to the Islamic Coalition Association, which is a coalition of conservative bazaaris[47], clerics, and grassroots Islamic organizations. The Islamic Propaganda Organization and Islamic Propagation Office carry out religious research, teaching, and training of missionaries. The Imam Khomeini Institute for Education and Research provides research and education opportunities at the graduate and post-graduate level in social sciences and the humanities for Islamic theology students interested in exploring these subjects from an Islamic perspective. The latter two institutions offer scholarships and interest-free loans to a large number of their students and staff. In addition to having their own grants and endowments, all of the above receive grants from the Office of the Supreme Leader to which they are accountable. The 15 Khordad and Resalat Foundations do not receive any funds directly from the government, while the other three have regular lines of their own in the budget. In 2001/02, this amounted to about $400,000 for the Imam Khomeini Institute for Education and Research, $8.6 million for the Islamic Propagation Office, and $12 million for the Islamic Propaganda Organization. They also receive indirect support

[47] Bazaaris are wholesale and retail merchants based in cities.

through subsidies of various kinds provided to all educational and religious programs[48]. The Bonyad-e Astan-e Quds is the oldest continuous organization in Iran. Its establishment as an autonomous unit dates back to the ninth century AD[49]. It is a conglomerate with large assets in all major sectors of the economy. Its proceeds are used for the provision of religious, cultural, educational, and other public services. Currently, the foundation and its associated establishments employ more than 18,000 people. Its medical units offer services to more than 800,000 people and a larger number benefit from its direct and indirect transfers. Astan-e Quds carries out these activities with its own resources and does not receive direct funding from the government for rendering welfare services.

Public Sector Employment and Wages

2.50 The public sector in Iran is large in terms of the number of labor force employed. The share of central government employees, excluding the armed forces and the employees of the Ministry of Defense, was around 14 percent (2.1 million) of all employed in 2001/03[50] while SOEs employed almost one third (4.8 million) of the employed labor force[51]. Central government employment in Iran is higher than the regional average and the average for the middle income countries (see chart 2.4). Employment in the civil service grew by around 24 percent over the 1990s[52]. The household survey of 1998 indicates that 30 percent of urban households and 13 percent of rural households are headed by a salaried employee of the civil service. It further indicates that 20 percent of households are headed by a public sector employee[53] while 23 percent of households are headed by a private sector employee. Wages and salaries constitute 7 percent of GDP, which compares favorably to the middle-income country average of around 8 percent of GDP and the MENA average of 11 percent of GDP.

[48] They submit regular plans for their activities to the MPO and maintain close ties with Majlis to keep the deputies informed and to remain abreast of the ongoing legislation that may concern the foundation.
[49] Its original mission was to manage religious endowments (*waqf* assets) according to the wishes of the donors. This included investment of the proceeds from donations to generate streams of revenues used for designated purposes. Over time, the assets had to be reshuffled, and the foundation received more general purpose donations. This gave it more flexibility to define it mission and tasks. In the 16th century, the royal court gained control over appointing the custodian of the endowments and this arrangement continued until 1979, when the control was taken over by the Supreme Leader of Islamic Republic.
[50] Statistical Center of Iran.
[51] Article IV, IMF 2001, Appendix.
[52] Statistical Center of Iran.
[53] 10 percent of rural households and 26 percent of urban households are headed by a public sector employee - Poverty in Iran, Trends and Structure 1986-1998, World Bank 2003.

Chart 2.4: Central Government Employment
(Percentage of Population—Average 1996-2000)

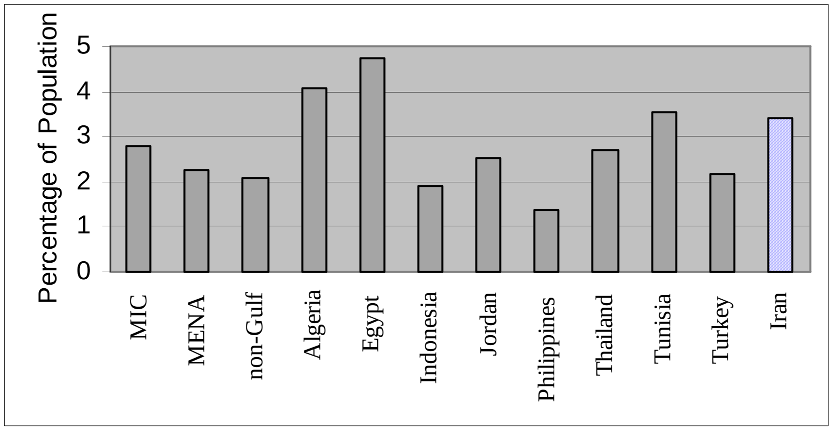
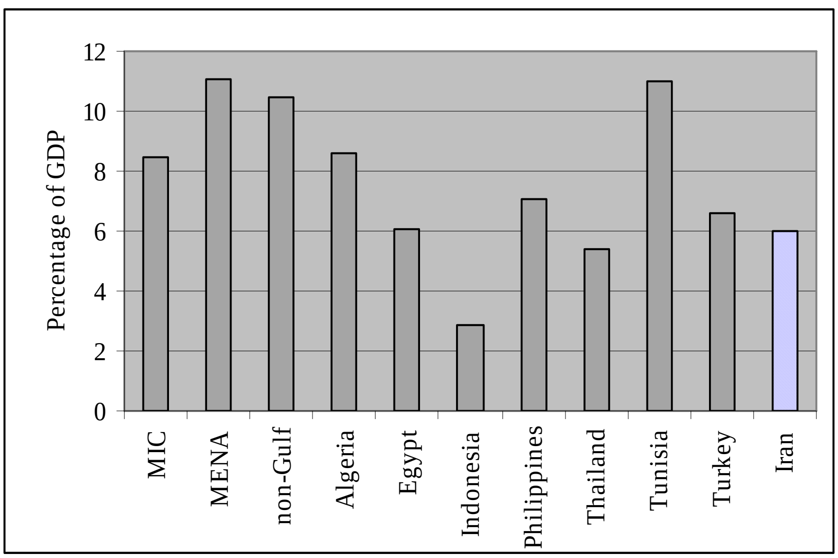


Chart 2.5: Central Government Wage
(Percentage of GDP – Average 1996-2000)



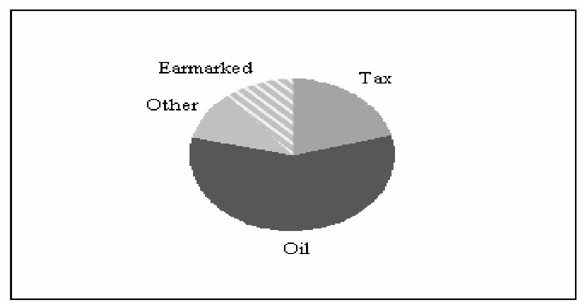
CHAPTER III: PERFORMANCE OF PUBLIC SPENDING

3.1. This chapter looks at the performance of public spending in The Islamic Republic of Iran. It analyzes the collection of revenues, the allocation and realization of expenditures, the impact of public spending on social indicators, the extent of usage of subsidies as a mechanism of reaching consumers, and the use of alternative mechanisms of delivering public services.

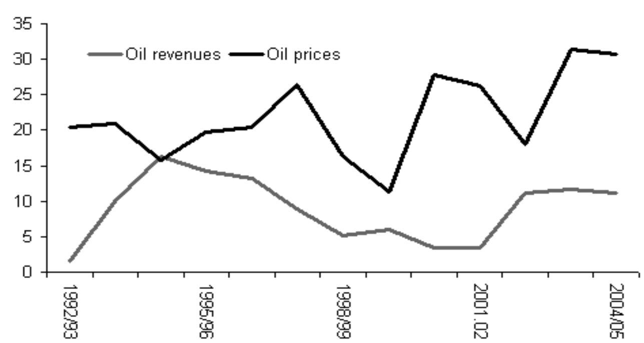
Revenue Trends

3.2. Iran's revenue is narrowly based. Oil earnings make up almost 75 percent of total revenue, which has averaged around 15 percent of GDP in the last three years. Given the volatility of world oil prices, oil earnings have varied considerably. In turn, this has led to considerable fluctuations in total revenue. To smooth revenue, the Government established the Oil Stabilization Fund (OSF) in 2000/01 (see Box 2.3).

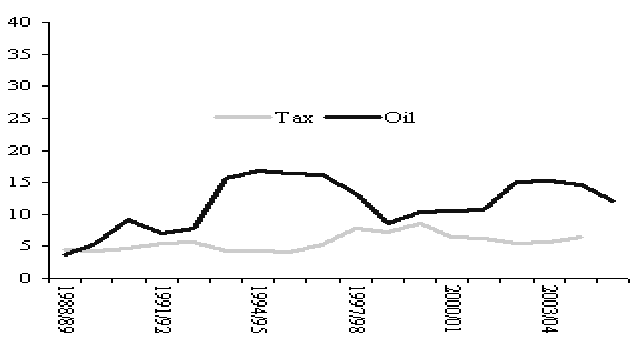
Over 1999-2004, oil earnings was the dominant source of revenue.



Oil Revenue has closely followed oil prices...



while tax revenue has remained fairly stable.



3.3. On the other hand, non-oil revenues (tax and non tax) have remained fairly stable, at around 10-11 percent of GDP.

3.4. Tax revenues, which have averaged 6-7 percent of GDP, are made up equally by direct and indirect taxes. Over the last few years, the government has initiated several steps to broaden the tax base. These include amendments to legislation aimed at lowering and simplifying income taxes; unification of a large number of fees and charges into a 2 percent sales tax; and plans to implement a value-added-tax (VAT) next year. To improve tax administration, the National Tax Organization and a large tax payer unit were also established in 2001/02. Iran also classifies some revenues as "earmarked". Earmarked revenues are generated by an agency through the sale of goods and services it provides and the sale of assets, as well as contributions to certain public pension plans, a

share of which the agency is allowed to retain in order to finance specific budgeted expenditures. Such revenues have increased somewhat, from around 2 percent of GDP in the mid-1990s to around 3 percent at present[1].

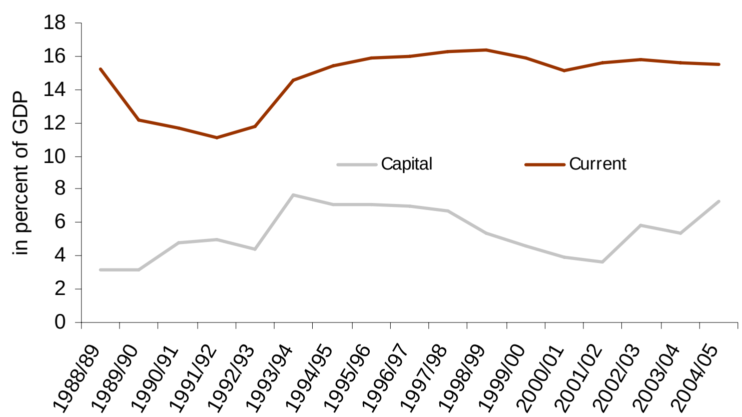
Expenditure Trends and Allocations

3.5. While much of Iran's public expenditure is presented in the central government budget, budgeted spending does not provide a comprehensive or wholly transparent view of public outlays. This is due largely to extra-budgetary spending and various implicit subsidies. However, as the following discussion on the performance of the public sector indicates, allocative efficiency is not too poor in Iran. However, as the discussion in Chapter 4 will show, the process of allocations in Iran is not yet tied sufficiently to performance in the sense of outcomes.

Expenditure Trends in Iran

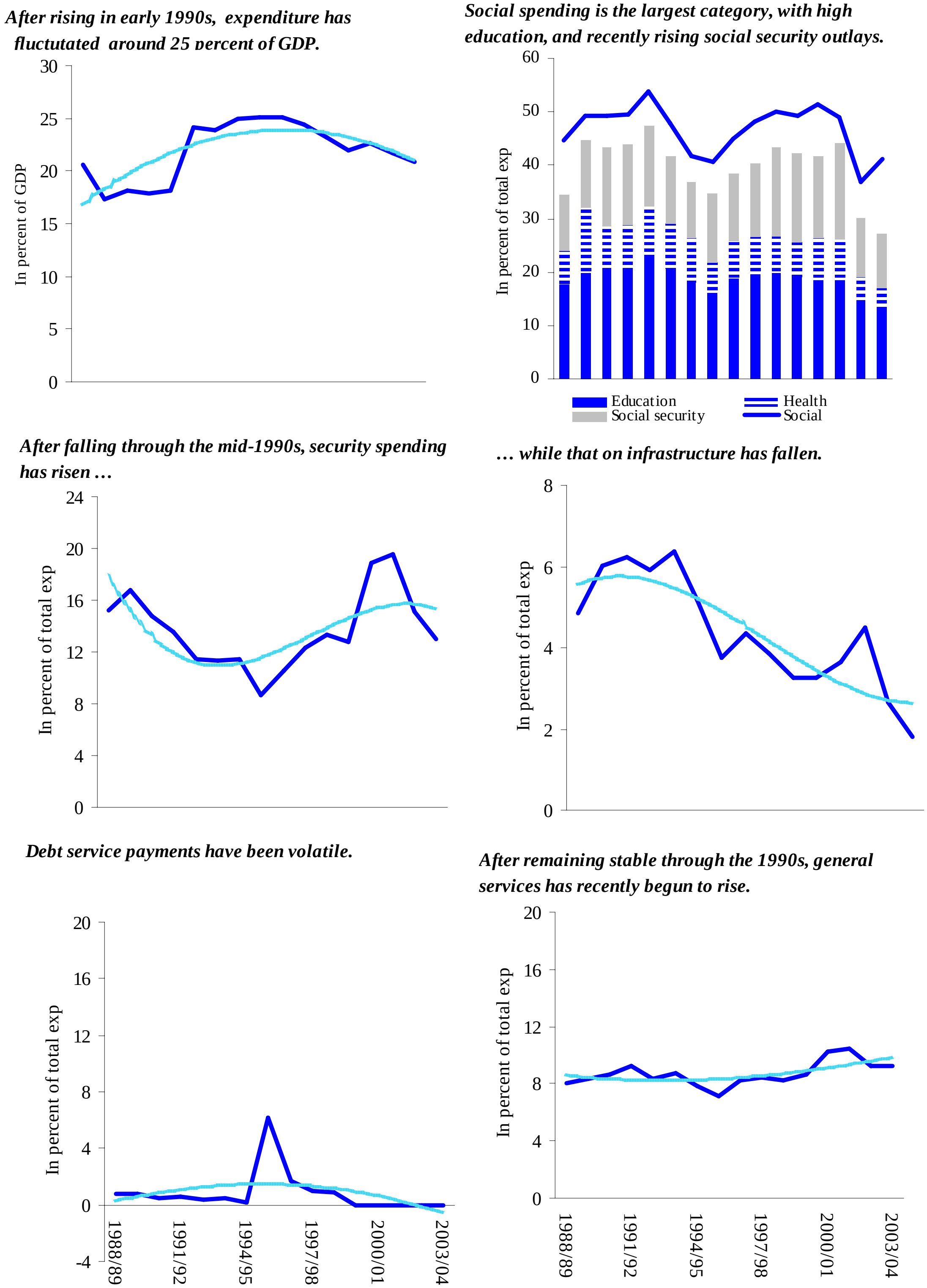
3.6. After rising from below 20 percent of GDP in the early 1990s, expenditures stabilized around 24 percent of GDP in the late 1990s before rising sharply in 2002/03 to 33 percent. With the end of the war with Iraq, defense expenditure fell in the early 1990s, while capital expenditure surged, a reflection of reconstruction spending. However, this momentum in capital spending was not sustained. Current spending, on the other hand, declined immediately after the war for the first three years. While overall expenditures remained at around 24 percent of GDP throughout the latter half of the 1990s and until 2002/03, there was a clear shift towards current spending at the expense of capital spending during this period. Social spending was protected, however, and remained fairly stable as the highest expenditure category. Expenditures have risen in recent years, reaching 27 percent of GDP in 2003/04. Some of this reflected a full accounting of the removal of the exchange rate subsidy in 2002/03, accounting for an increase of 3 percent of GDP. The remainder of the rise in spending was due to higher capital spending.

Capital spending has declined since the mid-1990s while current expenditure has risen



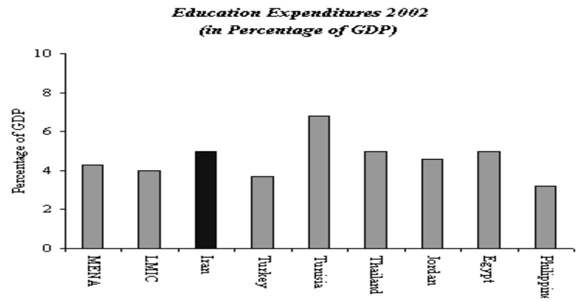
[1] See Annex 4 for a list of earmarked revenues. Some expenditures financed by earmarked resources are included in the budget.

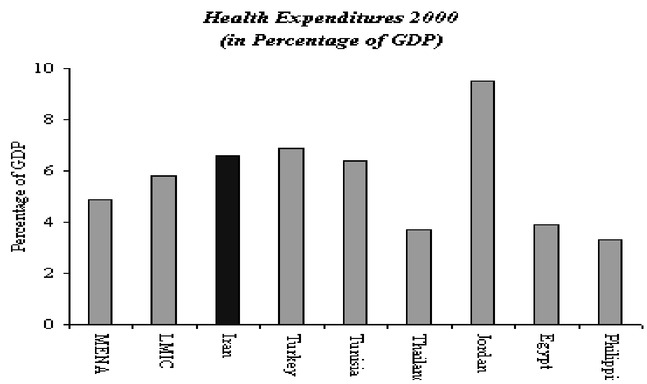
Chart 3.1: Expenditure Trend, 1988/89-2003/04



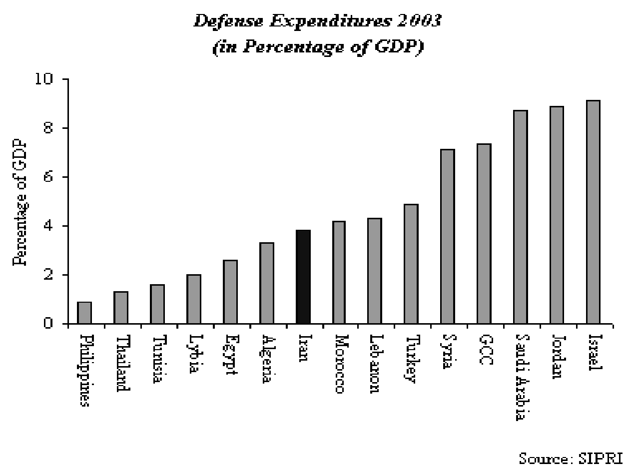
Note: Data provided by MPO. The trend is denoted by the grey line.

3.7. Among the broad expenditure classifications of general services, defense, economic services and social services[2], social spending has remained the highest expenditure category (see Chart 3.4). The protection of social spending reflects the constitutional mandate as discussed in Chapter 2. Education makes up the largest portion of social spending, averaging about 20 percent of total expenditures. Health expenditures constitute the other large category in social expenditures averaging around 8 percent of total expenditures. However, in contrast to education spending, the health expenditures in the 1990s were on a downward trend, although they have stabilized in the last few years. Spending on social security and welfare has risen steadily from around 12 percent in the early 1990s to around 17 percent in 2001. In both education and health categories, Iran compares well with countries in similar income categories and the region.





3.8. Security spending, consisting of expenditures on defense (military) and internal security, have risen since the late 1990s after declining with the end of the war with Iraq. This has been driven largely by spending on defense. By 2000/01, security-related expenditures comprised over 18 percent[3] of total expenditures, reaching their early 1990s level. However, despite the increase, Iran's total security spending (4 percent of GDP with



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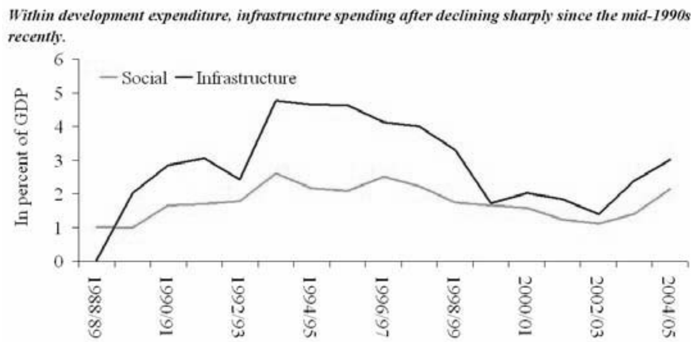
[2] Social services consist mostly of the standard categories with some variations according to the ministerial and organizational set-up in Iran. They include education, higher education and research, health and nutrition, social security and welfare, urban development, rural development, housing, environment preservation, culture and art, technical training, multipurpose operations, and youth and sports. Economic services similarly consist of agriculture and natural resources, water resources, electricity, industries, oil, gas, mining, trade and commerce, roads and transportation, communications and tourism. General services include regulatory affairs, legislation, public affairs, the judiciary, internal policies, internal security, foreign relations, financial management, statistical and public services, information and media, government apparatus and manpower. Of the general category, internal security is the only item of significance.

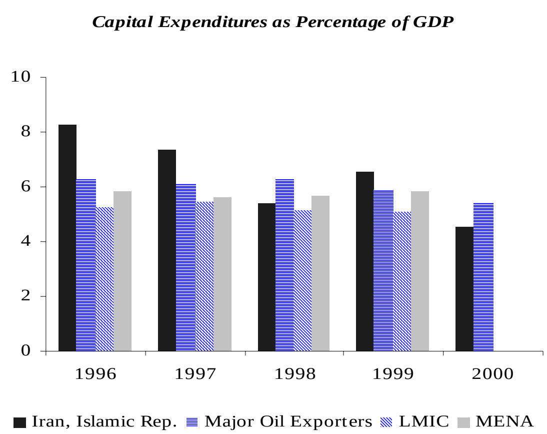
[3] Although the rise in security-related expenditures has been more or less steady, there is a significant jump from 12.2 in 1999/00 to 18.4 in 2000/01.

defense spending amounting to about 3 percent of GDP) is still well below the regional average and closer to the world average. Nevertheless, rising defense and welfare expenditures appear to have come at the cost of sharply declining infrastructure spending.

3.9. Whereas current expenditures increased steadily in the 1990s, capital expenditures decreased reaching a low of 5 percent of GDP in 2003/04. However, Iran's capital spending levels are comparable to the average for major oil exporters, the average for lower middle-income countries and the average for MENA. Within capital expenditures, spending on economic services, which rose to around 5 percent of GDP in 1995/96, has declined to 2 percent of GDP or below in the last few years. This decreasing trend is due mainly to a decrease in spending on infrastructure, which peaked in 1995/96 and has decreased steadily since then. It should be noted, however, that for the last few years, most capital expenditures in infrastructure have been financed by the related public enterprises using their own resources. Capital spending in the social sectors has been on an upward rise.



3.10. Miscellaneous expenditures, while fairly low in the first half of the 1990s, have risen since 1996/97, averaging at around 13 percent of expenditures in the latter half of the 1990s[4]. Debt service payments, which had been decreasing since Iran weathered the debt crisis in the mid 1990s, have once again started to rise (see Chapter I).



Expenditure Performance and Public Services

3.11. The efficiency of Iran's public expenditure program is comparable to countries at similar levels of development and in the region. However, the process of budget allocations in Iran is not tied to performance—in the sense of outcomes. Rather, it is tied to performance in the sense of outturns. Despite this weakness, the public expenditure program has been effective in improving social indicators and expanding the coverage of social safety nets.

[4] Until 1999/00, miscellaneous expenditures consisted of current expenditures exclusively, since 2000/01, around 30 percent of miscellaneous expenditures are devoted to capital spending.

A. Social indicators

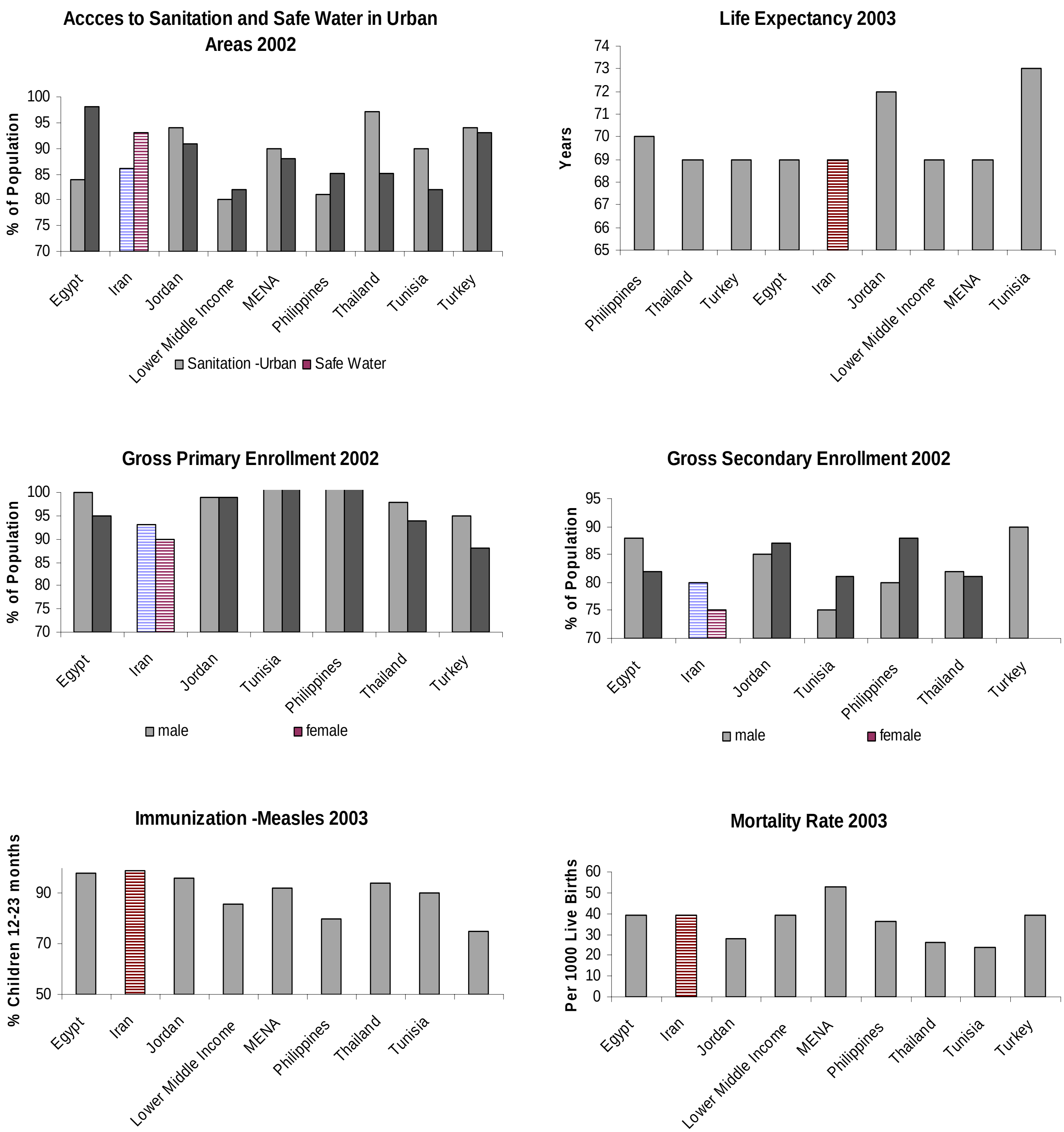
3.12. Iran's social indicators, particularly adult illiteracy and infant mortality, improved significantly from 1974 to 2004. Whereas the urban population's access to safe water and electricity were high in 1974 (76 percent and 90 percent respectively), the coverage of the rural population was almost negligible (10 percent and 14 percent respectively). In contrast, by 1998, the coverage of the rural population had almost caught up with the urban population. Thus, while the turbulence of the Revolution and the war years affected the economic activity to the extent that it took three years after the war had ended in 1988 for real GDP to return to the level of the mid 1970s, access to safe water and electricity for the rural population, during the same time period, increased to 89 percent (2004) and 76 percent (1998) of the population. Put differently, the public sector continued to increase delivery of electricity, safe water, and education to the population even though real GDP stagnated or declined due to the destruction of war and the Revolution (see Annex X).

3.13. In terms of health, Iran's spending effort while comparable to the regional and lower middle income country average seems to be mixed when compared to similar countries. Similarly in terms of education, its spending effort seems mixed. Its performance with respect to health and education indicators when compared to others is also mixed. When compared to the average for lower middle income countries and the average for MENA, Iran outperforms both with regard to access to safe water for the rural population. For the most part, it compares well to the comparator countries that we have selected. And while Iran performs better than the MENA average with regard to life expectancy, its performance varies when compared to other countries. Further analysis needs to be done in order to determine whether this is due to lower cost effectiveness or poor targeting.

3.14. Gross primary enrollment in Iran lags significantly behind the comparator countries. However, Iran seems to catch up with its comparator countries when it comes to secondary enrollment. In addition, overall public spending on education, although mainly distributional neutral in Iran, slightly favors the poorest households. This is illustrated by the fact that in 1998, 28 percent of total spending on primary education accrued to the poorest fifth of the population, compared to only 12 percent to the richest fifth[5]. Spending on intermediate schools is also pro-poor, particularly in urban areas where the enrollment rate among the poorer segments of the population is not significantly lower than that of the more affluent segments of the population. This is counterbalanced by the fact that from secondary education and beyond, the balance favors the rich, due to the fact that their enrollment rates are much higher than those of poorer households[6].

[5] Poverty in Iran, Trends and Structure 1986-1988, World Bank 2003.
[6] ibid

Chart 3.2: Social and Public Sector Performance Indicators for Selected Countries



3.15. The evolution of social indicators suggests that improvements in delivery of public services after the establishment of the Islamic Republic were the highest for those segments of the population where coverage previously had been the lowest and in some cases marginal. It also suggests that Iran compares favorably with countries of similar income and size for many indicators but lags in other cases.

B. Safety Net

3.16. Most services are delivered either directly by government agencies or by the institutions of the larger public sector. These services include those not traditionally delivered to all sections of the population by the public sector in developed countries, such as health insurance (see Table 3.1). Some services are also delivered by bonyads. Although, this is not necessarily unusual in other developing countries, the extensive coverage of these schemes, which cover nearly the entire population, sets Iran apart.

Table 3.1: Medical Insurance: Coverage of Population
(In millions)

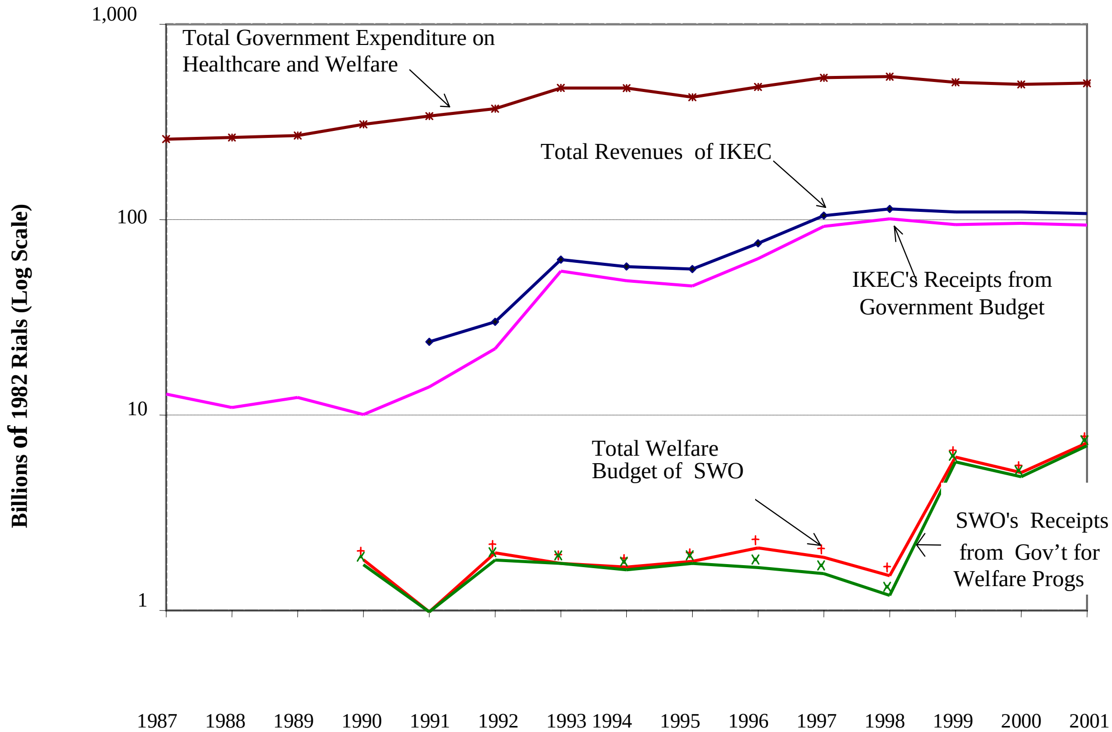
Medical Insurance Coverage of Population	
Social Security Insurance	25
Government employees Insurance	5.7
Armed forces	3.3
Low-income persons (Assistance Committee)	4.5
Low-income persons (Welfare)	0.5
Other categories	1
Farmers	20
Total coverage of National Medical Insurance program	60
Possible double coverage	3
Net coverage of National Medical Insurance program	57

Source: Report to the Budget Consolidation Committee 2002/03. Prepared by MPO.

The Role of Bonyads

3.17. In addition to their role as producers of goods and services, bonyads also act as alternative service delivery mechanisms in Iran. To assess how bonyads perform in comparison to government departments in delivering public services, one can compare the State Welfare Organization (SWO) and Imam Khomeini's Emdad Committee (IKEC). Both have similar responsibilities and receive funding from the budget through the budget. IKEC, however, is not fully funded by the government budget and receives a large share of its resources from personal contributions. They both target the poor and provide various forms of support including cash and non-cash payments for specific needs, technical and vocational training, orphan care, preventive services, and others services. A thorough analysis of which of the two is more efficient would require a comparison of their unit costs. Lacking this information, we instead looked at the number of poor reached by each (we use the number of cases handled per 100 people as a proxy) and the per capita budget spent by each (total expenditure of each divided by the population). Despite their crudeness, these simple measures capture the main trends in the two organizations.

Chart 3.3: Budgets of Imam Khomeini's Emdad Committee and the Social Welfare Organization



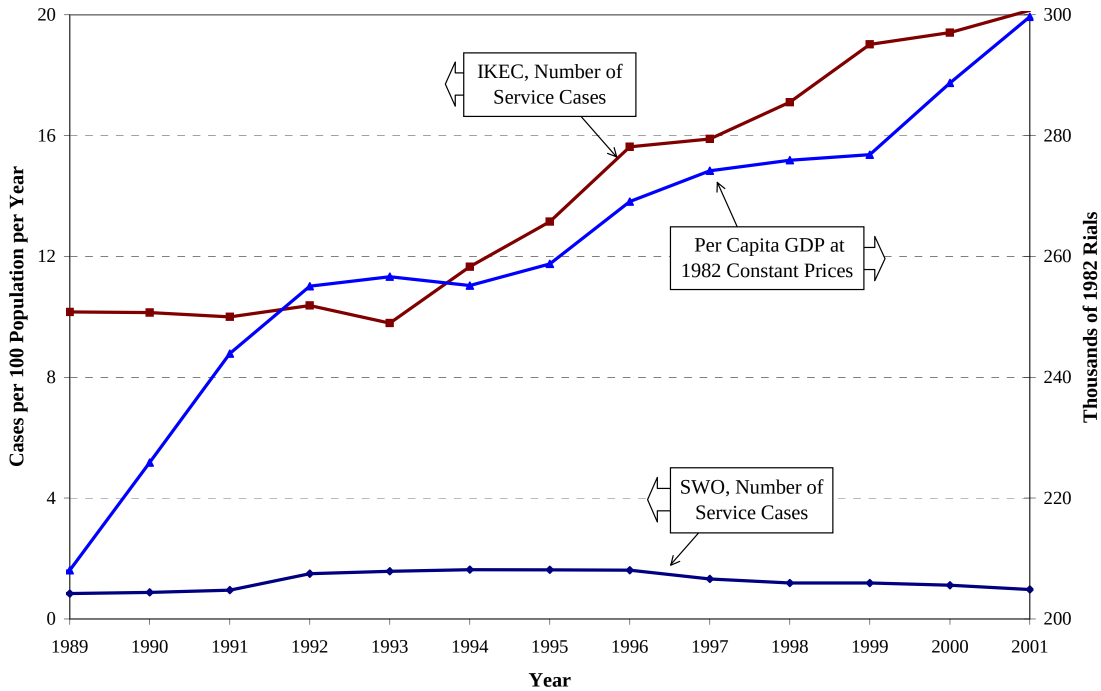
Source: IKEC (2001) and Statistical Center of Iran Yearbook, various years.

3.18. The data[7] show that during 1986-1988, IKEC continued to grow in spite of the mounting economic difficulties imposed by the war with Iraq. This process was reversed when the war ended in 1989. SWO's activities, on the other hand, remained relatively flat during those years. Both organizations started growing in the early 1990s under the First Five-Year Plan, when the economy began restructuring after the war. However, the economy experienced a foreign exchange crisis in 1993 and budgets were cut. IKEC used its own resources and expanded during this period, while SWO's welfare program began to decline[8] (see Chart 3.10). An increase in user fees by the SWO was considered politically unacceptable due to the ongoing recession. IKEC, on the other hand, continued expanding its services by making efficiency gains. This can be seen in Chart 3.11, which presents the total expenditure and revenues of IKEC.

[7] This section is based on a background paper commissioned for the Report entitled, "Public Financial Management, Procurement and Expenditure Systems in Iran: Alternative Service Delivery Mechanisms in Iran: by Hadi Esfahani.

[8] This was because of a crucial difference between the two. SWO was bound by its annual budget, which was centrally controlled by Majlis and the MPO. When the crisis set in, inflation had to be contained and all government expenditures were cut, including those of SWO. SWO did have some revenues of its own from user fees, but this was not sufficient to help SWO grow.

Chart 3.4: Number of Social Welfare Service Cases Provided by Various Agencies in Iran



Note: Thin arrows link labels to graphs and wide arrows point to the relevant axis for each graph.
Source: IKEC (2001) and Statistical Center of Iran Yearbook, various years.

3.19. This difference in response by the two organizations was repeated during the recession of 1998-1999 (see Chart 3.4). This time, the government initially cut the welfare budget of SWO, but not that of IKEC (see Chart 3.3). Since 1999, the government has kept its real payments to IKEC practically constant. Nevertheless, IKEC seems to have increased its coverage. Although the growth rate of IKEC's activities as a whole has declined somewhat since 2000, this seems to be more related to the rise in the economy's growth rate (which reduces the need for welfare services) than to resource pressure on IKEC. On the other hand, SWO has been struggling to set up NGOs that would fulfill the tasks expected of the organization. The response of IKEC to the recessions of 1994-95 and 1998-99, expansion during recessions, is more responsive to the welfare needs of the poor when these needs are the highest.

3.20. The main observable difference between SWO and IKEC in regard to the delivery of services is the flexibility that the IKEC is able to retain, since it is subject to fewer bureaucratic rules than the SWO. This is largely due to its ability to carry over its budget, which the SWO is legally not allowed to do. In terms of expansion of services to rural areas, initial studies indicate that IKEC is able to adapt its services and tailor its activities to rural populations, especially in times of need while SWO tends to be less innovative. However, further studies, including beneficiary assessments, need to be

conducted before this can be confirmed and the incentives that lead to these behaviors and results identified[9].

Subsidies

3.21. Iran also uses a system of subsidies established at the inception of the Islamic Republic and during the war years. They play a large part in fulfilling the role assigned to the public sector discussed in Chapter 2. Subsidies for basic goods are provided within price controls administered by the Organization for Protection of Consumers and Producers (OPCP)[10]. The Economic Council[11] oversees the OPCP and approves all decisions regarding the distribution of subsidized goods, the criteria for allocation of coupons, prices, and the amount of subsidy, as well as the volume of goods that OPCP will import. Basic subsidized goods include wheat, rice, vegetable oil, sugar, cheese, dry milk, medicine, and agricultural inputs such as fertilizer and pesticides. A system of coupons is used to target low income households for edible oils, sugar, and cheese. The subsidies provided for the rest of the items on the list (other than some medicines that require coupons) are provided to all citizens[12] in unlimited amounts. As a result, most of the subsidies benefit the non-poor (see Table 3.2)[13].

Table 3.2: Share of subsidies that accrue to the poor and non-poor for specific goods, 1998

	Rural poor	Rural non-poor	Urban Poor	Urban non-poor
Energy	11	89	6	94
Wheat	10	91	6	94
Pharmaceuticals	18	82	3	97
Edible oil and sugar	13	87	8	92

Source: Salehi-Isfahani and Souri (2002) and World Bank Staff calculations

3.22. Article 46 and 47 of the Third Five-Year Plan stipulate that subsidies for basic goods and some agricultural inputs will continue during the Plan period. As discussed before, while some subsidies were always shown in the budget, a large number of subsidies were implicit until the year 2002/03 (see table 3.3). Since then, these have been made explicit. Based on the breakdown of the exchange rate subsidies in budget 2002/03, a total amount of 26.6 trillion rials (about 3.1percent of GDP) has been allocated to

[9] For a stronger analysis and more definitive results, one needs detailed data on costs, quantities, and qualities of comparable services that IKEC and SWO have offered at different times and locations. Information on service quality (including impact) is particularly difficult to come by; the characteristics of the target population and those being supported are not easy to gauge. For this reason, the statistical analysis of the data needs to carefully assess the potential roles of unobserved variables and take account of them in the methods it uses to measure efficiency differences.
[10] Note 5 of budget 2002/03 put aside a total of 13.4 trillion rials of the government's budget to be allocated for basic goods directly subsidized through the budget.
[11] The Economic Council is composed of members of the Cabinet and other officials, including the Head of the MPO and the mayor of Tehran.
[12] The subsidy is indirectly.
[13] The incidence of consumer subsidies provided by public spending is discussed in Poverty in Iran, Trends and Structure 1986-1988, World Bank 2003.

compensate sectors involved in the import of subsidized goods[14]. In 2002/03, about 30 percent of the total amount of exchange rate subsidies were allocated to basic goods and 12 percent was allocated for the import of pharmaceuticals. However, in line with the President's reform agenda for the public sector, the government planned to reduce the size of the exchange rate subsidy by 20 percent for the Iranian fiscal year 2003/04.

Table 3.3: Subsidies in Budget Bill 2005/06
in billion rials

	1384 2005/06
	proj.
Flour, item 1B of note 15	18928
Agricultural input, item 4B note 15	5964
Eligible producers and consumers	1879
Coupon for deprived, item 2B of note 15	7712
Medicine and dried milk	2244
Interest on finanacial facilities	2
Price difference for goods and services with controlled prices	1605
Price difference for goods and services purchased and sold	1981
SSO-crimes prevention programs	40
SSO- insurance programs for rural area	150
SSO- poverty reduction programs	400
Total subsidies *	40904

Source: Government budget bill 2005/06
* Subsidies are part of the miscellanous expenditure.

3.23. In addition, the government assists people in obtaining housing by providing subsidies to different groups of people based on the type of housing and social group of the household rather than income. These subsidies amounted to 1.5 percent of GDP in 1999/00 and remains at 2 percent in the next year's budget 2005/06[15]. Land subsidies amounting to around 1 percent of GDP are also provided, mainly by allocating public land at less than market prices to different groups of beneficiaries, including cooperative bonyads, developers, funds, and private individuals.

3.24. Energy (consisting of electricity, gas, kerosene and gasoline) as discussed in chapter 2 is the most heavily subsidized item in Iran. The total amount of the implicit subsidy has been calculated at around 11 percent of GDP during the 1990s. The implicit revenue loss (see Table 3.4)[16] is substantial; i.e., if these four items were sold at market prices, the revenue from energy sales to the budget would have been seven times higher (*ceteris paribus*), which yields a subsidy rate of some 86 percent.

[14] The total amount of the exchange rate subsidy is about 10 percent of government's general public budget.
[15] Paper on Housing Subsidies, World Bank 2002.
[16] Poverty in Iran, Trends and Structure 1986-1988, World Bank 2003.

Table 3.4: Explicit public Spending on Energy Subsidies, Household Spending and Subsidy Rate, 1998

	Share of total spending from budget (percent)	Subsidy rate (percent)
Energy, total	*2.8*	*86*
- Electricity	1.1	87
- Gas	0.8	79
- Kerosene	0.5	84
- Gasoline	0.5	91

Sources: IMF (2000), World Bank (2002), Salehi-Isfahani and Souri (2002), and World Bank staff calculations

CHAPTER IV: THE PROCESS OF RESOURCE ALLOCATION

4.1 This chapter looks at the resource allocation process starting with the process of fiscal planning, which precedes the allocation process and defines the envelope that is used for allocations. The second part of the chapter describes in detail the process of preparing the budget itself.

Fiscal Planning Process

4.2 Two important rules limit government deficit and debt level under the Third Five-Year Plan: (i) a prohibition on government borrowing from the banking systems, including from BMJII, to cover the budget deficit, and (ii) a limit of 25 billion rials on total net external obligations at end 2004, including guarantees (Articles 69 and 85 of the Third Plan). However, additional spending is possible by raising the amount of budgeted oil revenue or by running down the balance of the Oil Stabilization Fund.

4.3 The Third Five-Year Plan sets the macro targets for each year. In light of these targets, the MPO reviews the macro outturn at the beginning of the year, prepares the macroeconomic framework, and presents it to the Cabinet. The macro framework has an annual outlook and consists of:

- total revenue;
- total expenditures;
- current expenditures;
- taxes;
- oil revenue; and,
- other revenue.

4.4 The macro framework report includes several scenarios based on different oil price and growth assumptions. It is based on a full set of national accounts data. The Cabinet decides which scenario to adopt, and its choice is generally on the conservative side. The macroeconomic framework and general priorities for the budget are explained to ministries in the budget call circular and are presented to the Parliament as part of the President's budget speech.

4.5 During the year, the MPO updates the macro-framework monthly[1] and presents its updates to the Cabinet when there are serious deviations from earlier forecasts. If there is an unforeseen shortage in the realization of revenues, the allocation committee adjusts the expenditure releases accordingly. The MPO collects the revenue data from

[1] BMJII's quarterly publication "Economic Trends" publishes disaggregated data on budget revenues, as well as data on assets and liabilities of BMJII and the financial public sector. The yearly bulletin of the BMJII, "Economic Report & Balance Sheet," provides disaggregated data on expenditures. "The Bulletin of Socio-Economic Statistics," published by the MPO, provides annual data on the budget of the central government and SOEs, as well data on public debt. The Statistical Center of Iran's statistical yearbook includes time series data on a variety of topics including the government budget, household expenditure and income, and national accounts.

MEAF, which has its own estimations on the realization of revenue estimates. The two agencies try to reconcile their estimates, and if unable to do so, present both opinions to the Cabinet.

4.6 Deviations between the revenue estimates in the Plan and revenue realization are typically 5-10 percent, often smaller, sometimes larger, as shown in Table 4.1.

Table 4.1: Revenue Deviations from Plan Targets
(in percent of target)

	2001/02	2002/03
Tax	92.5	97.3
Oil	114.9	109.8
Total	95.4	98.3

The Resource Allocation Process

4.7 Three main processes help the government to set national priorities and allocate public resources accordingly: (i) five year development planning, (ii) the annual budget and (iii) the allocation process that takes place throughout the fiscal year.

Resource allocation can be divided into seven subprocesses:

⇒ development planning;
⇒ setting expenditure ceilings and issuing the budget circular;
⇒ budget requests;
⇒ budget review;
⇒ presentation of the budget;
⇒ parliamentary review and appropriation; and,
⇒ apportionment, allocation, and allotment[2].

4.8 The MPO is the main actor in these processes. The MPO plays all the pivotal roles between the Parliament, the Cabinet and the executive agencies (see table 4.2).

4.9 The twenty-four sector bureaus of the MPO make up a mirror image of ministries and handle relations with the executive agencies, whereas the Department of

[2] Appropriation is the approval of the budget by the Parliament. Apportionment is the distribution of the approved (appropriated) budget among the spending entities. As discussed later, this is the responsibility of the Parliament (the specificities are discussed by the appropriate committees), which takes the recommendations of MPO into account. Allocation is the amount of credit released to the spending entity that is available for commitment. This is decided by the Allocation Committee. Allotment is allocation of the available credit to each budget heading (e.g., compensation of employees, use of goods and services delineated by type, such as telephone) within a spending entity, subject to agreement between the MEAF and each spending unit.

Economic Affairs Plan and Budget Coordination handles the overall coordination of the budget and the relations with the Parliament and the Cabinet.

Table 4.2: Action And Processes in Budget Preparation

Responsibility/Subprocess	Parliament	President and Cabinet	MPO	Management body	MEAF
Development Plan	Adopts	Approves	Prepares	Participates	
Expenditure ceilings and budget circular		Approves	Prepares		
Budget Requests				Prepares	
Budget Review and Government's Budget Proposal		Approves	Implements		
Parliamentary Review and Appropriation	Adopts		Supports		
Allocation	Participates		Chairs	Supports	Participates

A. Development Planning

4.10 The five-year development plan is prepared by the MPO in consultation with sector ministries and universities. It is discussed at great length among the Cabinet, the Parliament and the Guardian Council, and becomes a law with the approval of the Majlis and the Guardian Council[3]. Implementation of the plan is the responsibility of the executive agencies. Each executive body is required to submit an annual performance report to the MPO about the implementation of the plan that complements their budget request. The President is required to submit an annual progress report to the Parliament discussing the performance of the entire government no later than the end of August of the following year[4].

4.11 The main volume of the Third Plan law, for example explains the objectives, necessary actions to reach to these objectives, and the responsibilities of executive agencies in intra-sectoral and sectoral issues. The first part of the law presents issues that cut across sectoral boundaries, such as administrative and managerial reform, reorganization of SOEs, privatization, regulation of monopolies, social security, employment, taxation and the budgeting system, the provincial income and expenditure system, monetary and foreign exchange policies, and reorganization of the financial market. The second part discusses sectoral areas, such as water and agriculture, energy, post and telecommunications, transportation, housing, education, and health. The

[3] The planning tradition in Iran goes back to 1937. The first plan was called "Seven Years of Agriculture". The first serious plan and the planning organization were launched in 1949. The second seven-year plan was launched in 1955 with a mid-term review in 1958.

[4] The details of the monitoring and review arrangements are laid out in the Chapter 26 of the Third Plan.

thematic breakdown of the Plan resembles the organizational breakdown of the MPO[5]; form follows the function.

4.12 The law is accompanied by detailed plans in each area that present a mix of quantitative outcomes and output targets, sometimes broken down into annual, mid-plan and end-of-plan targets. Budget documents of executive agencies include progress reports on achieving these targets[6]. The detailed plans also include annual expenditure targets for the current budget and the investment budget, broken down by executive agencies, programs, and projects. These targets are indicative in nature, and the MPO revises them every year during the budget process.

4.13 The Plan lays out the medium-term development objectives of the government and a medium-term expenditure framework. However, it is not a rolling, forward looking plan, being constrained within the fixed five year timeframe of 2000-2004[7].

B. Expenditure Ceilings and the Budget Circular

4.14 Annually, the MPO updates the inflation estimates for different spending items, reviews the actual expenditures of executive agencies, and assesses progress in development projects in the last two years. It then assigns a ceiling to each executive body accordingly[8]. The MPO informs the executive agencies about their ceilings in the budget circular in August, roughly four months before formal submission to Parliament.

4.15 The ceilings for current expenditures are decided on a largely incremental basis; i.e., as a percentage increase over the previous years budget, although some account is taken of previous expenditure performance[9]. On the other hand, ceilings for development projects tend to be guided by the Five Year Plan[10]. For example, the development projects that received lower allocations over the last two years compared to the Plan figures receive higher ceilings[11]. Ministries are allowed to finance some of their services with user fees, but increases in these fees are also set by the Plan, with

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[5] Compared to other countries that have planning offices (Turkey, Egypt), the MPO is a much stronger body because it has authority over the entire budget (both current and capital) and also over personnel regulations. The organization of MPO is presented in Annex 2.

[6] An example on health and sanitation taken from the report to the Budget Consolidation Committee in 2002/03 is presented in Annex IX. It provides data on actual targets reached for 2000/01, while presenting planned targets for 2001/02 and 2002/03.

[7] Some developing countries like South Africa have adopted a forward estimates system a la Australian reforms in 1980s to provide a rolling plan and a medium term expenditure framework linked to the planning and budgeting processes.

[8] These are annual ceilings, and there are no rolling, forward looking estimates to link the Plan to the budget.

[9] Some countries require all programs to be evaluated every five years (Malaysia, Australia, and Canada).

[10]The Third Five-Year Plan includes a table of ceilings, which provides the basis for annual allocations. The ceilings are revised on a rolling, forward looking 3-year basis, incorporating outturns of the previous three years. The outturns of the previous three years are incorporated, and changes are made to the ceilings for the next three years.

[11] The control over current budget was transferred from the Ministry of Finance to the MPO in 1964, and a single budget office was established in 1967. In 1972, however, the budgeting authority was divided once again between the programming office and budget office, both within the MPO.

any further change requiring the approval of the Cabinet. In any case, fee increases cannot exceed 10 percent annually. The MPO does not allocate all expected revenues as expenditure ceilings to ministries; it keeps a reserve for budget negotiations, but there was no information on the size of reserve or how it is set[12].

4.16 Once the draft budget circular is prepared by the MPO and approved by the Cabinet, it is then sent to executive agencies by the President.

4.17 The budget circular begins with an overall description of the macroeconomic environment. Next, the circular presents the fundamental directions for the budget, which are generally whole of government issues and mainly rearticulation of the intra-sectoral goals set in the plan. Some of these issues are:

- reforming the financial structure of government spending and budget;
- reform of the administrative structure and management;
- reform of the structure of governmental companies, privatization, and expansion of public cooperation;
- reform of the structure and efficiency of the social security and subsidy regimes;
- increasing the employment level and reducing the unemployment rate;
- augmentation of production and investment;
- decentralization, regional balance, and elimination of deprivation;
- developing the export of non-oil products and services; and,
- Improving the situation of monetary system and exchange rate and settling foreign remittances and payments.

4.18 The budget circular clearly states that the attainment of these goals is the responsibility of ministers and top managers: "The leadership and direction of the affairs of every sector in the framework of the Third Development Plan and this circular would be the responsibility of ministers or the highest person in charge."[13] In its annexes, the circular includes detailed instructions regarding the time table, classification, and form of the budget. The ceilings are also part of the annexes.

C. Budget Request

4.19 After receiving the circular, central budget offices of ministries and other entities add their sector specific instructions and send the circular to spending units. They do not review or revise ceilings assigned by the MPO to spending units or detail them any further. Generally, ministries organize a conference with the heads of spending units where they discuss the priorities and budget instructions. However, there appear to be no strategic budget plans within ministries or spending units to guide the allocation of resources between competing claims.

[12] Some countries like Sweden and Spain have adopted a system where they reach a binding agreement between the executive and legislative branches on an aggregate expenditure ceiling, as part of macro-fiscal plan, and sectoral expenditure ceilings before the detailed resource allocation process begins. Hence, top down ceilings receive legislative approval.

[13] Budget Circular for FY 2003, last page.

4.20 Spending units prepare their budget requests and send them to their parent ministry. Their budget requests are essentially incremental, based on last year's allocation, plus inflation and a negotiation increment. Knowing that the MPO has not assigned all expected resources, spending units' requests exceed their ceiling by an average 20 percent. The incremental method of budgeting considers only past performance of funds, ignoring the connection between the budget and the planning goals. As the deviation analysis in paragraphs 4.57 and 4.62 indicates, this link between past utilization of budgeted resources and allocations is fairly tight. However, in this method, emphasis is placed on elements of cost rather than focusing on results. Thus, the adequacy and appropriateness of previous levels and quantities of service are not evaluated. The budgeting primarily follows the principles governing the agencies; that is, due to some presumption, all agencies view their management and organization as fixed. As a result, the major share of current expenditures is spent on administration.

Table 4.3: Formal Budget Preparation Cycle

Date / Iranian months	Major Activities
Tir (June / July) (-8)	MPO prepares the general framework of the next year budget
Shahrivar (August / September) (-6)	First draft of the budget circular is prepared by MPO and is approved by cabinet which is then communicated to executive agencies by the President
Mehr (September / October) (-5)	Executive agencies propose their own budget in line with the policies and ceilings indicated in the budget circular to MPO
Aban (October / November) (-4)	The proposed budget of the each executive agency is reviewed by relative (corresponding) deputies and offices at MPO and is sent to budget committee at MPO for review and confirmation. The confirmed figures (of the budget) are then presented to cabinet.
Aban (October / November) (-4)	The proposed budget bill is reviewed and finalized in the cabinet.
Azar (November / December) (-3)	The proposed budget bill is presented to Majlis by the President
Day (December / January) (-2)	The proposed budget bill is reviewed by relative (corresponding) committees and the consolidated committee of Majlis and the results are reported to the floor of Majlis within 40 days
Bahman (January / February) (-1)	The proposed budget is reviewed in Majlis and the results are submitted to Guardian Council within 15 days
Bahman (January / February) (-1)	After Guardian Council confirmation on the budget figures, Majlis gives it's final approval on the budget bill
Esfand (February / March)	The approved budget law is communicated to the president by Majlis for implementation
Farvardin (March / April)	Fiscal year begins

Source: Macro Bureau, MPO
Note: Figures in parentheses describe number of months prior to final approval.

4.21 Although the budget requests include a statement of objectives and outcome targets, as in the Plan, there is no correspondence between these targets and resource allocation[14]. The missing link is the lack of identification of outputs and performance measures of entities responsible for delivering these outputs. The absence of monitoring

[14] Some countries (Malaysia, Indonesia) complement their five year development plans with ministry level strategic plans, and some others are moving in this direction (Thailand, Turkey).

and evaluation mechanisms intensifies this gap[15]. As part of the budget reforms, the government is trying to address this problem by linking costs to activities[16]. A pilot on activity-based costing was launched in the health sector during preparation of the 2003/04 budget, and one is now being implemented in the education sector.

4.22 The central budget offices of ministries review and compile the budgets of various spending units and prepare each ministry's budget request. There are no negotiations between a ministry's central budget office and its spending units, even when a spending unit's budget request exceeds its ceiling[17]. Instead, negotiations take place between the spending units and the MPO, where the ministry budget office supports the spending unit[18]. The passive role of ministries in budget preparation indicates that there is little oversight by a parent ministry over its spending units.

4.23 There is no separation between costing of old and new policies in the current budget, although there is a separate process for new development projects. The projects have to be in line with the Third Plan. The preparation of new projects goes through lengthy feasibility and design studies by the implementing agencies with MPO oversight. Thus, it can take up to five years before projects are submitted to the MPO for final review and approval. Decisions to include new development projects in the budget are based on the submission of standard forms by the implementing agencies to the MPO during the budget preparation process.

4.24 If increased funding is requested for existing projects, the necessary funds and new terms are discussed between the MPO and the implementing agencies; the parent ministry is not an active participant in that process. No multiyear budgeting structure is provided for development projects, and funds are allocated on a year-to-year basis without much regard for initial cost estimates or the pace of implementation.

4.25 The SOEs prepare their budgets separately from their ministries and submit them to the MPO directly with no intermediation by parent ministries. MPO alone determines the size of any budget transfers to SOEs.

4.26 Ministries, spending units, and SOEs send their budget to the responsible sector bureaus of the MPO within 45 days of receiving the circular.

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[15] The MPO's assessment of the budgeting system (see Annex 3) discusses deficiencies in the information system and the low capacity of the supervisory institutions.

[16] The first attempt on program budgeting in Iran dates back to 1960.

[17] In Malaysia, for example, ministries prepare program and performance agreements with spending units under that ministry to establish performance expectations during budget negotiations.

[18] While there is no formal recourse, the agencies can nonetheless pursue their case in the Cabinet with the Minister, or with Parliament.

Box 4.1: Activity Based Costing in Iran

As part of the budget reform in Iran, Activity Based Costing (ABC) is being applied to measure process and activity performance by tracing costs to services/outputs according to the activities required to provide them.

The advantages of using a technique that captures organizational costs for the factors of production and administrative expenses and applying them to activities include

- a more representative distribution of resource use since cost allocations are based on cost drivers that cause the cost to be incurred by recognizing the causal relationship between the activities and the cost drivers thus providing more precise information about the total cost of services provided by the government.
- accurate information about the unit cost of an activity compared to the traditional method of applying overhead directly to the output thus facilitating comparisons of the efficiency of delivering services by alternative means.
- a move away from the current focus on variance from budget to evaluate performance to a focus on the results of resource use.

Although the exercise in Iran has been primarily driven by the effort to provide benchmarking for costs – there are several other possible applications for the information that is being generated, as a result of this exercise including- setting service standards; defining performance measures; facilitating accountability for services delivered; business planning and setting user fees.

The Ministry of Health is one of the pilot ministries implementing ABC. In the first stage of implementation, it has utilized the existing classification of the budget into programs in order to delineate outputs and has in addition identified the organizational structure (via implementing units). The next stages should focus on identifying activities within each cost center and integrating this information with the existing financial and operational system. The existing line item system of reporting in Iran reduces the costs of implementing ABC, once the initial mapping of activities is completed. The initial activities that the Ministry has focused on have been mapped to programs and been kept under manageable proportions. Relevant process and non-financial data is being gathered from the various units under the Ministry.

For full implementation of ABC, a decision will have to be made regarding which level of outputs and costing they would like to record. Although ABC systems are not transactional but periodic – the exercise becomes easier if the accounting system can be used appropriately. A traditional cash based accounting system as in Iran, makes it difficult to account for the full costs of capital assets used in the provision of goods and services since in order to do so, it is necessary to take into account both depreciation and remuneration of capital employed[1]. Although these can be approximated, the impact of imperfect information on costs is larger in a capital intensive sector such as health.

See *Managing Public Expenditure: A Reference Book for Transition Countries* edited by Richard Allen, Daniel Tommasi. OECD.

D. Budget Review

4.27 The proposed budget of each executive agency is reviewed by the responsible sector bureau of the MPO. After its review, each sector bureau compiles the budgets of all the executive agencies under its responsibility and sends them to the budget committee of the MPO for further review and confirmation. The budget committee of the MPO, based on revenue estimates, divides the budget among all agencies and forwards the result to MPO sector bureaus for consultation and negotiation with the

related ministry. After these consultations, the budgets from all the 24 MPO sector bureaus are consolidated and the confirmed figures are then presented to the Cabinet.

4.28 The Cabinet has another 15 days to review the budget and to finalize any remaining disagreements between the MPO and ministries. At that level, any request for higher funding by ministries needs to be matched with additional own sources[19] from that ministry. The budget bill is than presented to the Parliament by the President.

4.29 The reviews in the MPO are more concerned with respecting the ceilings than they are with the goals and objectives of the ministries and spending units. There is currently no systematic evaluation process and capacity within the MPO to provide feedback on the implementation of policies and plans, which could then be reflected in the budget decision.

4.30 In the development budget, the MPO's emphasis is more toward reviewing the new projects than achievement of objectives and the performance of earlier approved and on-going projects. In 2002/03, an additional 180 development projects were injected by the Parliament, even though the existing ones suffered from long delays resulting from poor management or design and limited financial resources; average completion time for capital projects is 9-10 years. However, the Government is cognizant of this problem and has decided that no new development projects would be proposed in the 2003/04 budget, unless inserted directly by Parliament during the approval process[20].

E. Presentation of the Budget

4.31 The Government presents a budget folder to the Parliament that includes the following documents:

- ⇒ The President's speech to the Parliament;
- ⇒ One short volume containing the budget notes;
- ⇒ The main volume of the budget, which includes summary tables, sources, and uses (This was 1030 pages in 2002/03, and is what is usually referred to as "the budget");
- ⇒ Appendix 1 listing development projects;
- ⇒ Appendix 2 containing the provincial budget; and,
- ⇒ Appendix 3 with summary budgets of public enterprises and banks.

[19] If ministries can come up with new user fees or increase the existing ones with Cabinet approval, they can get extra funds that are then included in their budget.
[20] This problem is not unique to Iran. Some countries (Turkey) or states (Orissa in India) introduced a zero-base review to rationalize the investment program. Mexico has tightened the approval process.

4.32 The President's speech explains the macroeconomic environment, the economic outlook, and the fiscal policy. It also lays out the overall objectives of the budget and its consistency with the objectives stated in the five-year plan.

4.33 The budget notes are used for special provisions that are not provided in the organic budget law but require parliamentary approval. They specify special tasks for the government, reallocate credits among ministries, determine exceptions and exemptions for specific entities, earmark revenues for special use[21], or prioritize ministries in receiving implicit subsidies. The Parliament discusses and votes on each note separately.

4.34 Previously, most of the non-transparency in the government budget was due to a lack of clarity in the budget notes. Until 2002, budget notes were unclassified and, more important, inconsistent with five-year development plan goals. In line with the reform agenda and to increase transparency in the budget, the government has amended the budget notes and reduced the number of the notes from 50 in 2001/02 budget to 20 in 2005/06 budget. Those notes that gained a permanent character have been added to the generic budget law (The Bill for the Reform of Part of the Government's Fiscal Regulations) [22]. Others were categorized according to subject and sector.

4.35 The main volume of the budget consists of four sections. The first section presents the budget notes. The second section displays the summary tables, including summary tables of SOE expenditures and resource flows and provincial revenues and expenditures. The third section details the resources, and the fourth details the expenses of the government. The main part of the budget, sections three and four, is organized around specific executive agencies[23] whether ministries, public institutions, bonyads, provinces, or even a library[24]. What is common to them is that they receive appropriations at the chapter level.

[21] The titles of the budget notes and the list of earmarked revenues are shown in Annex 4.
[22] Budget notes are used for special (or temporary) provisions that are not provided in generic budget law but require parliamentary approval. Budget notes are used in many countries to delegate special powers to planning and finance ministries, to allocate special allowances, provide specific tasks to ministries or other entities, and earmark special revenues. Iran added those that have gained permanent character to the generic budget law. Iran is taking care of this issue as part of its reform program as other countries should do (Egypt, Indonesia, Turkey).
[23] There are currently 92 such bodies in the budget.
[24] The governance framework for these different types of entities is discussed in Chapter 2.

Box 4.2: Presentation of the Budget 2002/03

Section I: First article and the budget notes

Section II: Summary tables

1. Summary of the government budget
2. Summary of the budget of executive agencies
3. Summary of government's revenue and expenditure
4. Summary of the change in capital assets
5. Summary of the change in financial assets
6. Summary of expenditure in terms of sectors
7. Summary of government's acquisition of capital assets in terms of sectors
8. Projection on national and provincial credits in terms of sectors, chapter and program
9. Provincial budget 2002
10. Summary of resources and expenses of SOEs, Banks and For Profit Organizations
11. Summary of resources and expenses of SOEs
12. Summary of resources and expenses of Banks
13. Summary of resources and expenses of For Profit Organizations
14. Credits for reinforcement of the Defense affairs

Section III: Resources of the general public revenue

III a) Revenue and sales of capital and financial assets in terms of sources
III b) Revenue and sales of capital and financial assets in terms of executive agencies
III c) Revenue and sales of capital and financial assets in terms of SOEs

Section IV: Expenses of the general public budget

IV a) Current expenditure of executive agencies in terms programs
IV b) Projections of the expenses for acquisition of assets in terms of executive agencies and programs
IV c) Miscellaneous expenditure
IV d) Acquisition of miscellaneous assets
IV e) Expenses of the general public budget from earmarked revenue

4.36 For 2002/03, as part of the budget reforms, the budget was reclassified according to GFS 2001 standards (see Box 4.2). Thus, the presentation of budget changed accordingly. In addition to expenditures and revenues, the budget began presenting changes in capital and financial assets separately for each executive body and for the whole government[25]. The adoption of GFS 2001 standards has had its biggest impact on identification and classification of assets, as well as in presenting the acquisition and sale of different types of assets separately. Hence, Appendix 1, which previously presented the development budget, now displays the details of governmental asset acquisition. Clearly, recognition of the concept of public assets has more significance in an oil economy such as The Islamic Republic of Iran, and oil revenues are now recognized as sales of capital assets. The summary tables display the net change in public assets. This has been an important step forward in fiscal transparency.

[25] The presentation of the 2003/2004 budget to the Parliament included a long explanation how the budget is different from previous budgets.

4.37 Functionally, the budget has a sector-program-subprogram-activity classification. Spending agencies are grouped within sectors, and their expenditures are broken down into programs and subprograms, where current expenditures are further detailed in terms of activities and capital expenditures are detailed in terms of projects (see Box 4.4). Another component of budget reforms has been to improve the activity classification of the budget and assign the costs across spending units accordingly. On this basis, the relevant forms and guidelines for completing the 1381 budget were sent to the provincial and sectoral offices of the MPO. The preparation of these forms was not completed on time for all line agencies, either as a preliminary exercise or in time for the budget. The reason for the delay was the novelty of the task, especially because part of the work involved the estimation of the total cost of the organizations' activities. The government's efforts continue; the MPO and the Ministry of Public Health launched a pilot to identify and cost activities of rural clinics. These will be followed by other pilots, including hospitals and schools. Moreover, the MPO has formed working groups to conduct studies on preparing operational budgets with goals and to design management information systems in the second stage of reforms. (see box 4.1)

4.38 The presentation of the budget is shown in Box 4.2. Section IV of the budget shows the entire expenditure of the general budget, classified as current and capital spending under executive agencies and programs, spending from earmarked revenues (which is included with the functional breakdown of spending elsewhere in the budget), and two categories of miscellaneous expenditures (recurrent and capital "acquisition of assets"). This miscellaneous spending has typically amounted to around 15 percent of total spending, although it was about 40 percent in 2002/03. Miscellaneous spending includes a wide variety of allocations, ranging from contingency funds, to loan repayments, to set asides that are allocated to spending agencies via the budget notes, to central funds that are subsequently distributed as part of the regular allocation process, to spending that is clearly labeled for specific spending agencies but for some reason was not included in the usual functional classification. For example, funding for exchange rate subsidies, made explicit for the first time in 2002/03, was budgeted under the miscellaneous category because MPO lacked reliable estimates of what the budget cost of the subsidies would be in specific units. In any case, miscellaneous spending is not reported elsewhere in the budget by functional category and cannot be easily mapped into the functional budgets of executive agencies or programs. This reduces the transparency of the budget document. The reforms introduced in 2002/03 shifted funding for almost 60 separate miscellaneous items into the allocation "other spending" in the current budget.

Box 4.3: Classification of Budget Resources

a. General government resources
- Revenue
  - Tax
  - Non tax
    - Social security contributions
    - Transfers
    - Earnings on government assets
    - Sale of goods and services
    - Fines, penalties, and forfeits
    - Miscellaneous
- Sale of capital assets
- Sale of financial assets

b. Earmarked revenues
- Tax
- Non tax
  - Social security contributions
  - Transfers
  - Earnings on government assets
  - Sale of goods and services
  - Fines, penalties, and forfeits
  - Miscellaneous
- Sale of capital assets
- Sale of financial assets

4.39 The budget includes entities classified as executive agencies (92) and spending units (550). As part of the budget reforms, the number of spending units was decreased from 850 to 550. Considering the fact that 308 of these agencies belong to institutions of higher education, bonyads, and to SOEs whose accounts cannot be combined, the reduction amounts to 50 percent.

4.40 One of the goals of implementation of the Third Plan concerning the SOEs had been to consolidate their presentation in the budget under the budgets of some 85 holding companies. However, this step requires changes in SOE constituting articles, and only 10 such holding companies have been set up so far. The SOE budget reforms will continue in the second stage.

4.41 Another component of budget reforms was constructing a new information system for budget preparation. New software was developed and used to prepare the 2002/03 budget. This integrated computerization of budget preparation has made possible the immediate publication of the 2002/03 budget on compact discs. In the second stage, the budget preparation system will be extended to include budget agreement and the allocation processes, and a new module will be developed for registering capital assets.

F. Parliamentary Review and Appropriation

4.42 Parliament reviews the proposed budget in three stages: first within sector commissions (11), second within the consolidation commission and third, within the General Assembly. Altogether, Parliament has 35 working days for these reviews. The Research Center of the Parliament assists the Parliament in these reviews. The Center analyzes different sections of the budget and presents its findings to relevant sector commissions.

4.43 Members of the Parliament have 10 days to submit their views to the sector commissions. They can make any proposal so long as it does not contradict the Constitution, Islamic law, or the five-year development plan. Sector commissions have another 10 days to investigate MP's requests and to submit the commission's view to the consolidation commission. Each sector commission forms a special committee to review the budget and selects two members to represent the sector commission at the consolidation commission. Ministers and heads of spending units are called to answer any and all questions sector commissions may have during their review.

4.44 Generally, sector commissions do not reduce budgets or reject any projects. They review neither past expenditures nor the implementation of policies. They have 10 days to decide on where to add more resources and how to finance it. Some officials of the executive agencies who fail to obtain their goals during the budget formulation process attempt to reintroduce their demands through the Parliament by getting in touch with the members of the sector committees.

4.45 The Parliament increases spending by around 3 percent almost every year but for each expenditure increase, Parliament must propose new revenues to preserve the overall macro-fiscal framework of the budgets. Article 75 of the Constitution requires that Members' bills and proposals, or amendments to government bills proposed by Members, that entail a reduction in revenues or an increase in expenditure be introduced in Parliament only if the means for compensating for the revenue decrease or meeting the new expenditure are also specified[26].

[26] The past few years illustrate the parliamentary increase. For example, for 2002/03, the Parliament has approved 180 new projects although ongoing projects are delayed due to a lack of financial resources.

Box 4.4: Classification of budget expenditures

Current Budget	Employee compensation	Use of goods and services	Expenditure on assets and properties	Subsidies	Grants	Social security benefits	Other expenses
<u>Functional classification</u> ***Services*** (or “Affairs”): General, Economic, Social, and Defense ***Chapters*** (e.g., Health care and nutrition, under Social Services; these typically – but not only -- correspond to “managing bodies” or ministries) ***Programs*** (e.g., Health service program) ***Projects*** (while not listed in the main budget, these are detailed in Annex I under the identical program classification; e.g., establishment of a production facility for hepatic vaccine)							
<u>Administrative classification</u> Executive Agencies ***Spending entities*** (e.g., National Organization for Youth, Parliamentary Research Center, etc.) ***Programs*** (e.g., Youth cultural and social partnership)							
Capital budget	**Building and other Improvements**	**Machinery and Equipment**	**Other Fixed Assets**	**Use of items in Inventory**	**Valuable items**	**Land**	**Other un-produced Assets**
<u>Functional classification</u> ***Services*** (or “Affairs”): General, Economic, Social, and Defense ***Chapters*** (e.g., Health care and nutrition, under Social Services; these typically – but not only -- correspond to “managing bodies” or ministries) ***Programs*** (e.g., Health service program) ***Projects*** (while not listed in the main budget, these are detailed in Annex I under the identical program classification; e.g., establishment of a production facility for hepatic vaccine)							
<u>Administrative classification</u> (Identical to current budget classification)							

4.46 The Consolidation commission consists of 47 members. Of these, 25 are standing members of the Plan and Budget Commission, with the rest consisting of two members from each sector commission of the Parliament[27]. The consolidation commission forms special committees to review the suggestions of the sector commissions. The commission decides on these suggestions on the basis of majority voting. They generally adjust the revenue forecasts to finance additional expenditures instead of adding real revenues to the budget. In the past few years, the discussion of budget proposals in the Consolidation Commission has been accompanied initially by a lot of criticism from the members, who have maintained that the revenue and expenditure figures were too optimistic. Yet each year, the criticisms subside with the passage of time and even more funds are added to the bill presented by the government[28]. These new funds are then distributed among the specialized committees of the Consolidation Commission to be allocated to the relevant sectors. The commission has 15 days to submit the budget to the general assembly.

4.47 After consolidation, the budget is presented to the floor (general assembly) for approval. Here MPs can submit their proposals and table what they oppose. First, the revenue side is reviewed and voted on as a single vote. Then, the expenditure side is reviewed in detail but voted on as a single vote. Each of the 23 budget notes is discussed and voted on separately[29].

4.48 Once the budget has been passed by the Parliament, the Guardian Council needs to approve the budget. The Guardian Council's role is, in effect, that of an upper house of Parliament that can vote out the lower houses' resolution. However, they can do this on two grounds only: (1) if it is opposed to the Constitution, (2) if it is opposed to the Islamic law. In the case of disagreement, the Majlis can send the bill back to the Guardian Council for a second reading. If the Guardian Council still disagrees, the Majlis can either accept the ruling of the Guardian Council or refer it to the Expediency Council. (See Box 4.5 for the resolution of the 1380 (2002-2003) budget dispute.)

4.49 If the budget is not passed by the New Year, the executive branch can continue spending up to 1/12th of the previous budget, pending approval of the new budget.

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[27] The members of the Plan and Budget Commission are selected from the majority and opposition parties. The basis for selection is their education and specialization, not party affiliation. In order to join any standing committee of the Parliament, each MP nominates himself or herself at the beginning of the term by filling out forms with their specialization and then announcing their candidature. Voting is used as the decision rule.

[28] The analysis on revenue deviations at the end of this section (para. 4.57-.4.58) indicates that there is a bias towards overestimation of revenue projections, which is partially due to increases made by the Parliament.

[29] The titles of the notes are presented in Annex 4.

Box 4.5: 2002/03 Budget Dispute: The ruling of the Expediency Council

During the 1380 (2002/03) budget discussions, for the first time since the establishment of the Islamic Republic, differences emerged between the Majlis and the Guardian Council over the budget. After the Guardian Council rejected the budget in February 2002, as ratified by the Majlis for a second time, the Budget Committee of the Majlis, in accordance with the provisions of the Constitution, referred it to the Expediency Council for a final decision. The Expediency Council convened a meeting of the heads of the three branches of government, the MPO, the members of the Guardian Council and the members of the Budget Committee of the Majlis and responded to the written report of the MPs in time for the budget to be ready for implementation in March 2003.

The Guardian Council objected to the following items in the budget that were ratified by the Majlis[30].

1. A decrease in funding for the state run radio and television (Islamic Republic of Iran Broadcasting) budget of 220 billion rials ($27.5 million), which the Majlis proposed could be compensated by increasing revenues from advertising[31].
2. Funding for political parties; 50 billion rials ($6.25 million) were allocated for a fund that would provide support to political parties.
3. A provision and financial guarantees for foreign investors in response to investment of up to $3.5 billion through the Central Bank of Iran, as well as insistence on buy-back guarantees[32] in conformity with the provisions of the Third Five-Year Plan.
4. Allocation of funds to support social and sports activities for recognized religious minorities.
5. The right of the provincial government to scrutinize the budgets of bonyads owning business enterprises under the direct supervision of the Supreme Leader.

The Expediency Council ruled in favor of the Majlis with respect to the third objection. Loans through the Central Bank and buy-back and finance deals had already been included in the bill proposed by the Government. However, the Majlis' changes had assured the Government's right to proceed with buy-back bills and increased the loan amount from $3 billion to $3.5 billion. These, in its entirety (with the changes) were retained by the Expediency Council. With respect to the remaining four, the Expediency Council ruled against the changes that had been made by the Majlis and suggested that the Administration's original budget proposal be retained. The Council argued that the original proposals were made on the basis of technical rather than political reasons. Specifically, it pointed out that the budget for minorities and political parties had been covered by the budget bill previously and that the same practice could be followed. The amendment according a supervisory role to over organizations affiliated with the Supreme Leader by the provincial government was rejected on the basis of a bill passed in the previous year by the Expediency Council exempting these organizations from scrutiny by the government[33]. The budget was adjusted to comply with the Expediency Council's decision.

[30] One other item on national aviation policy to which the Guardian Council objected was dropped by the Majlis.

[31] At the time, IRIB earned 180 billion rials through the sales of airtime. The Majlis provided for 400 billion rials to be spent by the IRIB from its own advertising revenues with the remainder going to the state treasury.

[32] Buy-backs refer to a kind of barter arrangement whereby a producer obtains needed equipment or inputs from suppliers who in turn are eventually paid from the sale of goods produced by the producer (or by other producers who may also benefit in some way). The contracts are for specific quantities and prices, but these may not always be published. The transaction is also guaranteed financially by banks (similar to letters of credit) and respected by Iranian regulations and laws. The system arose out of arrangements with foreign oil companies, who are prohibited from participating in direct investment but who instead supply equipment and expertise in return for a share of the oil sales. The approach is now broadly recognized as a way of encouraging and financing investment in Iran, especially involving foreign equipment and expertise, by both public and private companies.

F. Apportionment, Allocation and Allotment

4.50 After the expenditure budget is voted on and appropriated by the Parliament, the MPO prepares a Letter of Agreement with each executive body in which they agree on the distribution of appropriated funds to different operations and projects. This is called the apportionment. There are separate Letters of Agreement for the current and development budgets. At the apportionment stage, the budgets of the 92 executive agencies are also broken down into the budgets of the 550 spending units.

4.51 The budgets are allocated to spending units quarterly. The MPO leads the Allocation Committee[34] whose role is to limit allocations to the estimated revenue available and prioritize allocations between the spending units based on government priorities. The allocation committee differentiates and prioritizes expenditure based on the nature of expenditure and to the extent that the expenditure is considered unavoidable. Priority is given to salaries, interest on loans, and subsidies. These are usually funded at 100 percent. On average, 95 per cent of appropriations for current expenditure and 80 percent for the development budget are allocated within the year.

4.52 Subsequent to the deliberations of the allocation committee, the MEAF and the spending unit agree on the allotment of budget to each heading in line with the notice of allocation and in conformity with the Letter of Agreement. The release of funds to each spending entity is line with the allotments.

4.53 The release of funds to each spending unit is generally performed on a monthly basis. The first release of funds to the spending entity, covering essential expenditures for the first month of the year, bypasses the usual allocation process. The practice is to pay about 5 percent of the allocated budget as Imprest Accounting Advance[35] to allow the spending unit to meet the salaries for the first month of the year. There is generally no cash release for expenditures relating to the development budget in the first month of the year, except if the funding is already available from specific earmarked funds, external financing, special accounts, or other special-purpose funds. The cash release for the second and the third months each represent half of the approved allocated budget for the first quarter, adjusted by half of the advance paid in the first month. For the rest of the year, the cash release for each month equals a third of the allocated budget for that quarter. If the allocated budget is revised during the quarter, the cash release is adjusted accordingly.

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[33] The Expediency Council revisited the amendment that barred any probe into the performance of institutions under the supervision of the Supreme Leader's Office in June, four months after the dispute about the budget.

[34] The Allocation Committee consists of the Vice President and Head of the MPO (as Chairman); Vice Minister for Expenditure and the Treasury (MEAF); the Deputy Head of the MPO for Economic Affairs, or other deputy heads as required; Director General of the Treasury; Director General for Supervision over Execution of the Budget; and two members of the Parliament.

[35] This is in line with the definition of Article 26 of the Public Accounts Law (1987). It cannot exceed one twelfth of payments for the prior year (Article 5 of the Administrative Regulations Governing the Imprest Payments).

4.54 During the year, resources cannot be moved between executive agencies (chapters) entities or from capital to current budget without parliamentary notification. For the current budget, Article 79 of the Law on the Administration of Certain Financial Regulations of the Government (2002) provides that the MPO can reallocate up to 10 percent between different programs without parliamentary notification. Also, each spending entity has the right to reallocate expenditure between different spending items within a given program by 30 percent for central offices in Tehran, and by 10 percent for local offices of the same entity in the provinces. For the development budget, Note 1 to the Budget Law for 2002/03 stipulates that the budget can be reallocated between the development programs within a given spending entity by 10 percent and between the projects in that program by 30 percent. Furthermore, there is total flexibility for changes within the budget of a particular project.

Revenue Deviations

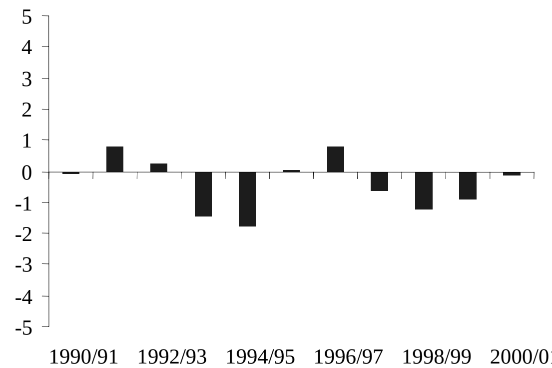
4.55 Deviations of actual revenues from projected revenues indicate that revenues have systematically been overestimated. This is especially true of tax revenues (see Chart 3.2) but also holds for sales of goods and services and transfers to the budget. However, oil revenue projections did not display any systematic bias, indicating that oil revenues are largely determined by volatility in world market prices.

4.56 To analyze how these deviations affect future projections, the correlation between growth in budgeted revenue in one year and deviation of projected revenue from actuals in the previous year were projected. The correlations are high and positive, indicating that past deviations from actuals are taken into account in projecting revenues. This implies that the budgeting process seeks refinement and accuracy drawing on past performance. For example, if the projected tax revenue was higher than actuals in a particular year, then in the following year, the new projections would be adjusted to take into account the actual realization.

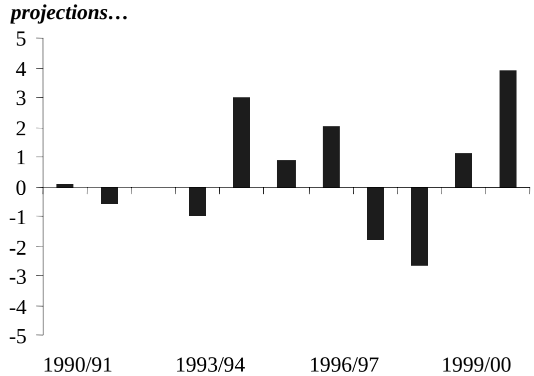
Chart 4.1: Deviations from Revenue Projections
(In percent of GDP)

Revenue has generally been overestimated..

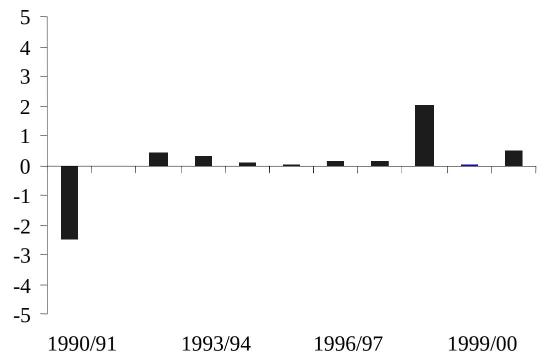
… and tax revenues quite consistently so.



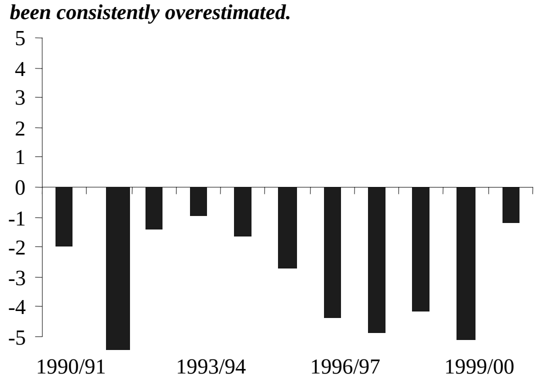
There is little systematic bias in oil revenue projections…



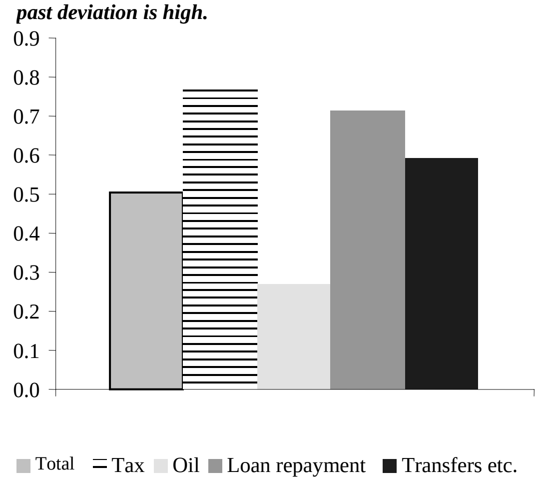
… while loan repayment has been close to projections.



However, sales of goods and services, and transfers have been consistently overestimated.



The correlation between budgeted revenue growth and past deviation is high.



Expenditure Deviations

4.57 As explained above, Iran has an elaborate resource allocation process. This section reviews the budget performance of Iran over the period 1990-2000 by looking at the difference between appropriations and actual spending. This deviation analysis explains two things. First, it shows whether the budget formulated after such an elaborate process is realistic and gets implemented as passed. Second, it demonstrates how the system reacts to unexpected shocks that cause revenue realization to be less than planned. The analysis looks at deviations in expenditures across broad categories, over time, and as a response to shocks.

4.58 Looking at expenditures on the whole throughout the 1990s, current spending was higher than projected amounts whereas development spending was lower (see Chart 3.5)[36]. However, deviations in the first half of the 1990s were lower than deviations in the second half of the 1990s in all broad categories of expenditure (defense, economic, general and debt servicing). Expenditure deviations seem to have increased for almost every category. The only notable exception was social expenditures, where deviations were significantly higher than any other broad category in the first half of the 1990s and were marginally lower in the second half.

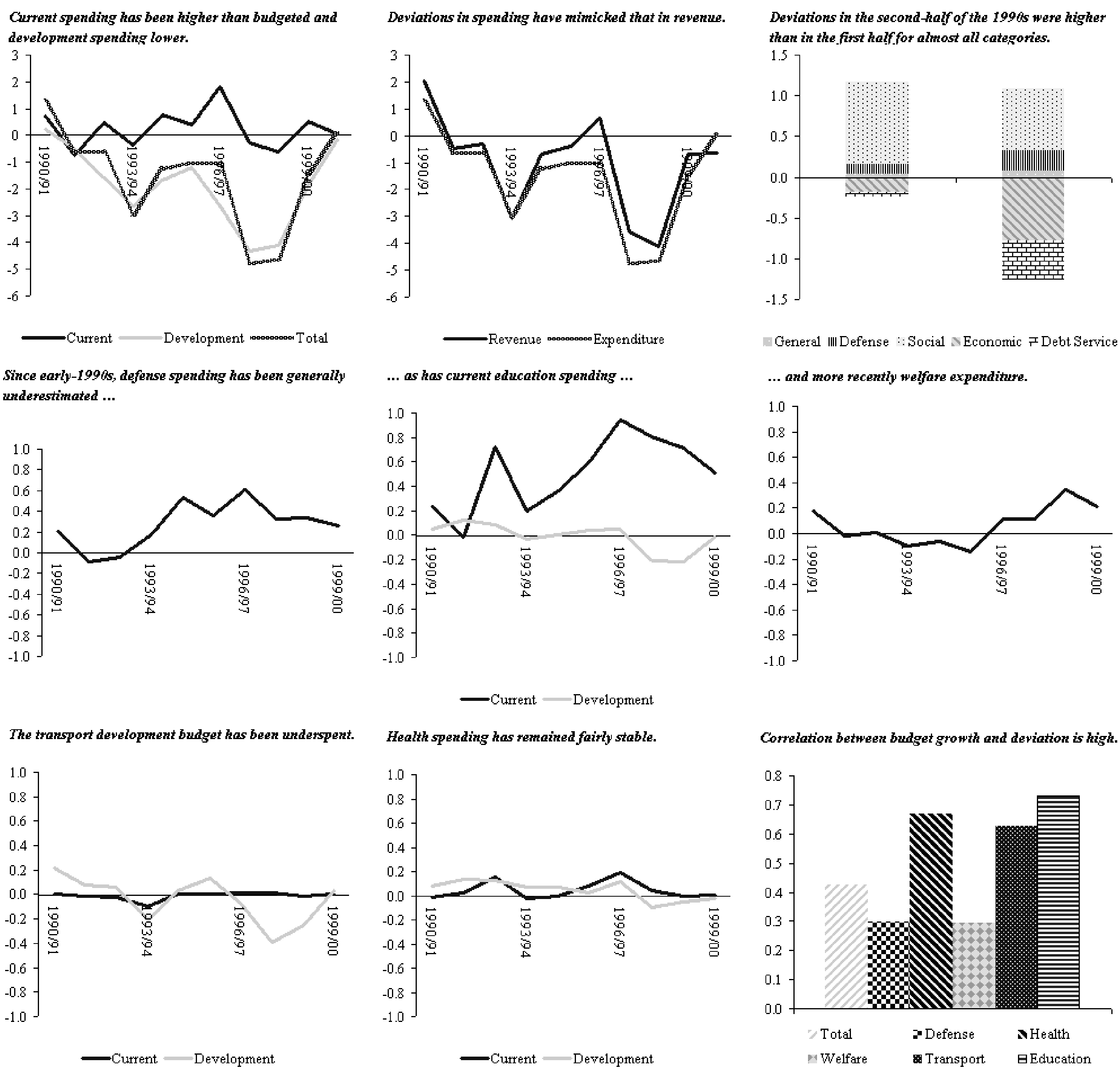
4.59 While analyzing whether deviations were a response to shocks, it is not surprising to find that deviations in expenditure have mimicked deviations in revenues. The highest shortfall in revenue collection and, correspondingly, in expenditures occurring in 1998/99, when oil prices fell suddenly.

4.60 Since the early 1990s, the two areas of persistent under-budgeting have been security and current expenditures on education. Health expenditures, by contrast, deviate less. Deviations in social security and welfare expenditures show a varied pattern, but were increasingly overspent in the latter half of the 1990s. Although budget allocations to infrastructure seem to be decreasing steadily, as discussed in the previous section, the development budget for roads and transportation appears to be underspent.

4.61 In order to analyze how these deviations affect future projections, one can compute the correlation between growth in budgeted expenditure and the deviation of allocated expenditures from actuals in the year before they were computed, as was done with reserves. The correlation between budget growth and the deviation is quite high, with the highest correlations for education, health, and transportation, and somewhat lower correlations for defense and social security and welfare. Budget authorities look at the actual implementation of the budget while deciding the allocation for the next year, the budgeting process remains even largely, an incremental process.

[36] All deviations in Chart 3 are calculated on the basis of percentage of GDP, so as to discount the effects of inflation on expenditure deviations. In nominal terms, the deviations are much higher, however, because inflation is far from insignificant.

Chart 4.2: Iran: Deviations in Expenditure
(In percent of GDP)



CHAPTER V: EXPENDITURE EXECUTION

5.1 Budget execution in The Islamic Republic of Iran is highly deconcentrated, carried out through some 560 separate spending units, each with one or more unit-specific bank accounts for the cash releases from the budget. Each spending unit is responsible for procurement decisions, and each maintains its own separate financial management information system. There is no centralized, computerized, real-time financial management and report system yet in place. This high level of deconcentration, coupled with the high level of flexibility within budget allocations, offers a number of advantages, including a deeper sense of participation and authority by line agencies, the potential for greater responsiveness, and ultimately an increased sense of responsibility and accountability for results. Although the design of this system may have been dictated as much by historical and geographic factors as anything, such delegation is nonetheless generally considered to be a hallmark of good budget management.

5.2 However, substantial deconcentration poses significant risks for the control environment, which necessitates that specific measures and systems be put in place to ensure sufficient accountability for the proper use of public resources. These include systems to manage the overall cash flow through the use of a comprehensive cash and treasury management information system; a comprehensive regulatory framework (notably for procurement) together with consistent application of the rules and regulations across spending entities, assured through active internal review, oversight, and sanctions; and adequate and independent external audits for both financial compliance and operational performance with sufficient follow up. For all of these elements, there needs to be a strong cadre of control professionals, managed in such a way as to assure their continued competence and independence. It is in the area of managing the risk environment where Iran is weakest, although the various budget reforms address some, if not all, of these weaknesses.

5.3 The current legal and institutional framework of budget execution in Iran has its roots in the French model for public finance and dates back to 1911. The original framework has been gradually modified overtime, partly in response to social and political events in Iran, and partly due to practical considerations in managing the execution process over Iran's relatively large geographical area and dispersed population. Changes to the execution process have resulted in decentralizing and de-concentrating the responsibilities for all budget execution and control matters.

Financial and Operational Controls

5.4 At the Ministry for Economic Affairs and Finance (MEAF), the Department of the Treasury and Expenditure (DTE) is responsible for oversight of budget execution, cash management and consolidation of accounts[1]. The DTE has six offices under its responsibility, namely: i) the Office of Supervision over Execution of the Budget, ii) the Office of Supervision of Financial Controllers, iii) the Office for Consolidation of

[1] The organization chart of the MEAF is shown in Annex III.

Accounts and Accounting, iv) the Office of the Treasury, v) the Office of Government Property, and vi) the Office for Bond Financing.

5.5 The Office of Supervision over Execution of the Budget is primarily responsible for the administration of procedures relating to the allocation of the budget and supervising its subsequent execution. This office organizes meetings of the Allocation Committee and is responsible for the execution of its decisions and deliberations. The Office of Supervision of Financial Controllers is responsible for all matters relating the appointment, transfer, training and supervision of financial controllers (FCs). The Office for Consolidation of the Accounts and Accounting is responsible for consolidating the monthly statements of receipts and payments submitted by the FCs, as well as the review of bank statements and bank reconciliation statements. The Office of the Treasury is responsible for all the treasury operations, review of compliance for opening bank accounts in the name of the spending entities, and transfer of funds to those bank accounts. The Office of Government Property is responsible for control and consolidation of the property reports received from the spending entities. The Office for Bond Financing is responsible for budget financing matters.

5.6 Expenditure execution authority, including the management of procurement, remains at the spending unit level and is entrusted to the head of that unit in conjunction with the FCs. This authority includes the management of procurement of each spending entity. However, the FC who manages each office is appointed by and, in a majority of cases, is an employee of the MEAF. In short, the FC is at the center of the financial and operational control system in Iran. This role is entrusted to some 1200 staff located in Tehran, the provinces, and the SOEs[2].

5.7 The size of the budget of each spending entity is the determining factor for the size and responsibility of the office of the FC. An entity that has a large budget may have two FCs, one responsible for the current budget and another responsible for the development budget. The total staff of the FCs' offices can add up to 20 or 25. On the other hand, a single FC may have responsibility for both budgets at a number of the smaller spending entities.

5.8 FCs are assigned to the spending entities based on their qualifications, background, and experience. There are no comprehensive, formal rotation procedures currently in place, but as a general rule, a FC works for 4 to 5 years at a given spending entity on average.

5.9 The FC performs his work under the authority of the head of the spending entity. The staff members assigned to the office of the FC (vs. Office of FC) are the employees of the spending entity; however, they are functionally responsible to and report to the FC. The number of staff assigned to the office of the FC is a function of the size of operations of the spending entity. Large operations can have up to 20 or 25 staff members. In a

[2] Of the 1200, 500 (40 percent) work in the SOEs, 350 (about a third) work in Teheran, and the rest work in the provinces.

small operation, all related functions are carried out by the FC as there is little opportunity for the segregation of functions and assignment of the responsibilities.

5.10 The following table shows the stages in the expenditure execution process and the respective responsibilities of the FC and spending entity.

Table 5.1: Expenditure Execution Processes

Steps in the Expenditure Management Process	**Assignment of Responsibility**		**The Existing Situation**
	Financial Controller	**Spending Entity**	
Expenditure Execution			
Determining (initiating) Expenditure		X	Expenditure is initiated by the responsible official at the spending entity, under responsibility of the minister or head of the entity.
Credit Commitment (Ensuring availability of credit)	X		Credit commitments are undertaken in line with the allotments. FC is responsible for this function as well as for liquidation of commitment and signing of the checks.
Incurring Expenditure, Procurement and Delivery of Goods and Services		X	All these functions are carried out by the spending entity. Details of the procurement process is discussed in a separate section below. FC is also responsible for procurement activities and is a member of the procurement action committee and tender evaluation committee.
Approval for Payment (determining the amount of the indebtedness)		X	The spending entity approves the payment. The FC reviews the documents for compliance with laws and regulations, liquidates the commitment, signs the checks or payment transfers and submit them for the signature of the head of the spending entity. In a large-size operation the FC, is assisted by accountants that are responsible for preparing the checks and documents in support of the expenditure.
Compliance with Regulations, and Liquidation of Commitment and	X		
Signing Checks and/or Approving Payment Transfers	X	X	FC has to approve the payment and is usually one of the signatories for checks issued while the head of agency is the other.
Payment to the Supplier	X		The signed checks are returned to the office of the FC for delivery to the suppliers and service providers.
Request for Funds (Request for Cash Release)	X		FC requests funds, based on the available and the unfounded balance of the credit allocations and the balance at the bank account of the spending entity, through issuing a Request-for-Funds voucher.

Steps in the Expenditure Management Process	Assignment of Responsibility		The Existing Situation
	Financial Controller	Spending Entity	
Recording of Expenditure (Reporting is described in Table 5.4)	X		Receipts and payments are recorded in the books that are kept manually or in a partially computerized financial recording system. The method of recording is on a cash basis.

5.11 The main feature of the existing financial controls exercised by the FC is the *ex ante* compliance review work carried out by the office of the FC prior to the payment for expenditures. The control function is integrated in the budget execution process and forms part of the due diligence and verification work during the expenditure and payment processes. The *ex ante* review work is essentially a desk-and-paper review of supporting documents and encompasses voucher verification controls and a review of the hardcopies of available vouchers and other documentation. The other control function performed by the FC represents an infrequent and an occasional verification of physical quantities of the stocks of material and equipment. This is carried out mainly for reporting purposes[3]. There are limited work guidelines given to the FCs and their staff for this purpose. Any control work other than the said verification functions is determined on a case-by-case basis at the direction of the FC.

5.12 Table 5.2 below presents the control process during execution of the budget and management of the financial records at the spending entities. It demonstrates that internal control activities are generally limited to the control functions that are carried out by the FC over its own activities.

Table 5.2: Financial Control Processes

The Financial Control Process	Assignment Of Responsibility	The Existing Situation
A. Control During Execution of Expenditure		
Ex-ante control functions for: Availability of credit Liquidation of Commitment	Office of the FC Office of the FC	The ex ante control function represents the due diligence work that is carried out at 2 stages: (i) before execution of the commitment by the spending entity, (2) before approval for payment by the FC, to ensure availability of credit and assure that the expenditure is in line with the budget. A separate unit in the office of the FC is in charge of this function. This unit is not involved in the other functions relating to expenditure execution, receipts and payments, or accounting and recording.
Material and equipment control: Safeguard, Accounting, and physical counts	Spending Entity Office of the FC	Art. 106 (PAL-87) provides that the responsibility for material and equipment is with the spending entity, and accounting and control of the material and equipment on hand is with the office of the FC.

[3] There is no legal provisions requiring the FC to inspect physical receipts of goods or services.

The Financial Control Process	Assignment Of Responsibility	The Existing Situation
B. Records Management		
Financial Records and Supporting Documents Submission	The FC to the auditing Board of the SAC (Art. 38 of the SAC Act of January 1983).	Art. 95-4, PAL-87 provides for a Committee on Records Management to resolve issues relating to insufficient and missing records. The Committee is composed of a Member of the Parliament, and a representative each from the SAC and the MEAF.
Safeguard	As determined by the auditing board of the SAC.	

5.13 In the expenditure execution process in many other countries, the commitment, approval for payment, and the actual payment functions are separated at an organizational level within the entity that is in charge of execution of the budget. In Iran, however, all these functions are assigned to the FC. The concentration of the financial management responsibilities within the Office of the FC and, in particular, in the position of the FC, streamlines management and coordination of the budget execution processes. The insufficient separation of these functions and duties results in instances where the size of operations is small enough that allows the FC to individually carry out all the functions and duties relating to the budget execution process. In such instances, the accounting system is largely dependent upon the integrity of the FCs. The FC authorizes payments and sign checks. At the same time, the same individual exercises the *ex ante* audit and the internal control functions, as detailed below. This concentration of functions is contrary to the standards of best practice.

The Internal Audit Function

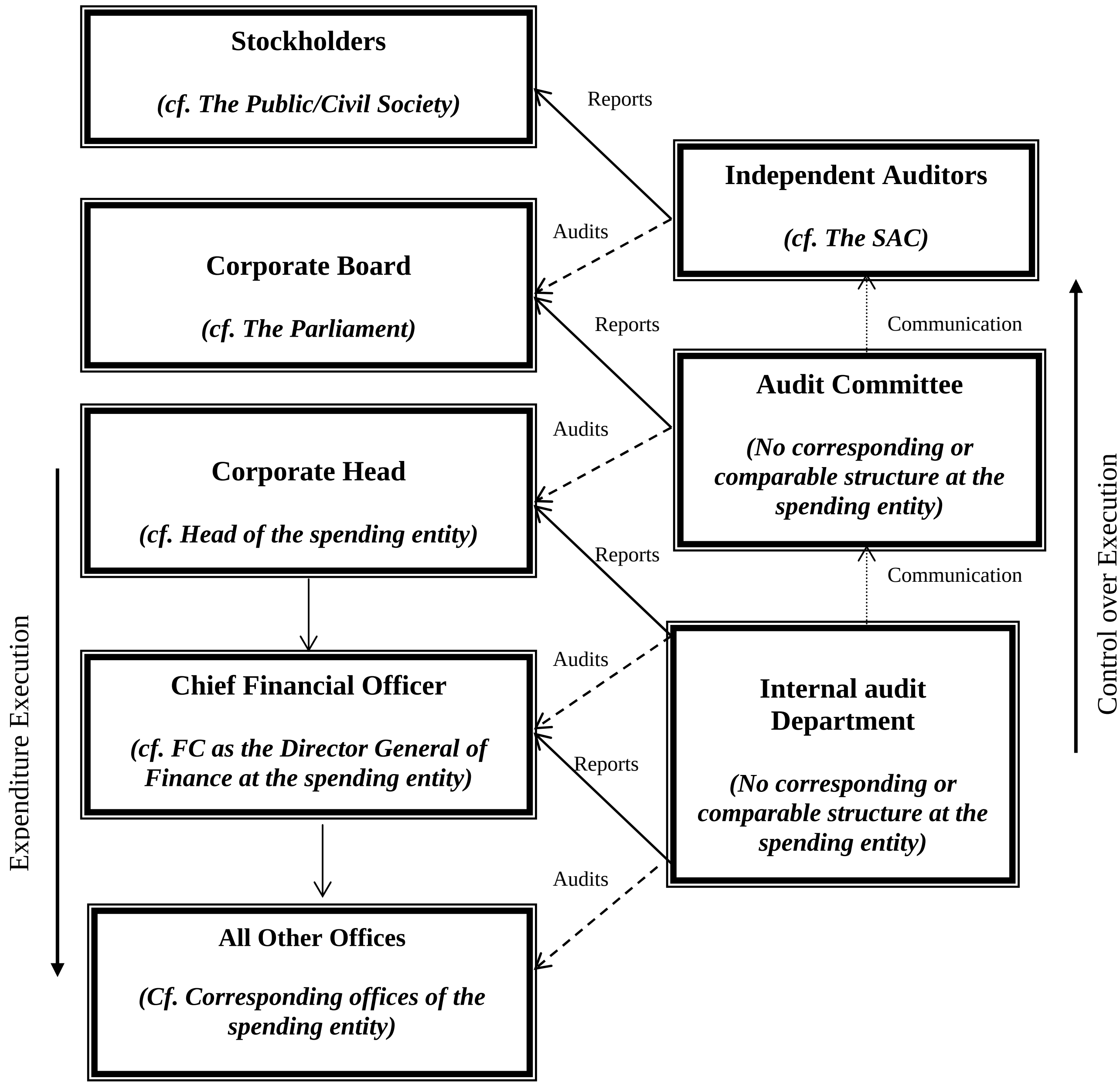
5.14 The objective of the internal audit function is to ensure effectiveness in the financial operations of the spending entity[4]. This function generally is carried out by an office that is not involved in the execution aspects of the budget. Normally, the internal audit function is further divided between financial control aspects and technical performance aspects. In Iran, however, the responsibility for the financial controls during execution is assigned to the Office of the FC. The responsibility for operational and performance controls is vested in the same offices of the MPO that are responsible for the preparation of the development budget. From a functional perspective, supervision and control during execution is given to the same units within the MEAF and the MPO that are responsible for budget preparation and execution. In addition, the spending entities are also required to report to the MPO on an annual basis on the execution of their development budget. There is no separate set-up that is in charge of the internal audit of the budget within these institutions. The FCs are responsible to the MEAF for the financial control deficiencies at their respective spending entities. The spending entity is

[4] The 1979 Constitution changed the role of the SAC. Under the previous constitution, the SAC was effectively administered by the MEAF, and its role was that of an internal auditor of the MEAF. It used to carry out a pre-audit of expenditures and a review the operations of the FCs. Under the new Constitution, SAC, though independent from the MEAF, effectively carries out the same work. But this work is done as a post-audit under the same structural set-up. This is discussed furthering detail below.

responsible to the MPO for reporting on deficiencies in the operational performance aspects in particular, as they relate to the execution of projects provided for in the development budget.

Chart 5.1: Organization Of The Execution And Control Functions In A Model Corporate Environment

(Comparison with the Public Expenditure Management in Iran)



5.15 Lack of a separate internal control structure can be seen from comparing either the internal control structure present in the management structure of public finance in some other countries or with a corporate structure. There are distinct similarities between these two, as referred to in the section on organizational structure within the spending entities. The internal financial control in most public expenditure systems is normally assured, on an organizational and/or procedural basis, by individuals that are not involved in making credit commitments, opening bank accounts and signing checks, as the FC is in Iran. As to the comparison with a properly-structured corporate system, the diagram below demonstrates the implementation and execution process versus the control aspect.

5.16 In addition, the MEAF generally limits its supervision over the activities of the FC during the budget execution process to issues that are of an administrative nature. The MEAF considers that the review of FC operations lies in the domain of the SAC. The Office of Supervision of the FCs at the MEAF is responsible for oversight and evaluation of their compliance with the guidelines and their conformity in the application of practices and procedures. The extent to which a comprehensive plan is in place at the MEAF to undertake a regular review of the activities of the FCs and ensure quality control and a consistent application of rules and regulations across the spending entities is not clear.

5.17 The only comprehensive review of the activities of the FC is the in-depth SAC review of the receipts and payments of the spending unit. The intervention of the MEAF in the performance of the functions of the FC seems to be limited to instances where there is a conflict between the head of the spending entity and the FC, or where a non-compliance issue is raised and reported by the auditing boards of the SAC. The FC is, in effect, functionally responsible to the spending entity but is subject to control by the SAC. In a similar manner, the responsibility for the review of the entity's operational and performance controls is generally limited to work that is carried out by the MPO, essentially as part of the normal review that takes place as part of the preparation of the spending entity's annual development budget.

Accounting and Reporting

5.18 Each spending entity has its own bank accounts in a state bank. The total number of these bank accounts, for budget expenditure purposes, is roughly 2000. Different state banks manage these accounts. The cash basis of accounting is used for accounting and reporting, and there is no accounting for commitments.

5.19 The accounting and reporting functions are carried out by the FCs and the account consolidation office at the MEAF. Each FC submits a monthly report of the budget execution for each spending entity, along with the bank account statement and the bank reconciliation statement, to the MEAF. Monthly reports to the MEAF constitute the basis for management of cash held in the bank accounts of the spending entity. In practice, however, the MEAF proceeds with the allotments in line with the approved allocations.

5.20 Each spending entity has its own financial management information system. Its reports are generally submitted to the MEAF on diskettes, and the MEAF reenters the

data into its own information system in order to prepare its monthly budget execution reports.

5.21 In line with the provisions of Article 95 of the Law on Public Accounting (1987), the FCs are also responsible for the submission of a list of receipts and payments of each spending entity, including the original supporting documents for each month, to the auditing boards of the SAC at the related spending entities. This must be performed by the end of the following month. Similarly, the annual accounts of the spending entity need to be closed and submitted to the auditing board by the end of the first quarter of the subsequent fiscal year. The auditing boards of SAC, in effect, carry out an ongoing *ex post* audit of the expenditure to assess compliance with the budget.

5.22 Until 2000/01, accounts were to be closed at the end of year, and no commitments could be made after the end of the year. However, this law has been modified by the Parliament[5]. Under the new regulations, there is an extension of one month for the current budget and four months for the development budget, after the end of the fiscal year, for undertaking further commitments and making expenditure payments for the past fiscal year. This law further provides that the preparation and submission of the final statements of receipts and payments for the year, for both budgets, be made by the end of the fifth month of the subsequent fiscal year. The ramifications of the new law on the existing deadline for reporting by the SAC to the Parliament are not clear. The reporting requirements are summarized in Table 5.3 below.

5.23 Furthermore, it is unclear to what extent the deadlines provided by the law are respected in practice. Most sanctions for non-observance of the law are of a general nature and are not specific to respecting the deadlines for reporting requirements.

Table 5. 3: Budget Reporting Requirements

Type of Report	Report Submission Requirements[6]		Legal Delay in Reporting And Other Comments
	By	To	
Monthly Statements of Receipts and Payments (Except for the last month of the fiscal year),	FC	Auditing Boards of the SAC/ MEAF	By the end of the following month.
The final Statements or Receipts and Payments[7],	FC	Auditing Boards of the SAC/ MEAF	By the end of the fifth month of the subsequent year,

[5] Article 63 of the PAL (1987) provides that commitments and payments under current and development budgets can be made only to the end of the fiscal year and that the FC should remit the unspent cash to the Treasury within a month. The Parliament revised this provision by an amendment in February 2001.
[6] The MEAF and the SAC can agree on changes to requirements for the preparation and submission of the reports. (Article 95-2, of PAL 1987).
7 The final statements should be signed by the FC, the representative of the SAC auditing board at the spending entity, and the head of the spending entity.

Type of Report	Report Submission Requirements[6]		Legal Delay in Reporting And Other Comments
	By	To	
The Treasury's Monthly Statements of Receipts and Payments (Except for the last month of the fiscal year),	By the Treasury at the MEAF	SAC	Within two months following the end of each month,
The final Statements or Receipts and Payments. (see8 below	By the MEAF	SAC	By the end of the ninth month of the subsequent year.
Annual Operational Reports	Spending Entity	SAC/ MEAF/ MPO	Within six months after the end of the year.
SOE and Not-for-Profit Organizations (NPO): Annual Financial Reports, and	SOE/ NPO	MEAF	Immediately after approval by the Annual General Assembly and not later than 6 months after the end of the year,
Annual Statements of Receipts and Payments for the development budgets	SOE/ NPO	MEAF	Immediately after approval by the General Assembly, and not later than six months after the end of the year
Public, Non-Governmental Organizations	the Entity	MEAF	Within six months after the end of the year.
Annual report on budget executions, including the Treasury cash movements reports	MEAF	SAC/ Council of Ministers	Within nine months after the end of the year.
Budget Liquidation Report, including observations of the SAC	SAC	The Parliament	Within the subsequent fiscal year (Art.104 of PAL-87)[8].

5.24 Within the framework of the budget reform program, the government is planning to move to a modified accrual base of accounting in order to harmonize the accounting and reporting standards with generally accepted public sector standards. The government also plans to develop an integrated financial management information system to ease the information flow during budget execution.

Procurement

5.25 General provisions of public procurement in Iran are laid out in two main documents. The first, entitled, "By-Laws on Government Transactions," was ratified in March 1971. This by-law is effective until the procurement provisions contained in Articles 79 to 88 of the second document, "Government Accounting Law 1987," are ratified by the Parliament[9]. In principle, these laws govern procurement by all public

8 There is no specific submission date. In practice, this should be done within the remaining 3 months of the year, when compared to the MEAF reporting requirements.

[9] An analysis of the current procurement law is presented in Annex 6. Information on ratification of the second document with its related implementation rules and regulations is lacking.

sector entities, including SOEs, although purchases from public sector entities are exempt[10].

5.26 The provisions of these laws authorize spending entities to establish procurement boards or commissions of at least three members to conduct competitive bidding processes, to provide exceptions and waivers to the application of regulatory provisions, and to clear contracts above the thresholds for subsequent approval by the head of the spending unit. Within each spending entity, procurement is conducted by procurement staff with the coordination and approval of the FC, who also sits on the procurement action committee and the evaluation committee. As a result, the procurement system in Iran is decentralized, with the primary responsibility for the implementation and execution of procurement resting with the spending entities.

5.27 The Ministry of Finance and Economic Affairs MEAF is responsible for executing the public procurement law, including centralized monitoring and coordination of the procurement of goods, works and services. However, there is no national public procurement office responsible for developing uniform procurement regulations and standard bidding documents or for assuring that spending agencies apply them.[11] The lack of a centralized procurement agency to ensure uniformity of practice is a particular deficiency in such a highly decentralized procurement system.

5.28 To fill the gaps caused by the generality of the existing law, different agencies of government have developed rules on procurement that are being implemented to varying degrees and with little uniformity. The lack of uniform public procurement implementation regulations also has caused the Technical Affairs Office of MPO to take a centralized role in awarding public works and service contracts. It has developed instructions on the use of unit prices for different activities in civil works construction, as well as establishing a database and regulations for the selection of engineering consulting firms for civil works. Also, MPO has issued "guidelines for construction projects." Under the current system, no foreign consultant, regardless of the type of service provided, can be hired unless approved by the MPO. This centralized role conflicts with the decentralized public procurement system provided for under the law. Many implementing agencies also have their own "guidelines for equipment". The aim of these guidelines is to support the existing legislation with implementation details as the agencies may deem necessary. Integrating these functions in a national public procurement office would substantially enhance their effectiveness.

5.29 The current law divides public procurement actions into "small", "medium", and "large." The thresholds for these three categories are updated or increased on an annual basis. According to the law, the "large" category of procurement actions must follow a

[10] Although in principle the procurement law applies to all public agencies, in practice it remains unclear whether procurement by SOEs and public agencies, other than central and provincial governments, are required to follow the procurement provisions.

[11] For example, in many countries (Poland, Ukraine, Azerbaijan), there is an independent procurement agency that reports directly to the Cabinet. Within Iran, only the SAC could conceivably perform this monitoring of compliance, but its focus is on financial oversight and, in any case, is based only on an *ex post* review of transactions. See below.

fully competitive process including the advertisement of tenders. Contracts above 1.2 billion rials must be approved by the Economic Council[12]. However, through a long list of exceptions, the law provides for flexibility in the conduct of procurement actions and presents means by which the spending entities can avoid implementing a competitive bidding process.

5.30 The procurement set-up within spending entities should be expected to handle procurement not only in compliance with procurement rules but also with adequate planning of procurement needs and the monitoring of procurement activities so as to ensure a competitive, transparent, efficient procurement process. However, the limited size, capacity and skill base of spending entities means that they are not often able to respect these obligations. The result is that they end up taking the easier route of contracting on a sole source basis rather than via a competitive approach.

5.31 The MPO, through its Technical Affairs Office, plays a key role in the procurement process and execution. MPO prepares the regulations for contractors and engineering firms, including the development of unit rates for public works, which are updated and published annually based on the market prices. It also maintains a database of pre-qualified, registered contractors and engineering firms. The Technical Affairs Office also influences awards to civil works and engineering consulting firms by ranking contractors and determining, in an informal manner, the volume of jobs given to each of the registered contractors and engineering firms in any given year.

5.32 Works contracts are issued based on MPO published unit prices, and prequalified contractors bid based on a percentage above or below the advertised cost estimate calculated by the spending entity using the published unit rates. Eligible bids must be within 10 percent of the advertised cost estimate. In addition, irrespective of the advertised cost estimate and contract, winning contractors have the possibility of increasing costs during execution, through variance orders, by up to 25 percent of the contract value[13]. Thus, while in principle the lowest bidder receives the award, the procurement committee of the spending agency (composed of three members nominated by the head of implementing organization) retains discretion in selecting contractors and determining the effective value of contract awards.

5.33 Decisions on hiring engineering consulting firms are made from the list of registered consultants by a three member committee (one from the spending unit and two from MPO). Fees are set by the MPO, and are calculated as a percentage of the estimated works contract. Hiring of foreign consultants is closely monitored by the MPO, whose approval is needed before the implementing agencies may proceed with hiring them.

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[12] This threshold was applicable to budget year 2000/01. The threshold changes annually.

[13] In cases where the bid has a variance of +/- 10 percent of the cost estimate, or where a variance order exceeds 25 percent of the contract value, the spending agency must obtain approval from a supreme committee consisting of two representatives from the private sector and one from the MPO. Committee members are selected by the President. As much as 20 percent of contracts may involve such substantial variations from the award price. If approval is denied, spending agencies have the further option of signing an additional contract with the bidder to make up the difference.

5.34 There is no formal process for informing bidders on the award process and its results. There is no publication of the awards. However, should a contractor have a complaint on the selection process or its outcome, he can register it with the MPO's Technical Affairs Office. The Office will review the complaint and make a ruling. For consulting firms, there is no formal complaint process.

5.35 All equipment purchases are based on fixed prices determined annually by the Office of Protection of Consumers and Producers (OPCP) in the Ministry of Commerce. These fixed prices are communicated to the trade groups for each of the goods categories. Suppliers have to use these rates for sales to the public sector. The OPCP also provides the spending entities with a list of suppliers for their purchases, but the entities are not obligated to use these suppliers. They can select any supplier they choose as long as they respect the fixed prices.

5.36 The Parliament has recognized the need for efficient and transparent public procurement legislation to assure more effective utilization of resources, and it has approved a new law for the bidding process. The new law would bring more efficiency and transparency to the bidding process and provide that contractors are answerable for their performance. The new bidding law covers six sections:

(1) applications and definitions;
(2) organization and qualification criteria;
(3) documents, technical specifications, evaluation criteria, submission schedule;
(4) bid preparation and submission process;
(5) bid opening and evaluation process; and,
(6) the method for records keeping requirements for the government's information bank.

5.37 In general, the new law addresses all aspects of the procurement process for the purchase of goods and services. It does not, however, cover consulting services. The new law is a welcome step in the right direction. It provides instructions for the preparation of regulations for different types of procurement and will replace relevant provisions contained in the General Accounting Law and other guidelines on public procurement.

5.38 However, the new procurement law addresses only the bidding process in detail and instructs preparation of regulations for different topics of procurement. The provisions relating to opening and evaluation of bids in two-envelope system and two-phase procurement process, as laid out in the draft, need to be more transparent and equitable. International practices to assure transparency of the procurement process involve either one envelope (with both technical and financial proposals) in a single phase bidding process for the majority of contacts. For complex contracts, a two-phase process is used, where the technical bids are submitted in the first phase and financial bids are requested in the second phase from contractors with acceptable technical bids.

5.39 What is needed is a comprehensive public procurement reform process culminating in a single, unified procurement law and supporting implementation regulation. It should be developed in consultation with all agencies, public and private, involved in the procurement process. Thus, the reform needs to address several additional issues, including:

a. establishment of an authoritative regulatory and oversight entity for public procurement at national and provincial levels;
b. clear definition of procurement methods to achieve economy and efficiency for procurement of goods, works and services;
c. increased transparency in the procurement process, with the establishment of an appropriate appeal and complaint mechanism; and,
d. establishment of a professional stream and curriculum for staff charged with public procurement functions.

External Audit

5.40 There are three external audit organizations with separate jurisdictions. The Supreme Audit Court (SAC) is charged with auditing all the financial management aspects of government-funded activities that pass through the national budget. It reports to the Parliament. The Audit Organization (AO), which is affiliated with the MEAF, audits all SOEs and banks. A not-for-profit audit firm, Mofid Rahbar, has been set up by and is affiliated to the Office of the Supreme Leader. It audits the bonyads and all other activities under the purview of the Supreme Leader[14].

A. Legal framework and mandate of the Supreme Audit Court.

5.41 The SAC was established by the 1980 Constitution (Articles 54 and 55). It operates under the direct supervision of Parliament, which appoints its president and receives its reports directly[15]. The Constitution mandates that the SAC examine all financial accounts of "ministries, government companies, institutions and other organizations which, in any manner whatsoever, benefit from the national budget." The budget of the SAC is voted on separately from that of the executive branch by the Parliament, in line with its constitutional independence. Staff members of the SAC, however, are considered civil servants and are subject to the rules and regulations that

[14] In addition, there are a variety of other external mechanisms of control provided for in the Constitution. These do not focus on financial management but could cover such issues. Article 90 invites anyone having a complaint against any of three branches of government to submit it directly to the Majlis, which is required to investigate and report to the public. Articles 173 and 174 establish two judicial bodies mandated to check the performance of the bureaucracy, one of which receives complaints while the other exercises administrative surveillance (the Inspector General). The mission did not investigate the degree to which these are actually used and whether they have dealt with budget management issues.

[15] While the Constitution provides for the appointment of the head of the SAC by the President of the Republic, subject to the approval of the Parliament, the Supreme Audit Court Act of 1982, in its Article 11, provides for the appointment of its president by the Commission on SAC and Budget of the Parliament at each inauguration.

govern the civil service, which are administered by the MPO. The current line of responsibility of the SAC conforms to international standards on financial accountability of the executive vis-à-vis the legislature.

5.42 The 1982 Supreme Audit Court Act[16] mandates the SAC to: (i) monitor and control the financial operations and activities of all ministries, institutions, government companies and other organizations which in any manner whatsoever benefit from the national budget[17], (ii) examine and audit revenues and expenditures in relation to the approved budget based on the operational and financial audit reports received from the related spending entities, and (iii) prepare and submit to Parliament and the public a Budget Liquidation Report, together with its own related observations, within the subsequent fiscal year. The SAC does not audit extra-budgetary funds or SOEs.

B. Functioning of the SAC[18]

5.43 Similar to the budget execution process, the monitoring and control stage is also decentralized and de-concentrated. This decentralization and de-concentration responds to the substantial presence of the public sector in the financial and economic activities in Iran. As described above in the section on the internal audit, the functional responsibility for supervision of financial controls during execution is assigned to the offices of the FC. The responsibility for operational and performance controls are vested in the same offices of the MPO that are responsible for the preparation of the development budget. The control subsequent to execution is similarly divided between financial audit and performance review of project implementation. For the purposes of that control, the operations of the FCs are subject to the audit by the SAC, while there is no corresponding arrangement by the SAC to examine the work of the units at the MPO that are responsible for performance oversight in budget execution. At an institutional level, the MEAF and the MPO share responsibility for supervision of budget execution, but they are not themselves subject to control by the SAC.

5.44 The SAC is responsible for two separate functions, namely the audit function and the public prosecution function. The detailed audit function is organized through the auditing boards, which are assigned to and located at the spending entities. The

[16] The institutional precursor to the SAC under the previous constitution was an arm of the MEAF, responsible essentially for independent internal audits. As such, it had both ex ante and ex post authority, and could effectively intervene in the budget execution process as part of the executive branch. As noted above, creation of the SAC from this internal agency left the executive with no internal audit capability. While under the new constitution, the authorizing environment and the reporting requirements for the SAC have changed, the responsibility of the SAC and the overall objective of control over the financial affairs have essentially has remained the same, as well as its structure of auditing boards located within spending agencies.

[17] The institutions that are in the budget but exempt from compliance with the provisions of the PAL, (Article 66), including the Guardian Council, the Parliament, and the Expediency Council, seem to be equally exempt from the audit by the SAC. Furthermore, Article 78 of the PAL, which exempts expenditure for important, exceptional, and sudden events from compliance the provisions of the PAL, extends that exemption from compliance to other general government regulations. This includes the audit by the SAC. See the Annex on budget notes for other details or exemptions, approach by Parliament.

[18] An organization chart of the SAC is included as Annex 7 to the current report.

organization of the auditing boards is similar to that of an audit team at a private audit firm. An experienced auditor is in charge of a number of spending entities, while the less senior and junior auditors are located at each specific entity. Similar to the FC set–up, the allocation and presence of the auditing boards to any given spending entity, as well as the composition and the number of auditors in the team, is a function of the size of the operations of that entity and the relative importance of its budget. The total staff of an auditing board can add up to a few auditors. On the other hand, a couple of auditors could have the responsibility for auditing a number of spending entities. At the center, in Tehran, the Directorate for Technical and Auditing Affairs of Ministries, Government Institutions and Foundations and its three offices provide technical support to the auditing boards. A similar structure is replicated in the major provinces. Each FC at the related spending entity submits his monthly receipts and expenditure reports to the auditing board that is responsible for the audit of that entity. Subsequent to the audit, the auditing boards determine the location where the audit records should be kept. The records are normally kept at the spending entity.

5.45 The SAC budget is relatively small, especially given its broad mandate, and the SAC remains understaffed relative to its organizational chart[19]. Human resource management is as important to effective external audit as is institutional setup and funding. There is a program for rotation of the staff of the auditing boards. However, in practice, due to the shortage of experienced staff, the rotation program is not enforced on a regular basis. There is also a training program for new staff, but the bulk of experience seems to be acquired on the job. The extent to which codes of ethics and conduct for the staff of the auditing boards are renewed, taught, or enforced is unclear. The shortages of budget and staff, and the absence of comprehensive and regular staff rotation and training, are risks to the integrity of the external auditing system.

5.46 Despite the broad mandate of the SAC, its work plan and the actual work carried out remain limited essentially to a financial audit and even more restrictively to a compliance audit of receipts and payments. Notably, the SAC monitors the conformity of budget execution by the FCs who are the individuals ultimately responsible for the financial transactions involved in budget execution. In practice, the mandate of the SAC is focused on ensuring that the individuals that are vested or involved with the receipt, payment, and custody of the public funds comply with regulations on public expenditure.

5.47 Although the Public Accounts Law of 1987 requires spending agencies to submit operational reports to the SAC, the MEAF and the MPO, there is no explicit reference in the Constitution or the SAC Act of 1982 giving powers to the SAC to perform operational audits of the activities and development projects of the spending entities. Furthermore, the current expertise of the SAC may constitute yet another constraint on its ability to carrying out such an audit.

[19] In 2002/03, the entire SAC budget was equivalent to about $9 million (0.03 percent of the national budget). This is half the budget of the equivalent agency in Turkey, which has a smaller jurisdiction. As a result, total staffing of the SAC is limited to about 1,400, of which some 950 are actually auditors. The approved staffing chart contains 4,100 positions.

5.48 Within Parliament, the Commission on the Supreme Audit Court and the Budget of the Parliament is responsible for supervision over the execution of the budget. The Commission carries out its function either through direct participation in committees of the executive, such as the allocation committee (in accordance with Article 30 of the Law on Planning and Budget of 1975 and its subsequent amendments) and the committee on records management (in line with the amendment to Article 95 of the PAL) that form part of the budget execution process, or by review of the reports that the SAC is required to submit to the Parliament. While involvement in the budget execution process could blur the distinction between the executive and the legislative branches, and compromise the independence of parliamentary oversight, it is unclear how actively the Parliament is actually involved in allocation discussions and records management by the executive.

5.49 The last report submitted to the Parliament by the SAC relates to the accounts for the fiscal year ended in March 1998, despite the requirement that the SAC submit such a report annually and within the subsequent year. Effectively, the SAC is three years behind in its reporting to Parliament. Moreover, it is unclear to what extent the Parliament actively examines the SAC reports or whether it uses the information as a mechanism for increasing accountability.

C. The Audit Organization

5.50 The AO, set up by a special act of Parliament in 1987, is the other public audit institution. It is responsibile mainly for the statutory examination and financial audit of all SOEs and banks, as well as projects of SOEs that are funded through the national budget. The AO's mandate covers all SOEs, whether they are owned by the government, other SOEs, banks, or bonyads. (The bonyads were not originally covered by the AO, but it commenced audits of them for 2002/03). Secondarily, it is mandated to sell consulting services, set accounting standards, and enhance auditing and accounting practices in the country. In 2001/02, it conducted audits of 1,949 entities, of which about 10 percent had an "adverse" option reflecting fundamental problems[20].

5.51 Organically, the AO is a distinct spending agency within the MEAF but has an autonomous status. It reports to a board composed of different government institutions, including the MEAF, the MPO, the Head of the Central Bank, and two additional ministers appointed by the Council of Ministers (currently, ministers of Commerce and of Industry). It is also subject to a supervisory body. The AO is financed both by the national budget and by the sale of services to enterprises. It is required to submit its audit reports to the SAC, the Inspector General of the Judiciary, the Central Bank, the parent ministries of the SOEs, and the governing boards of the SOEs.

5.52 The organizational structure of the AO is patterned in line with the structure generally adopted by international accounting firms to meet their specific obligations with respect to two generally different activities: standard setting and the provision of

[20] Of the remaining reports, 14 percent were fully unqualified. About three-quarters were qualified owing to insufficient or ambiguous data (10 percent) or other issues (67 percent), including noncompliance with regulations.

audit services[21]. In organizing the AO, however, attention has been given to separating the standard setting activity from the general audit activity to the extent possible.

5.53 The audit standards of Iran conform to the International Audit Standards with one exception, which relates to the accounting of government grants and the disclosure of government assistance. This discrepancy is due to the fact that some government transfers are treated as equity contributions (and should be treated accordingly) and to assure that transfers in kind are valued at no more than fair market value.

D. Audits for the Supreme Leader

5.54 The Office of the Supreme Leader, which is funded by non-public funds, is outside the purview of the SAC. In addition, the bonyads are outside the purview of the AO, although SOEs owned by bonyads, amounting to over a quarter of the SOEs, are audited by the AO[22].

5.55 In these circumstances, the only audit of activities managed by the Office of the Supreme Leader and the bonyads and other financial activities overseen or managed by the Supreme Leader is carried out by Mofid Rahbar, an audit firm set up by the Office of the Supreme Leader as a non-profit organization to carry out financial and performance audits. Mofid Rahbar is managed by a board of trustees, also appointed by the Office of Supreme Leader. Its board of directors, which includes certified public accountants, manages its professional staff. Mofid Rahbar is also a member of the Iran's Society of Certified Public Accountants, as an organization (rather than as a firm of accountants)[23]. The organization reports directly to the Supreme Leader. Since it functions as an internal audit arm of the Office of the Supreme leader, its reports are not published.

[21] These activities are kept institutionally and organizationally separate in many countries to minimize obvious conflicts of interest.
[22] Beginning in 2002/03, the AO now audits bonyads and SOEs. It is unclear whether AO audits will replace the audits of Mofid Rahbar or supplement them.
[23] To become a member, the Council of Ministers had to grant it an exemption from the rules governing membership in that society.

CHAPTER VI: ASSESSMENT OF RISK IN THE IRANIAN PUBLIC FINANCIAL MANAGEMENT SYSTEM

6.1 A full assessment of risk is an essential part of any description of a public financial management system, as systems for dealing with risks are central to modern budget management. The risk assessment helps identify systemic strengths and weaknesses, so that strengths can be built on in order to help attenuate weaknesses.

6.2 There are essentially two definitions of risk used in assessing the quality of a public financial management system – narrow and broad. The narrow definition, sometimes called "fiduciary risk," is the risk to the providers of finance that their funds will be misused or stolen; i.e., the risk that actual expenditures diverge from the expenditures authorized in the budget which in turn reduces the coherence between intended use of resources, as reflected in the country's budget, and the actual expenditures. This is essentially the definition used by the World Bank in its CFAA. (See Country Financial Accountability Assessment, Guidelines to Staff, World Bank, Discussion Draft, 2003). This report uses a wider definition of risk that incorporates both the concept of fiduciary risk and the risk that key economic and social policy objectives, such as poverty reduction and the efficient and effective delivery of health, education and other public services, are not achieved because resources provided through the budget are diverted or wasted through inefficient institutions and organizational practices.

6.3 The elements of the risk can be defined and categorized as exogenous or endogenous. Exogenous risks are not directly related to the public financial management system (natural disasters, evolution of export prices, etc.). The organization and functioning of the public financial management system, however, can mitigate or exacerbate exogenous risks. Endogenous risks are directly related to the public financial management and control systems. Endogenous risks represent a range of risks, including risks in macro-economic planning and various risks to budgetary implementation and the impact of public spending.

6.4 Endogenous risks can be further disaggregated into several components of risk, which can be defined in the context of an accountable and transparent public financial management system as follows:

- Systemic risks: These risks stem from the inherent characteristics of the management system for public finances, including the size and complexity of the public sector itself, the organizational structure of public financial management, the clarity with which roles and responsibilities are delineated, and the rules and regulations that determine how the system functions. All of these substantially affect the quality of budget preparation and implementation, including transparency and accountability, as well as operational performance of public agencies funded by the budget. Larger public sectors inherently generate more risk. Both highly centralized and highly decentralized systems have inherent, if different risks, and complex budgetary procedures may be more prone to being compromised as they require strong human resource capacities.

- Operational risks: The extent of these risks is a function of the management structure including the internal control system for public financial management and the human, organizational, and technical resources, tools, and incentives to make the structure function effectively. Risks increase, for example, if the system lacks key organizational features (such as a strong internal audit authority) or sufficient technical or staff capacity and/or incentives to assure proper execution of the national budget by implementing agencies.

- Detection risks: This class of risks refers to the likelihood that actual deficiencies in budget management that stem from either inherent or internal control risks can be reliably observed (as a step in risk mitigation) by agencies with formal oversight authority as well as by other institutions that often act as watchdogs (e.g., the media). The size of the risk is a function both of the quality and availability of information on budget execution (including revenue collection) and transparency in the budget process, as well as the mandate, authority, capacity, and incentives of the institutions in charge of external audit and oversight (notably, but not only, the independent audit organization).

- Inaction risks: These risks reflect the failure to take mitigating or remedial action when situations of high risk are detected. It is in part the risk of non-enforcement of sanctions when budgetary procedures are violated by officials, and in part the risk of failing to design and implement reforms to reduce or manage the risks.

6.5 Table 6.1 lays out a framework for identifying, classifying and discussing the endogenous risks in The Islamic Republic of Iran's public financial management system, drawing on a number of standard definitions and classifications of risk. This framework divides the budget process in Iran into key processes, and allows both the risks and efforts to manage them to be identified and discussed. Other classifications could be used, as many of the processes, as defined in the table, can have overlapping elements. For example, the flow or transparency of information is an essential cross-cutting feature of sound risk management throughout[1]. The classification used in the table seems best adapted to the particularities of the Iranian system as the mission understands them.

6.6 There are a number of processes that can give rise to potential fiduciary risk, which are not covered in Table 6.1 because the team did not have the mandate or resources to cover them in sufficient depth. Important examples include: government payroll and payroll management; the incentive structure and ethical environment for public servants; management of public debt; management of government property; records management and retrieval; provincial and municipal administration; reconciliation of fiscal and monetary accounts; and revenue administration.

[1] For example, the HIPC reporting framework and various CFAA reports use somewhat different classifications, which match better the characteristics of the particular countries concerned. The classification proposed here draws on these frameworks.

6.7 In examining risks associated with the various budget management processes, one approach is to look at key elements of the system that affect management of public finances. These include size; the legislative or regulatory frameworks of that establish various budget management agencies, organize their functions, and confer upon them their mandate and authority; the mandate, structure and procedural tools of supervisory bodies charged with overseeing the public finance system; human capacity and incentives; and, as cross cutting themes, the public availability of timely, reliable information on the functioning and performance of spending agencies and other entities involved in budgetary management and the capacity within the country to use such information to press for greater government accountability. The table below loosely uses this approach rather than hewing narrowly to the four components of risk outlined above.

6.8 While the table does not actually rate risk levels in Iran, as the mission had insufficient time to acquire the information and to discuss it in detail with Iranian counterparts, it does discuss the features of the Iranian budget management system in each process that affect risk levels and some of the reforms the Iranians are currently planning or implementing that could mitigate risks. Thus, while the mission did not discuss all the detailed aspects of a full risk assessment, its examination of various budget management and control issues provided substantial information that can be used to launch a discussion of risk management. These will help orient the planned follow up diagnostic work on Iran.

6.9 Irrespective of the degree of risk one might assign to the Iranian budget management system, it is important to recognize that the government has already begun to address a variety of these risks through a multiyear budget process reform program. Compared to similar countries worldwide, this is already a significantly positive step, which is further enhanced by the speed and scope of its effort[2].

[2] In comparison, it took Turkey nine years to jumpstart a reform program and it has a much weaker PEM system than Iran; it may take even longer in Egypt. Thailand, after five years of study and foreign technical assistance, has not yet reclassified its budget in accordance with GFS 2001, whereas Iran did it in a year with virtually no external support.

Table 6.1: Risk Assessment Framework for Public Financial Management in Iran

Areas in public financial management	Identification of risks	Risk management efforts
0. Overall legal framework		
	A key systemic risk is that the legal framework for sound public financial management is inadequate. In Iran, a number of constitutional provisions and laws provide for the legal basis of taxation, expenditure, and the annual budgets, the deposition of all revenue collections with the central treasury; and the establishment of the SAC, as well as specifying the various aspects of planning and budget preparation, expenditure execution including procurement, control and payment, government accounting and the consolidation of annual accounts and their submission to the Parliament. If implemented fully, the provisions provide for considerable transparency, but there are weaknesses in implementation. Moreover, the older laws are not fully consistent with the reform orientations of the current Plan, the overall legal framework for procurement seems incomplete, and the intended movement towards program-oriented budgeting and greater accountability will undoubtedly require new legal provisions.	To facilitate reforms in the budget process, a joint committee between parliamentary representatives and government officials from the MPO has been established.
1. Budget formulation		
a. Strategic priority setting	The key issue is the degree to which plan targets and objectives match underlying national priorities and whether the budget follows the country plan– i.e., whether budget formulation is used as a strategic tool or not. Risks arise from the process of consultation to define priorities, from the process of reflecting these in plan objectives and from taking the plan seriously during resource allocation. The risks in Iran are: Strong top down approach to planning and budgeting	In Iran, the first linkage between the national priorities and plan have a long established tradition. An elected President and Parliament, a competent planning organization with overall central budget authority for both current and capital budgets, and a well-established and increasingly consultative planning process constitute this linkage. The issue is not apparently perceived as a significant

Areas in public financial management	Identification of risks	Risk management efforts
	may lessen the ownership of the Plan in the spending ministries. The risk is exacerbated by limited capacity of budget offices in ministries to translate the priorities of the plan on spending agencies. Nor is there any direct consultation with civil society. Nonetheless, the Plan is extensively used as a frame of reference for government budgeting, and it reports deviations from Plan targets to Parliament. Plan Targets are updated annually, although the policies remain the same. The main part of the budget - current expenditures- is largely incremental and perceived as a fixed legacy. Hence it does not allow for easy reprioritization. Although the entire budget preparation process – both capital and current – is under the same agency (MPO), decisions on capital and recurrent spending appear to be largely divorced from each other; and capital budgeting appears to give priority to new initiatives, even though there is a well defined process for vetting new capital spending. (However, Parliament has added additional capital projects, without such vetting and without corresponding changes in other parts of the budget). Lack of monitoring and evaluation capacity breaks the feedback loop between the implementation and planning processes and it increases the risk to the effectiveness of plans.	risk by the government. The top down risk is attenuated in part through extensive annual budget consultations with provincial officials (both elected and appointed) and Parliament, which could be developed further. The government's reform program recognizes the problem posed by the absence of a multiyear budget formulation framework and is taking steps to introduce it, including introduction of a medium-term expenditure framework (MTEF). The budget reform program is trying to bring current expenditures under more regular and rigorous scrutiny by requesting spending agencies to introduce elements of performance budgeting, including activity based costing during 2003/04 budget preparation. The need for closer integration of current and capital budgeting decisions may emerge from the ongoing budget reform efforts aimed an improving budget performance. The government has a strong interest in enhancing M&E capacity and has asked for help in this area
b. Realism	The generic risk issue is the degree to which the proposed activities – on which spending is based -- can be effectively implemented within the budget proposed.	

Areas in public financial management	Identification of risks	Risk management efforts
	The budget circular includes top down ceilings and budget requests exceed these ceiling by an average of twenty percent, which is better than in many countries with bottom-up budget proposals.	The move to more performance oriented budgeting, as envisaged in the government's reform program, may shift the budgeting process from one of matching ceilings to one of justifying increased spending over that required for existing policies and efficiencies.
	Incremental budgeting, which is largely the process in Iran, exacerbates this risk.	The budget reform program is trying to bring current expenditures under better and more scrutiny during annual budget preparation by introducing activity based costing.
	Fiscal sustainability directly affects this risk, although in Iran the extremely low debt levels and the availability of oil reserves reduce the risk of fiscal unsustainability. But statutory limits on external borrowing could create borrowing constraints that could impact on budgetary execution.	This is not perceived as a critical short-term risk, although the government wants to improve its macro-fiscal projection capabilities.
	An additional risk is that the budget is changed during implementation, such that the budget document is not a realistic representation of actual spending priorities (see below under Execution). Actual expenditures are generally slightly below their voted levels and there is a well-established and consultative allocation process for distributing available resources among spending agencies. The effects of this is to push the risks that stem from inadequate realism from the macro-level to the operational level. Realized figures for revenue are lower than those approved by the Parliament.	While the government does not apparently consider this to be a significant risk at the present, there are significant efforts to monitor and report on deviations from the voted budget, including by the Treasury and the SAC. There, is however, a process via approval of the allocation committee to bring expenditures in line with realized revenues.
c. Comprehensiveness	All government spending should normally be reflected in the budget. In Iran, there were a large number of implicit consumer subsidies, most of which have now been explicitly included in the budget. When funds from the OSF are used, they are mentioned in the budget. In addition, there are some extra budgetary funds, whose operations are not in the annual budget, although increasingly more of these are being	Implicit subsidies financed directly by oil revenues are in fact authorized by Parliament, although there may be insufficient oversight of actual implementation and impact. Most implicit subsidies have now been made explicit and are now mentioned explicitly in the budget. The main accounts of 500 of the largest state-owned enterprises are annexed to the budget, and all transfers from the budget to SOEs and to bonyads are clearly

Areas in public financial management	Identification of risks	Risk management efforts
	incorporated in the budget. Finally, there is a very large non-government public sector, including some 2000 public enterprises and several quasi public foundations, which receive funding through the budget and carry out mandated public activities. While in the past tax expenditures to benefit SOEs and bonyads, were excluded from the budget (as in most countries), bonyads are now subject to taxes. The budget now includes repayment of capital loans to SOEs (which had been treated as grants until the mid-1990s). There is no statement of tax expenditures in the budget documents.	identified and audited (as are the entire accounts of all the SOEs and bonyads). The budget reform program, under direction of the Third and Fourth Five Year Plan, is progressively bringing implicit revenues and expenditures into the budget. Although itself an EBF, the Oil Stabilization Fund was created in 2000 as a means of increasing the transparency in the channeling of oil revenues. (The other main EBFs – the public pension funds – have separate oversight arrangements that were not reviewed). The budget (from 2002/03) now schedules repayment of capital transfers to SOEs (albeit without interest), and bonyads are no longer considered tax-exempt. (There are other tax exemptions but these were not examined by the mission; see the IMF Fiscal ROSC).
	The risk is that the accumulation of contingent liabilities is insufficiently monitored, controlled and provisioned, and that their realization could have an unexpected and large negative impact on budget discipline. The risk is magnified where the public sector is large, extra budgetary activities are significant, and the linkages between SOEs and banks and the budget process are not always clearly articulated, as in Iran. The large number of public enterprises and banks – including those owned by some of the 800 municipalities, some of which are directed by the budget to engage in quasi-fiscal activities, represent a significant source of potential contingent liabilities in Iran.	Neither loan guarantees nor the future liabilities of the public pension funds are part of the normal budgetary preparation and approval, there is no formal process of risk assessment or management or provisioning, although the MEAF must approve all loan guarantees. The issue of managing contingent liabilities and explicit loan guarantees is apparently not perceived as a significant risk by the government. The quasi-fiscal activities result from caps imposed on price increases by the Parliament. This is recognized as a problem and measures to mitigate this are being considered.
d. Classification	The main risk is that the classification system is inappropriate or inaccurate, and fails to provide budgetary data sufficient to monitor both financial and operational performance. Financial classification had been antiquated in Iran, and an economic classification of spending was largely nonexistent.	A program structure has existed for several years under the functional and administrative classification. GFS 2001 was fully introduced in 2002/03 for the economic classification of expenditures (although some issues remain with classifying some expenditures). There is now an empirical basis on which to build operational

Areas in public financial management	Identification of risks	Risk management efforts
		performance monitoring.
e. Approval	Generic risks include the fact that the legislature could increase spending without due regard to revenues, thus weakening fiscal sustainability, or alternatively, that the legislative approval process is proforma and/or nonpublic, failing to provide an adequate check on the strategic and financial realism of executive proposals. In Iran, there are constraints on the Parliament's ability to amend the budget. However, Parliament may adjust fiscal projections and estimates of agencies' own revenue to allow spending increases, and an average three percent is added to expenditures by the Parliament which, while below the increases experienced in many other countries where Parliaments add significant expenditures to budget proposals, can nevertheless distort spending patterns and priorities. Not all increases raise government borrowing requirements (e.g., Parliamentary increases in 2002/03 were funded by authorizing additional transfers from the OSF). In the event, the budget deficit has remained very low and stable, except for the past year. While Parliamentary debate in Iran is a testament to transparency, there remains a sense that critical Parliamentary scrutiny is limited, as the body is disadvantaged by the lack of relevant experience and expertise and most changes are to add programs favored by particular interest groups. Nonetheless, Parliament has shown itself capable of taking tough political decisions on the budget, as in making consumer subsidies increasingly explicit – a first step in managing them.	The Iranian constitution restricts parliamentary proposals to be fiscally neutral. Moreover, the allocation process assures that actual expenditures do not exceed budgetary resources, although preservation of fiscal balance may come at the cost of underfinancing of some activities. The Parliament, organized in a series of working committees, openly and publicly debates the budget over 2-3 months, with the administration obligated to respond. The Parliamentary Research Center prepares detailed analyses of the various budget proposals. Parliament must also approve significant deviations in expenditures from voted allocations, but this approval is typically ex post and pro forma.
2. Budget execution		

Areas in public financial management	Identification of risks	Risk management efforts
a. Revenue forecasting and implementation	The risk is that revenue volatility will make it impossible to achieve expenditure targets. In Iran, some of the volatility could stem from oil prices as well as poor fiscal marksmanship on tax projections, but the risks are attenuated by the relatively modest oil price used in budgeting (about $20 per barrel, with some variations from year to year) and by the fact that nonoil revenues are only about a quarter of resources	Efforts to deal with oil price volatility include the creation of the Oil Stabilization Fund (which provides a structure for constituting a reserve fund, although Parliament has chosen to spend rather than increase OSF reserves during relatively high oil prices). An analysis of deviations of realized revenues compared to forecasts suggests that Iranian revenue performance is reasonably satisfactory, even if it could be improved.
b. Cash and treasury management	One risk is that the Treasury is unable to manage its cash position efficiently; in Iran this risk is exacerbated by the existence of some 2000 bank accounts of spending agencies, into which the Treasury disburses, and the required consolidation of these accounts only on a monthly basis. The large number of commercial bank accounts trades off centralized control for operational flexibility. Many countries have chosen to handle all government revenues and expenditures through a single account held by the central bank or an authorized commercial bank because it simplifies cash management, substantially reduces the government's overall liquidity requirements, and increases transparency.	The Budget Allocation Committee is supposed to take account of unused balances in these accounts but apparently does not do so systematically. The government intends to introduce a computerized financial management information system as part of its reform program. To yield positive results, such a reform will require careful design, planning and implementation to avoid the mistakes and excessive costs experienced in many other countries.
c. Budget release processes	First, there are risks in the apportionment, allocation and allotment processes which reduces budget predictability. Specifically, the risk is that the appropriated resources are not allocated 100 percent to spending units and/or that the resource flow to spending units is not predictable. In Iran, there is a well-established and consultative allocation process (including Parliamentary representatives) to allocate available resources among spending agencies. Second, there are opposing risks in terms of budget flexibility. On the one hand, the risk is that the spending units are rigidly constrained by line item appropriations and unable to respond flexibly during budget execution. The opposite risk is that the flexibility in budget spending in practice is so wide that	There is no proposal to change this budget release/allocation system. Budget flexibility is not perceived as a significant risk by the government, although there may be a need for more detailed work to assess the extent to which actual deviations between the voted and implemented budget may compromise budget policy.

Areas in public financial management	Identification of risks	Risk management efforts
	the original intent of the budget is not reflected in spending. In Iran, there is a well-established and clear flexibility arrangements, that provide reasonable operational margins within spending agencies, with an ex post reporting to Parliament. (An analysis of budget deviations suggests that those in Iran are within a normal range). An additional risk is that spending surges at the end of the fiscal year may lead to unwise spending decisions, as in other countries without automatic budget carryovers.	 In Iran, the longer complementary period for committing resources following the end of the year may help reduce distortions caused by end-year bunching, but – as noted below – at the probable cost of increased accounting complexity and reduced transparency.
d. Procurement	The efficiency and transparency of the legal framework, the effectiveness of the regulatory and organizational infrastructure and procedures, the qualification and skill of human resource, and the perception of pervasive corruption in the country generally, determine fiduciary risk and the risk of receiving inadequate value for money in procurement. All of these risks exist in Iran, notably the absence of a comprehensive legal framework, the significant exceptions to competitive procurement rules, the preferences given to SOEs in government contracts, the lack of transparency and recourse in actual the bidding and award process, and inadequate control and oversight procedures and capacity to ensure integrity in the procurement process and the quality of delivery by government contractors. Weak integrity in the procurement process increases the detection risks as well.	The Iranian law enshrines competitive bidding, although implementing procedures allow (or even encourage) pervasive exceptions that are not monitored. The new law corrects some, but not all, deficiencies and stops short of providing what would generally be considered an adequate overall procurement framework to manage risks adequately has been passed by the Parliament and is awaiting the final approval of the Guardian council. There was little evidence that the executive itself was in the process of strengthening the procurement process to lower the risks of uneconomic or inefficient use of public funds.
e. Internal control	To minimize risks of collusion, financial irregularities and improper use of budgetary resources, many countries separate key functions in the expenditure execution process (commitment, approval for payment and actual payment) at an organizational level within the entity that is in charge of executing the budget. Such arrangements are reflected in international norms	This issue may be addressed in subsequent phases of the government's budget reform, but the mission did not receive details on possible reforms in this area.

Areas in public financial management	Identification of risks	Risk management efforts
	(e.g., 1992 INTOSAI guidelines). This appears to be the case in Iran where the FC is responsible both for the internal control function and for approving and processing payments.	
f. Internal audit	Many countries have an independent internal audit function located either in a central agency, usually the ministry of finance, or the spending entity itself. The purpose of internal audit is to ensure the integrity and reliability of the spending entity's management systems, including its systems of accounting, payments, procurement, payroll management and internal control. The absence of such internal checks and balances, operating independently within an established set of laws and regulations, increases the vulnerability of internal control and other core financial management functions to misuse and irregularity. Since the transfer of SAC from the MEAF to an independent status in 1980, Iran has lacked an independent internal audit capacity.	Strengthening the internal audit could be part of the government's budget reform program but the mission did not receive details on possible reforms in this area.
g. Financial reporting and reconciliation	The first risk in Iran is that the accounting system can not provide full and timely information on commitments and arrears. The second risk is that the financial management information system is not able to provide full and timely information on spending outturns and their reconciliation with the budget. In Iran, although there is monthly reconciliation between spending and the budget and with bank statements at the level of the spending entities by the FCs (and eventually the SAC), there are no consolidated monthly fiscal reports to central agencies, the Central Bank, the Parliament or the public. In addition, there is no published comprehensive semi-annual report on budget implementation although Parliament can always request such information on an ad hoc basis. Further, there is insufficient reconciliation of MEAF and Central Bank data. Final, certified accounts are	Accounting reforms are proposed as part of the second phase of government's reform program. Because much of the problem can be attributed to the lack of an integrated financial management system, the government's reform program envisages, in its outer years, computerization of its financial management system to enable more timely production of comprehensive reconciliation and budget management reports.

Areas in public financial management	Identification of risks	Risk management efforts
	submitted to Parliament with a lag that of one year. The other inherent risk is that the recent legislation that extends the period for budgetary commitments beyond the end of the fiscal year creates reporting delays and accounting complications, and is not conform with standard norms of fiscal discipline.	It is unclear the degree to which this extension of commitment periods stems from the weakness of the information system to provide up to date expenditure data, and thus could be reversed with an adequate financial management information system. In any event, a move towards accrual accounting, which is implicit in the government's budget reform program could help deal with this extension of the commitment period.
3. External oversight and transparency		
a. External audit organization	A key detection risk is that the external audit agency may not be able to carry out a regular and comprehensive audit of expenditure at the spending entities or to provide the audit reports in a timely manner to the legislature. In addition, there is the risk of non-enforcement when anomalies are discovered. In Iran, although the SAC has appropriate independence and organization, it is understaffed (relative to authorized positions), its audits are limited to compliance audits, and they are currently delivered to Parliament with a delay of up to one year. Moreover, the SAC mandate has gaps -- the Parliament can exempt certain expenditures and agencies from regular SAC oversight (e.g., extra budgetary funds), although in some cases the quasi-independent Audit Organization may take up some of the slack (e.g., SOEs). In addition, the Parliament deliberates the SAC reports and recommends action.	The organization of the SAC, with auditing boards assigned to each spending entity to carry out a compliance review of expenditure, would seem to limit detection risk in this area. There is little evidence of government plans to strengthen external oversight to deal with various weaknesses observed.
b. Parliamentary oversight	The risks include structural factors that restrict the powers of Parliament and weak capacity or authority where the power of oversight is strong. In Iran, the	Parliament is required to vote the budget, and does so after substantial internal debate and discussion, through a series of committees with support from its own

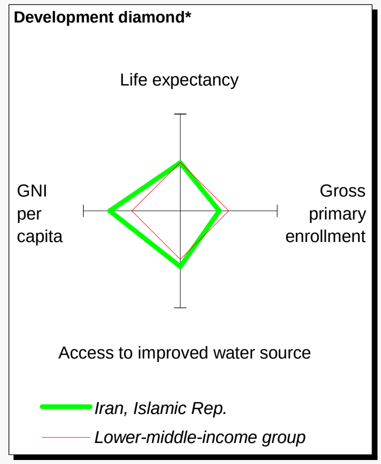
Areas in public financial management	Identification of risks	Risk management efforts
	mandate of the Parliament, and its authority to approve and audit budget spending seems clearly established, but its capacity and willingness to digest and act on budgetary information seems limited	research center.
c. Public disclosure and debate	The inherent risk is that the real budgetary process remains essentially closed to public scrutiny, or that where it is more open, the complexity of the information provided and the weaknesses of independent private oversight bodies, academic institutions, and the media limits meaningful public debate. The MPO publishes the budget in exceedingly great detail – in draft and in final, including on CD. The various budget analyses of the Parliamentary Research Center are published. Parliamentary debates are televised. While there is no publication of a separate, readily comprehensible "budget in brief" document or of regular progress reports on budget execution during the year, the budget itself does include summary tables. Some research institutes evaluate the budget, but it is less clear that these are either independent or influential. In formulating the budget, it is unclear of the extent of consultations and hearings with the wider public, either by MPO or the public.	While the government is generally very receptive to enhanced public disclosure, there was no discussion of plans to expand or deepen it. MEAF prepares implementation reports which are snet to relevant departments and public officials. However, these are not published.
4. Budgetary impact		
a. Performance management and assessment	The risk is that while the budget is spent as intended, without undue fraud, the spending is inefficient and does not fully succeed in achieving results. The risk is exacerbated where the budget process is excessively top-down with little accountability for results, where the budget classification fails to provide analytical data, and where the focus of oversight bodies is on budget conformity, as in Iran.	The government's budget reform program has begun to introduce a results-oriented approach, beginning both with a detailed pilot and with agencies required to submit unit cost assessments as part of the 2003/04 preparation process. The newly adopted classification system will facilitate budget tracking and subsequent analysis. There is as yet no emphasis on performance auditing, and the reform process remains driven by the MPO, with uncertain agency buy-in. Some ministries, e.g., Health, appear to be making useful progress in developing an operational framework for monitoring and evaluating performance.

Iran, Islamic Rep. at a glance

8/25/05

POVERTY and SOCIAL

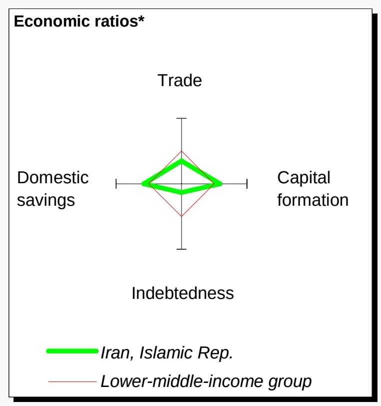
	Iran	M. East & North Africa	Lower-middle-income
2004			
Population, mid-year *(millions)*	66.9	294	2,430
GNI per capita *(Atlas method, US$)*	2,300	2,000	1,580
GNI *(Atlas method, US$ billions)*	153.9	589	3,847
Average annual growth, 1998-04			
Population *(%)*	1.3	1.8	1.0
Labor force *(%)*	3.6	-1.3	0.7
Most recent estimate (latest year available, 1998-04)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	67	56	49
Life expectancy at birth *(years)*	69	68	70
Infant mortality *(per 1,000 live births)*	33	45	33
Child malnutrition *(% of children under 5)*	11	..	11
Access to an improved water source *(% of population)*	93	88	81
Literacy *(% of population age 15+)*	77	69	90
Gross primary enrollment *(% of school-age population)*	92	100	114
Male	93	104	115
Female	90	94	113



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

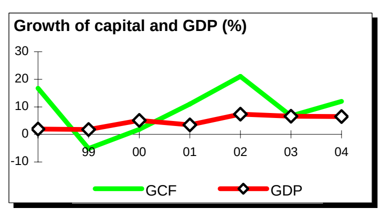
	1984	1994	2003	2004
GDP *(US$ billions)*	161.1	68.1	137.1	162.7
Gross capital formation/GDP	24.3	23.5	41.0	36.3
Exports of goods and services/GDP	10.6	29.3	25.3	23.5
Gross domestic savings/GDP	24.1	29.6	43.4	37.4
Gross national savings/GDP	24.4	31.0	42.8	37.9
Current account balance/GDP	-0.3	0.2	1.5	-0.1
Interest payments/GDP	0.0	0.4	0.2	0.3
Total debt/GDP	3.2	33.3	9.0	8.2
Total debt service/exports	4.1	20.1	3.9	4.3
Present value of debt/GDP	..	..	7.6	..
Present value of debt/exports	..	..	24.1	..

	1984-94	1994-04	2003	2004	2004-08
(average annual growth)					
GDP	3.0	4.2	6.6	6.5	5.4
GDP per capita	0.5	2.7	5.2	5.1	4.2
Exports of goods and services	10.0	-0.4	11.2	7.4	7.2

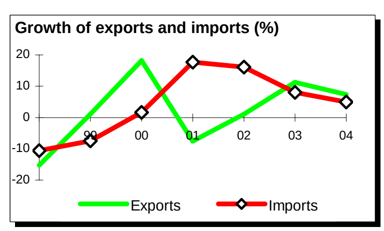


STRUCTURE of the ECONOMY

	1984	1994	2003	2004
(% of GDP)				
Agriculture	19.8	15.7	11.3	10.9
Industry	31.3	39.0	41.2	41.0
Manufacturing	9.2	13.7	12.5	12.7
Services	48.9	45.3	47.6	48.1
Household final consumption expenditure	61.1	58.2	42.6	48.9
General gov't final consumption expenditure	14.8	12.2	14.0	13.6
Imports of goods and services	10.8	23.2	22.9	22.3



	1984-94	1994-04	2003	2004
(average annual growth)				
Agriculture	4.2	3.1	5.3	4.9
Industry	5.2	2.7	11.7	10.4
Manufacturing	6.7	7.1	10.0	11.0
Services	1.3	5.7	4.8	5.2
Household final consumption expenditure	2.5	4.3	6.7	4.5
General gov't final consumption expenditure	0.2	2.0	1.4	5.5
Gross capital formation	-1.3	9.2	6.7	12.0
Imports of goods and services	-0.2	0.4	8.0	5.0



Note: 2004 data are preliminary estimates.

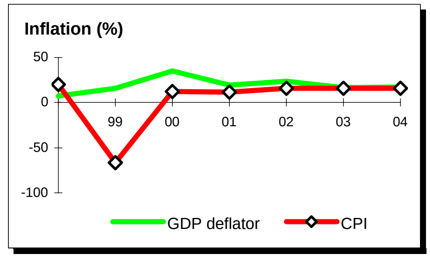
This table was produced from the Development Economics LDB database.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Iran, Islamic Rep.

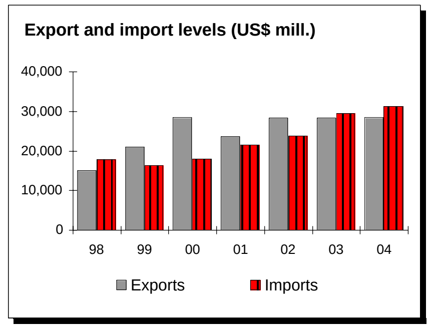
PRICES and GOVERNMENT FINANCE

	1984	1994	2003	2004
Domestic prices				
(% change)				
Consumer prices	10.5	35.2	15.6	15.6
Implicit GDP deflator	10.1	30.4	16.5	17.1
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	5.9	27.9	26.8
Current budget balance	..	-15.6	5.9	4.6
Overall surplus/deficit	-4.0	-23.8	-0.2	-1.3



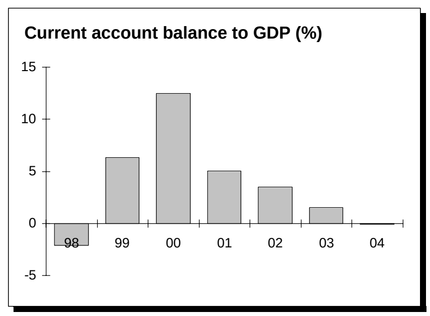
TRADE

	1984	1994	2003	2004
(US$ millions)				
Total exports (fob)	17,087	19,435	28,283	28,538
Fuel	16,726	14,604	24,057	23,940
Textiles	..	54	..	..
Manufactures	..	1,179	..	..
Total imports (cif)	14,729	11,795	29,547	31,216
Food	..	..	2,461	2,677
Fuel and energy	400	324	1,044	1,115
Capital goods	..	..	16,257	16,820
Export price index *(2000=100)*	147	93	..	..
Import price index *(2000=100)*	77	100	..	..
Terms of trade *(2000=100)*	189	93	..	..



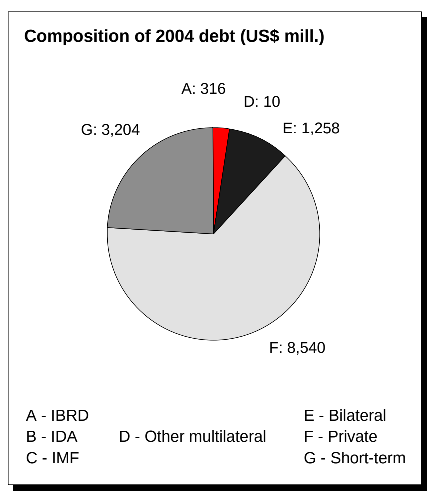
BALANCE of PAYMENTS

	1984	1994	2003	2004
(US$ millions)				
Exports of goods and services	17,562	15,042	40,254	44,111
Imports of goods and services	18,427	15,843	39,320	45,587
Resource balance	-865	-801	934	-1,476
Net income	451	-271	2,195	851
Net current transfers	0	1,198	-1,065	541
Current account balance	-414	126	2,063	-84
Financing items (net)	-3,722	796	-5,063	-2,916
Changes in net reserves	4,136	-922	3,000	3,000
Memo:				
Reserves including gold *(US$ millions)*	..	..	23,706	23,875
Conversion rate *(DEC, local/US$)*	91.9	1,945.0	8,193.9	8,614.0



EXTERNAL DEBT and RESOURCE FLOWS

	1984	1994	2003	2004
(US$ millions)				
Total debt outstanding and disbursed	5,160	22,634	12,325	13,328
IBRD	318	260	350	316
IDA	0	0	0	0
Total debt service	744	3,293	1,663	2,048
IBRD	77	24	92	85
IDA	0	0	0	0
Composition of net resource flows				
Official grants	10	56	64	..
Official creditors	-71	-1,565	127	77
Private creditors	-294	1,052	1,142	645
Foreign direct investment (net inflows)	43	2	120	..
Portfolio equity (net inflows)	0	0	0	..
World Bank program				
Commitments	0	0	200	579
Disbursements	0	48	14	29
Principal repayments	51	8	63	63
Net flows	-51	40	-49	-34
Interest payments	27	16	29	22
Net transfers	-77	24	-78	-56



Note: This table was produced from the Development Economics LDB database.

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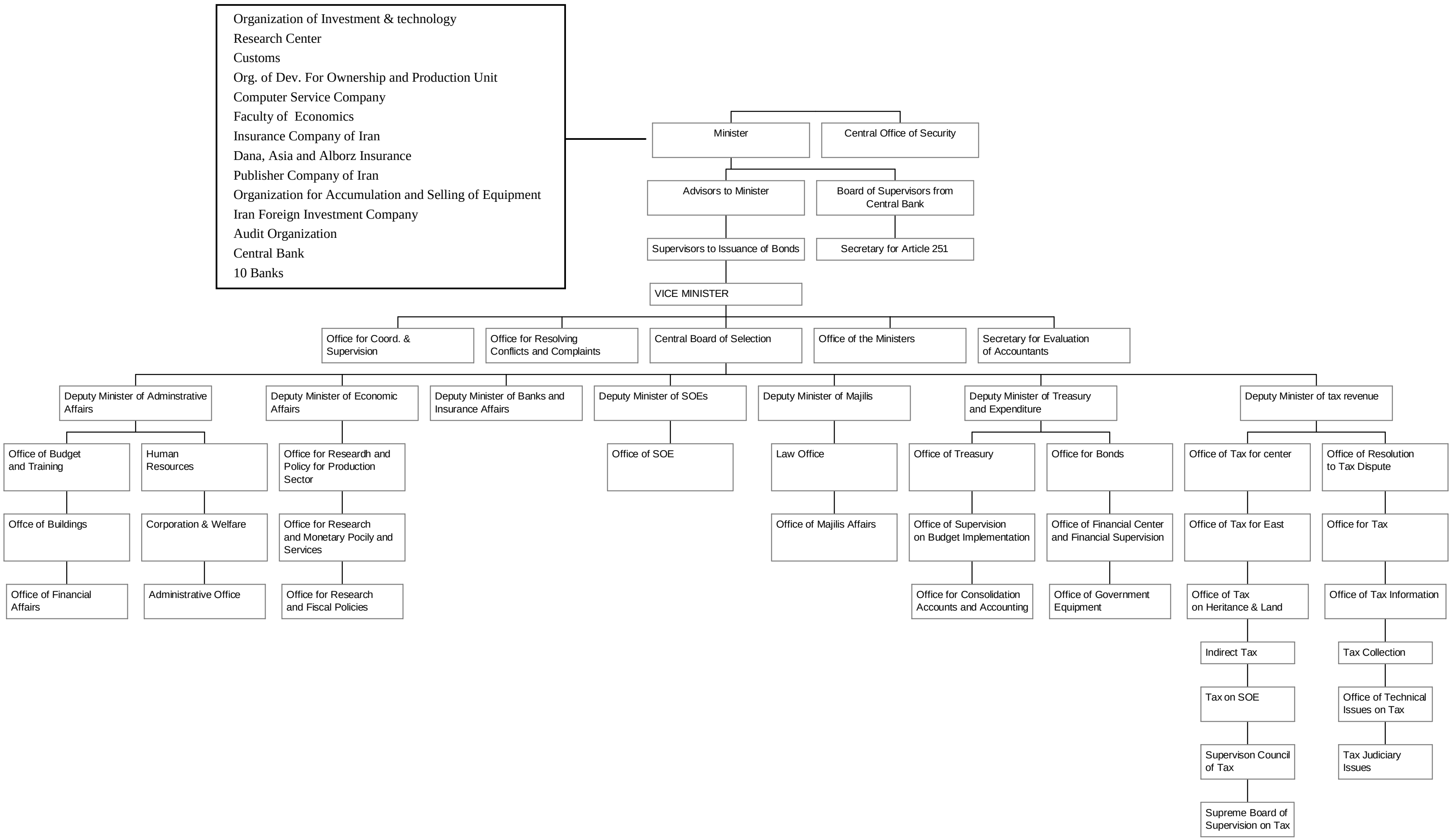
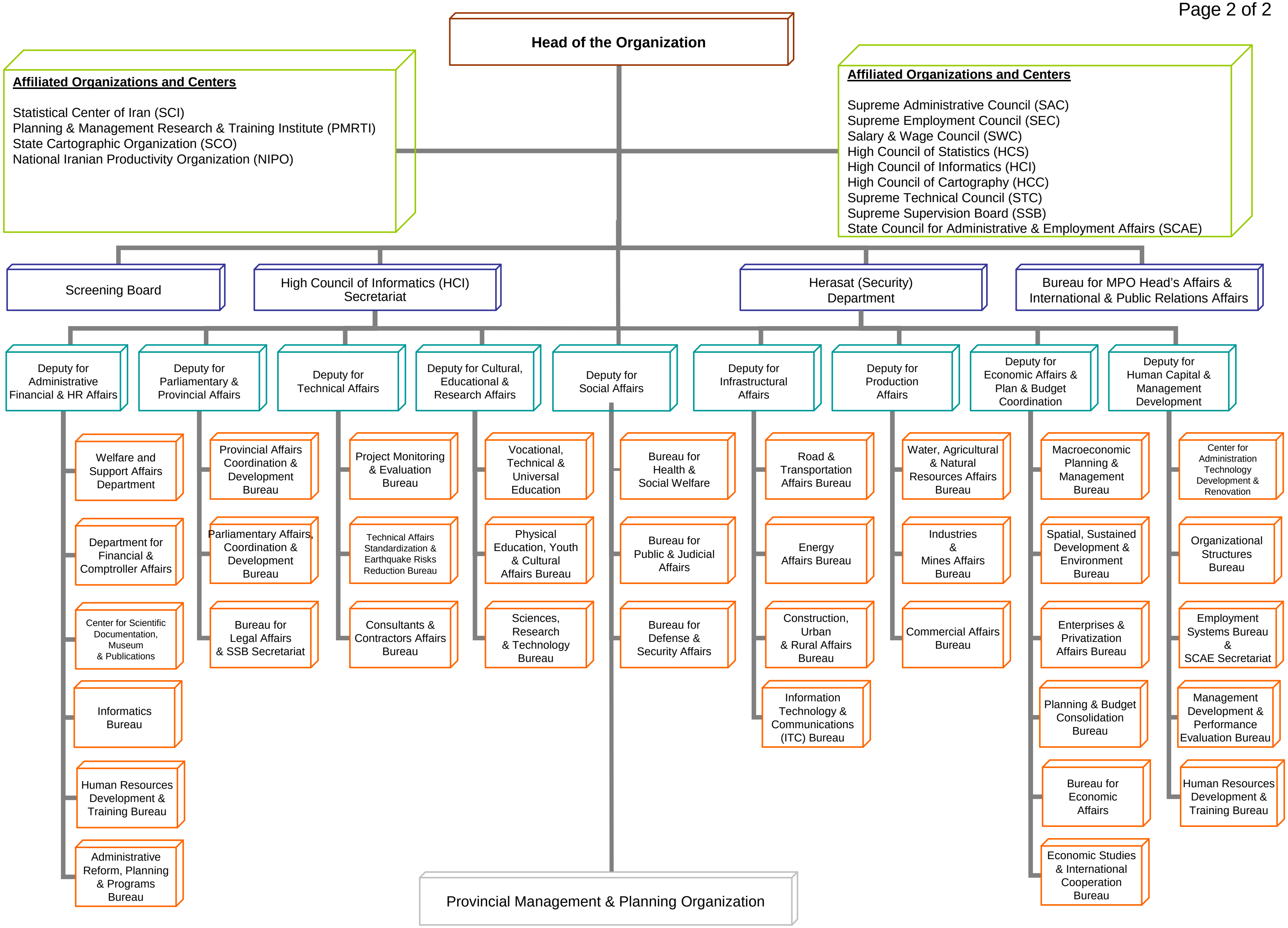
MINISTRY OF FINANCE & ECONOMIC AFFAIRS



Management and Planning Organization



Summary of Note on Planned Budget Reform

The assessment of the existing problems in budget management and the proposed reforms that have been put together by the Office of the Assistant Director of Economic Affairs and Coordination of Planning and Budget in MPO entitled “The Foundations of the Budget Procedures Reform, A Study of the Existing Difficulties and a Proposal for New Methods of Implementation” , focuses on the following issues.

- Disciplining of public expenditures especially given that the deficits of the last 20 years have been highly inflationary.
- A multi-year budget formulation framework that links medium-term strategic priorities to the annual budget and better connects the 5-year Plan to the annual budget while at the same time facilitating a move away from the current system of incremental budgeting.
- Consolidation of all public expenditures in a unified comprehensive budget.
- Strengthening the budget formulation system such that each ministry uses project appraisal, methods and techniques so expenditures can be evaluated on a common basis focused mainly on the criteria of efficiency for all sectoral submissions to the plan and the budget, which can hold every line ministry more accountable for delivering services efficiently.
- Development of an efficient, transparent and reliable accounting, auditing and monitoring system for all public expenditures.
- A move from a system of universal subsidies, to targeted and more efficient subsidies.
- Integration of sectoral budgets with regional budgets.

The **main problems** that have been highlighted in this assessment relate to the following:

1. Size and Composition including a low tax base with high dependency on oil revenues; high current expenditures with little left over for capital expenditures; the existence of several off-budget accounts; inclusion of SOE budgets in the budget without a proper definition of what constitutes SOEs.

2. Laws and Regulations are not comprehensive especially with regard to laws pertaining to taxes; lack clarity and are difficult to interpret and implement in addition to which several address same issue; insufficiently transparent with loopholes allowing entities to exceed their mandate.

3. The design and preparation of the budget faces problems due to the classification followed; use of incremental budgeting; lack of comprehensiveness; poor linkage between the Plan, annual budgets and activities undertaken by line agencies.

4. Supervision of the budget and its implementation suffers from poor monitoring; the process of allocation of funds does not take evaluations into account; coverage – in that all entities that receive budgetary transfers do not report to the government; poor oversight; weak appraisal of development projects; cash rather than accruals used as the basis for accounting; slow and insufficient reporting of SOE performance.

5. Organization and overall structure of government is compromised by no clear delineation between the regulatory and operational roles of the government; poor linkages between the organizational structure of the government and its fiscal and budgetary policies; the existence of structures that parallel the government in the broader public sector.

Planned Reforms:

The planned reforms include designing a new expenditure management system that focuses on results (goals); reengineering of SOEs; reducing the activites of the government.

The reforms will take place in two phases:

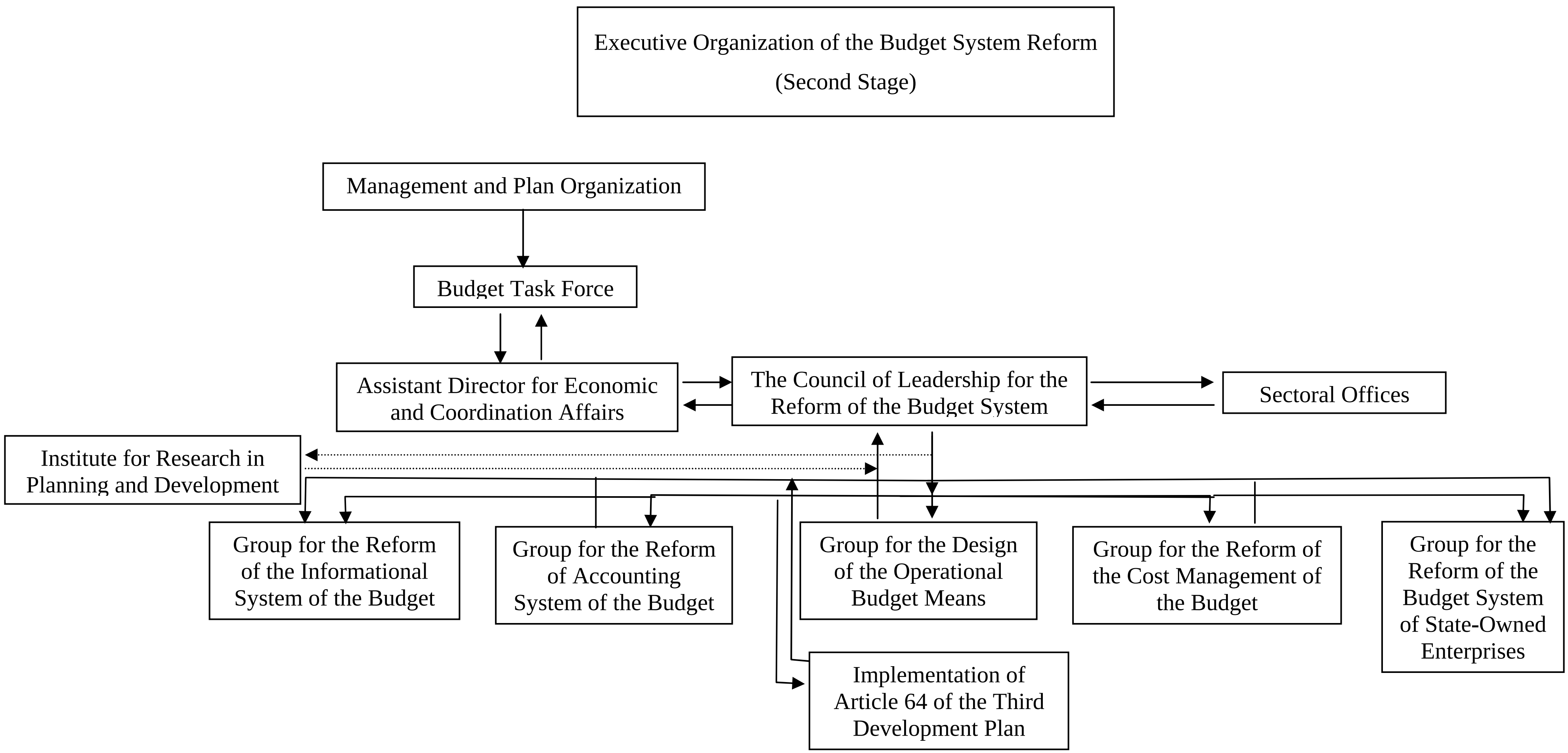
The first phase starting in 2000 focuses on the following areas

1. Reform of the volume and composition of the budget bill prepared for consideration by the Majlis including reduction in line items and inclusion of SOEs using a single definition.
2. Reform of the classification system of revenues and expenditures bringing it and the National accounting System in line with GFS.
3. Reform of the methods of estimating revenues and expenditures including moving from incremental budgeting to performance-oriented budgeting using Activity Based Costing .

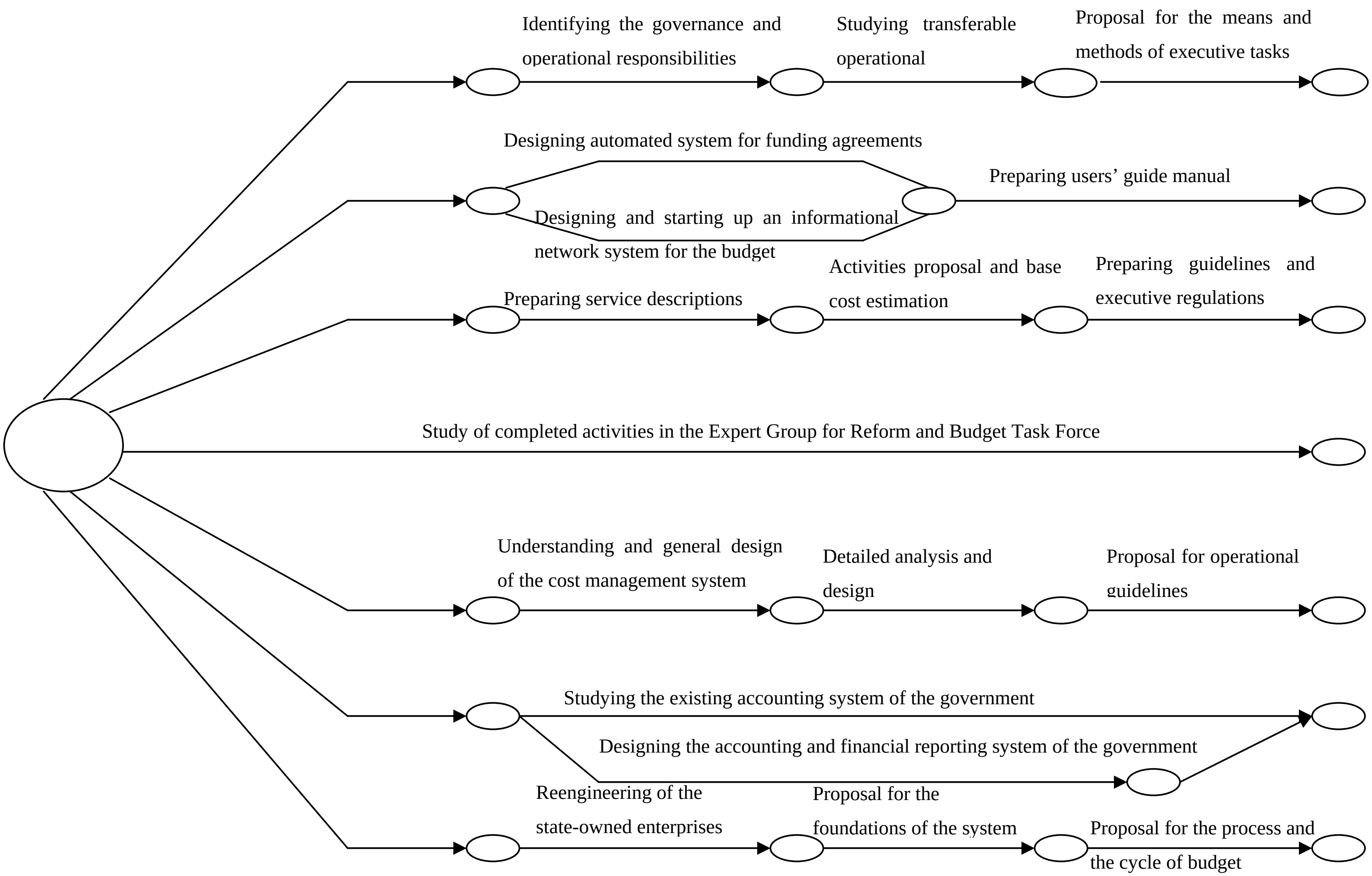
The second stage of reforms which is to be started during the third five year development Plan seek to address the following:

1. Reform of the accounting system of budget including planned activities for each agency with base cost estimations. An assessment of the existing system will be conducted and a new system of accounting and financial reporting designed and regulations issued.
2. Reform of the organization, management, and implementation of the budget including designing a computerized system of the allocation of appropriated funds and the accompanying informational system.
3. Reform of the supervision over the budget
4. Reform of the laws and regulations governing the budget

The organizational structure of the executive entities involved in the second stage of the reform and the timetable for the reform are laid out in the following charts.


Executive Organization of the Budget System Reform
(Second Stage)
Management and Plan Organization
Budget Task Force
Assistant Director for Economic and Coordination Affairs
The Council of Leadership for the Reform of the Budget System
Sectoral Offices
Institute for Research in Planning and Development
Group for the Reform of the Informational System of the Budget
Group for the Reform of Accounting System of the Budget
Group for the Design of the Operational Budget Means
Group for the Reform of the Cost Management of the Budget
Group for the Reform of the Budget System of State-Owned Enterprises
Implementation of Article 64 of the Third Development Plan

Steps for the Second Stage of Budget System Reform in 2002/03



Earmarking in the Budget

Government general budget resources consist of government general resources and earmarked revenues (Table 1). In the new presentation of the budget 2002/03 consistent with GFS classification, government general resources are classified under three categories of revenues, sales of capital assets, and sales of financial assets. Oil and gas receipts are now classified under the section of Sales of capital assets, and income from internal, external loans and banking facilities are classified under sales of financial assets.

Revenues are generated through tax and non tax resources:

- Tax
- Non tax
    - Social security contributions
    - Transfers
    - Earnings on governments assets
    - Sales of goods and services
    - Fines, penalties and forfeits
    - Miscellaneous revenues

Earmarked revenues are generated through a variety of tax and nontax measures, as detailed in Table 1. Earmarked revenues are generated by an agency thorough the sale of goods and services it provides, the sale of assets it owns, and contributions to certain public pension plans, some share of which the agency is allowed to retain to finance its specific expenditures. The share of earmarked revenue in the government general budget resources has been increased from 8 percent in 1997/98 to about 12 percent in 2004/05, doubling as a share of GDP. The Social Security Organization is the major contributor to earmarked revenues, although the share of SSO has declined, it remains over 50 percent.

On the expenditure section of the budget law, expenditures are categorized either as expenses financed from the general resources or from the earmarked revenues. A list of expenses from the earmarked revenues executive organs is included in the last section of the main budget law book. Bonyads proposals and discussions, however, focus on total spending by the agencies, irrespective of how they are financed.

The major share of the earmarked revenue is affected to the SSO. In 2004/05, the SSOs received the largest share, with over 50 percent of earmarked revenues, followed by the Islamic Revolution Guards Corps (IRGC) with a share of 6 percent. The remaining 40 percent were allocated to universities and ministerial departments for providing health and education services.

Table 1. The Structure of Government General Budget Resources 2005/06
in billion rials

Total General Revenue, 2005/06 *fiscal year ending March 20*	**2005/06 1384 proj.**			
	General	**Earmarked in billion rials**	**Total**	**Earmarked % of total revenue**
Total General Revenue	**500226**	**25401**	**525626**	**4.8**
Sales of capital assets	132261	401	132661	0.1
Tax	125883	834	126717	0.2
Non tax	144274	24166	168440	4.6
Social security payments		1000	1000	0.2
Government monopoly	132440	94	132534	0.02
of which Dividends	3329		3329	
Sales of goods & services	7570	16063	23633	3.1
Fines and forfeits	2373		2373	
of which Drug trafficking	650		650	
Miscellaneous	1891	7008	8900	1.3
Sales of financial assets	97808		97808	

Source: Government annual budget bill 2005/06

Table 2. Earmarked Revenues of the Government Budget, 1996/97-2005/06
shares are in percentage

	1996/97 1375	**1997/98 1376**	**1998/99 1377**	**1999/00 1378**	**2000/01 1379**	**2001/02 1380**	**2002/03 1381**	**2003/04 1382**	**2004/05 1383** Approved	**2005/06 1384** proj.
					in billion rials					
Earmarked revenue	**4,780**	**5,941**	**8,931**	**11,575**	**16,481**	**22,717**	**32,988**	**5,321**	**59,090**	**25,400**
of which:										
Social Security Organization (SSO)	3,528	4,228	6,607	8,175	10,465	14,025	17,500	---	30,000	---
% of earmarked revenue	73.8	71.2	74.0	70.6	63.5	61.7	53.0	---	50.8	---
Earmarked revenue										
as % of GDP	2.0	2.2	2.7	2.7	2.9	3.4	3.5	0.5	4.3	1.5
as % of total general revenue	7.7	8.4	12.2	10.9	13.3	16.1	14.3	2.0	12.8	5.1
Memorandum items:										
Nominal GDP at market prices	235,234	275,903	326,476	428,298	567,591	669,996	932,373	1,143,517	1,371,294	1,721,916
Total general revenue	62,123	71,014	73,290	106,146	124,285	141,156	229,963	267,257	459,925	500,226

Source: Government annual budget bill different years

Selected Budget Notes, Budget Law 2002/03

#	Budget Notes Headings	Item	Content of the Budget Notes	Classification of the Budget Notes: Use of Earmarked Revenue	Classification of the Budget Notes: Exception to Rules and Regulations	Classification of the Budget Notes: Re-allocation of Funds from Central Budget Account
1	Taxation and Financial Affairs	D	Relative executive organs are allowed to spend as proposed by MPO and approved by the Cabinet, max 2% of total of acquisition of capital goods of general budget, max. 1% of capital expenses of SOEs, max. 1.5% of current and earmarked expenditures, max. 0.5% of SOEs & judicial research and education programs expenditure and max. 5% of line item 503616 based on their needs without obligation to obey General Audit Law or relevant laws.		X	
		Z	Government is allowed to distribute the credit line item of 503156 among executive organs for completion of semi completed development projects The amount would be 1.5 times and 4 times of the charitable funds in urban and rural areas respectively.			X
		N	100% of amount of tax on the sales of shares of the Bank of Industry and Mines of its affiliated companies is to be deposited to the general revenue account at the treasury line item 110539. From the credit line item 503560 is paid to the Bank as an increase in Government fund at the Bank.			X
		O	Government is allowed to settle the tax debt of Telecommunication Company for the amount of 30 billion rials in return of the building offered to the government.			30
3	Bank Facilities and Employment Affairs	L	The amount of 4500 billion rials of the credits from line item 503610 (managed fund for production projects) is allocated to economic sectors to create employment opportunities for households -especially- headed by women. The amount of 60 billion rials of the credit line item 503610 is allocated to SWO to create employment opportunity for disabled.			4500 60
4	Management & Administrative Reform	A	Max of 100% of the sales of capital assets form the line item 503412 is allocated to the seller unit for completion of semi finished development projects or purchase of buildings.			X

				Classification of the Budget Notes		
#	Budget Notes Headings	Item	Content of the Budget Notes	Use of Earmarked Revenue	Exception to Rules and Regulations	Re-allocation of Funds from Central Budget Account
		B7	The amount of the sales of machinery and equipment is allocated to the Government general revenue account # 890160 at the Treasury by the seller executive organ and about 100% of this amount up to the max. of 1000 billion rials from the line item 503412 is allocated to relative executive organs for purchase of machinery and equipment and implementation of related development projects.			1000
		K	The government is allowed to distribute the credit line item 503632 of the amount of 3650 billion rials for increase in wages and salaries among the relative executive organs.			3650
		L	The government is allowed to distribute the credit line item 503622 of the amount of 1500 billion rials among the relative executive organs for the government retired employees.			1500
5	Social Security Benefits and Subsidies	H	OPCP is obliged to deposit the amount of 100% of its revenue (from exchange rate difference between the price of imported goods and the local price) to the line item 710114. 10% of this amount (Max. 1060 billion rials) is re allocated to OPCP from line item 503573.	1060		
		Y	The amount of max. 80 billion Rials from line items 104001, 106001, 111195, 132500 and 111120 is allocated for providing medical insurance for Government and Armed Forces retired staff.	80		
		K	The government is allowed to settle its debt to CSRO, SSO, Teachers Reserve Fund, Bonyad Ghods and municipalities by privatizing its assets and properties, its shares of SOEs and its share in development projects for the amounts of 4000, 4000, 250, 200 and 550 billion rials respectively.			4000 4000 250 200 550
		M	SSO is allowed to use 500 billion rials of its reserve and revenue for workers housing issues.			500

				Classification of the Budget Notes		
#	Budget Notes Headings	Item	Content of the Budget Notes	Use of Earmarked Revenue	Exception to Rules and Regulations	Re-allocation of Funds from Central Budget Account
		S	Government is allowed to increase 30% in the percapita coupons share for the IKEC and SWO workers in 1381 which would take effect through increase in the number of coupons or goods.		The facilities given by Bank Refah Garegaran are exempt from tax and banks fees and is repaid to SSO with out charges.	
7	Cultures, Art and Youth Sport	A	Allocate 60 billion rials of the credit line item 101016 to the cooperative sector to create employment opportunities, marriage assistance and Youth sports. At least 30% of this credit is re allocated to technical projects.	60		
		B	Allocate 25 billion rials of the credit line item 101016 to the relevant organ to create the opportunity for employment of graduated unemployed youth.			25
		J	Allocate 30 billion rials of the credit line item 101024 to the Center for Women Participation to create the opportunities for women's involvement in economic activities.			30
		D	Allocate 30 billion rials of the credit line item 503289 to cover the basic needs of women social and economic activities.			30
		H	Allocate 6.5 billion rials of the credit line item 30201286 to the Cultural Heritage Organization for repair of old historical buildings.			6.5
		V	Allocate 2 billion rials of the credit line item 30202 to the Farsi Literature development Council for promoting Farsi language and literature around the world.			2
		HH	Allocate 25 billion rials of the credit line item 30201298 to the Cultural Heritage Organization for purchase or rental of historical buildings.			25
8	General Education and Vocational Training	B	Amounts due from section D, note 8 of budgets of the years 1371 to 1373 (2% of gross profits of companies, factories and banks) are receivable and allocated to re structure and re build of schools in urban and rural areas.			X

#	Budget Notes Headings	Item	Content of the Budget Notes	Classification of the Budget Notes: Use of Earmarked Revenue	Exception to Rules and Regulations	Re-allocation of Funds from Central Budget Account
		D	Vocational Training Organization is allowed to use 40% of revenue stated in the law for training up to max of 40 billion Rials to purchase equipment for training centers.	40		
		H	Ministry of General Education is allowed to sell its old machinery and deposit the amount of 100 billion rials to the line item 850302 and could use 100% of this amount to purchase new machinery.	100		
9	Defense Affairs	A	The amount of 5607 billion rials of the credit line item 111103 is allocated to Ministry of defense and Armed Forces for the programs approved by the Commander of three powers.			5607
11	General Affairs, Judiciary and Internal Security	J	15% of the revenue of section 154 of the labor law deposited to income code 419945 of the budget law and the amount of 2.55 billion rials is allocated from credit line item 112524 for equipment, repair and administer of sport clubs.			2.55
		D	Ministry of Interior is allowed to allocate max. of 300 billion rials (of the credit line item 153900) of the receipts of sale of production of Mobarakeh Steel Complex and Esfehan Iron Smelting and 10 Rials of Kashan irrigation project to be used for development projects.			300
		Z	MPO is allowed to distribute the credit of line item 503479 among relative executive organs engaged in issuance of National Identification Number (NIN).			X
		T	Government is allowed to allocate max of 50 billion rials of the credit line item 503335 to foreign firms or organizations in terms of facilities, grants and the difference between bank fees and interest rate.			50
		K	The Center for Drug Control is obliged to deposit its revenue to the Government general revenue account (credit line item 610316). The credit line item 101034 is used for the related activities and about 20% of the credit is allocated to the proposed drug control plan.			X
		N	Ministry of Foreign Affairs is allowed to use 45 billion rials of its receipts of sales of lands and buildings to purchase the buildings belong to military for its office use.			45
		F	Allocate 1200 billion rials of credit line item 503628 to the Organization of Records and Registration of Properties.			1200

				Classification of the Budget Notes		
#	Budget Notes Headings	Item	Content of the Budget Notes	Use of Earmarked Revenue	Exception to Rules and Regulations	Re-allocation of Funds from Central Budget Account
13	Communication and Information Technology	Z	Centers affiliated to the Ministry of Post, Telegraph and Telephone are obliged to deposit their revenue in the amount of 9 billion rials and the Communication Company to deposit 70 billion rials of its revenue to the credit line items 519945, 490790, 510603. This amount is allocated to their development projects of the Communication services.			9 70
15	Housing	B	The amount of 250 billion rials of sales of lands by the National Land Organization and 10 billion rials of rental income and 100 billion rials from return on investments and 101 billion rials from project # 30830205 are allocated for housing and construction.			250 10 100 101
16	Urban and Rural Development	T	Provincial Sewage and Water companies are obliged to deposit 5% of their revenue to a special account at the Treasury max. of 65 billion rials. This amount could be used to cover the loss of the loss-making companies.			65
19	Industry, Mining and Commerce	H	Institute of Standard and Industrial Research is allowed to use 1% of its revenue max. of 1 billion rials from credit line item 503577 to promote its staff.			1
		S-6	15% of 40% Government share as stated in the law for implementation of Government Punishments regarding smuggling of goods and foreign exchange is allocated from the credit line item 503116 to relative ministries.			X
22	Revenue and Expenditure of Provinces	A-3	Excess of the actual revenue in 1380 for each province max. of 1155 billion rials is allocated to corresponding provinces. At least 20% of this credit is used for completion of semi finished development sport projects in each province.			1155

* The [X] shows, for that particular section, the amount is contingent on other factors and/or percentages of totals.
Source: Budget Law 2002/03

Analysis of Current Public Procurement Law

The procurement law of 1971 and procurement provisions of 1987 are general in nature and overlapping in many procurement aspects. These do not address all the functions and steps of procurement for a clear and transparent bidding process. In general, procurement law(s) should mandate transparent competitive proceedings based on which procurement regulations need to be developed for compliance by implementing agencies. The following paragraphs assess the main prevailing policies and practices contained in the two documents. Two broad issues are the limited transparency and competitiveness of the procurement process.

Applicability of Public Procurement:

The law is applicable for all government agencies at central and provincial levels, state owned enterprises and other public institutions except for procurements where suppliers are a ministry, government organizations or state enterprises. The exception is not conducive to a competitive and economic procurement, in particular as purchases from the state enterprises are on cost plus basis. The negative impact on efficiency is compounded inasmuch as purchases from state enterprises currently constitute the bulk of government procurement.

Competitiveness:

The private sector does not feel to be in a competition as there are state enterprises in almost every sector of economy which have priorities in supply of goods, works and services within the government structure and which supply on a cost-plus basis. The information collected from various meetings of the mission shows that a large number of contracts are awarded within the public sector.

Bidding Information :

The provisions in the laws provide considerable coverage of advertising information for business community on procurement within and outside the country (depending upon the nature/value of contracts), together with detailed information on qualification, technical, commercial, and process aspects of procurement. But the law does not mandate use of standard bidding document for procurement by implementation agencies. The agencies, thus, prepare own documentation which may not address all the required elements of procurement.

Classification of Contracts:

Contracts are classified in three categories of "small"(below RLS 1.2 million), "medium" (between RLS 1.2 to 18 million) and "large" (above RLS 18 million)[1]. The

[1] These thresholds were applicable to budget year 2000.

use of competitive process in the procurement law is applicable only to the "large" contracts. Even though these thresholds are adjusted upward every year, they are established at a very low level, and as such the threshold value of large contracts (RLS 18 million or USD 2,500) is very low to justify the administrative time and resources needed for open competitive process, which may encourage spending agencies to request, and to be granted, exceptions to the competitive process.

<u>Eligibility for Procurement:</u>

Because of many exceptions and waivers provided in the law and executed by implementing agencies, procurement of "large" contracts, if not exempted by the head of agency from bidding, is subject to "restrictive" tendering process in which only selected enterprises from the qualified ones are allowed to participate. Thus, only a limited number of contracts are subjected to procurement through an open competitive process. It can be reasonably justified that the law should mandate "open" tendering process without other restrictive provisions as the main procurement method for contracts above a specific threshold in which qualified domestic and/or international enterprises can participate without any restrictions. This would lead to much more economic and efficient public procurement.

<u>Bidding Process:</u>

The law contains some positive elements for the bidding process relating to bid security, appropriateness of bids submission, public bid opening, commercial conditions, price adjustment, performance guarantee etc. However the effectiveness of these features may be constrained due to absence of standard bidding document and is left to discretion of individual implementing agencies on the coverage of these important features in the bidding process. Under the current law, there is no central monitoring agency to conduct compliance reviews of the procurement process.

<u>Evaluation of Bids:</u>

The qualification and tendering commission of 3 members board/commission conducts the evaluation of bids to determine a "fair" price with respect to deviations to the estimated price which is not defined or described in the law. In case of deviation it has discretion to either (re)rebid until the board/commission finds a bidder with a "fair" price, or award the contract on a single source basis outside of the bidding process. The process on determination of "Fair" price and subsequent bidding/single sourcing lacks transparency. The considerable latitude in the decision making for award of contracts based on estimated price creates concern about the economy and efficiency of procurement.

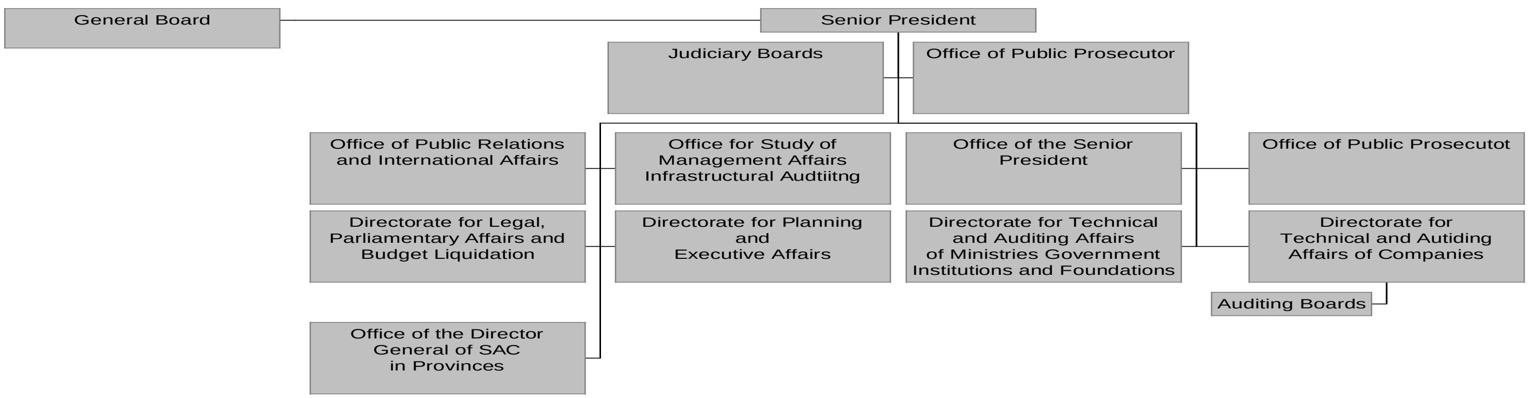
Award of Contract:

The law provides satisfactory and appropriate provisions for conclusion of contracts with possibility for variation of quantities, performance security, retention money etc. including the approval process by the tender board/commission of the spending entity, the head of the agency, or “supreme committee” depending upon the value of the contract. But there is no mandated process for formal notification of bidders of the award or publication of the award.

Dispute Resolution:

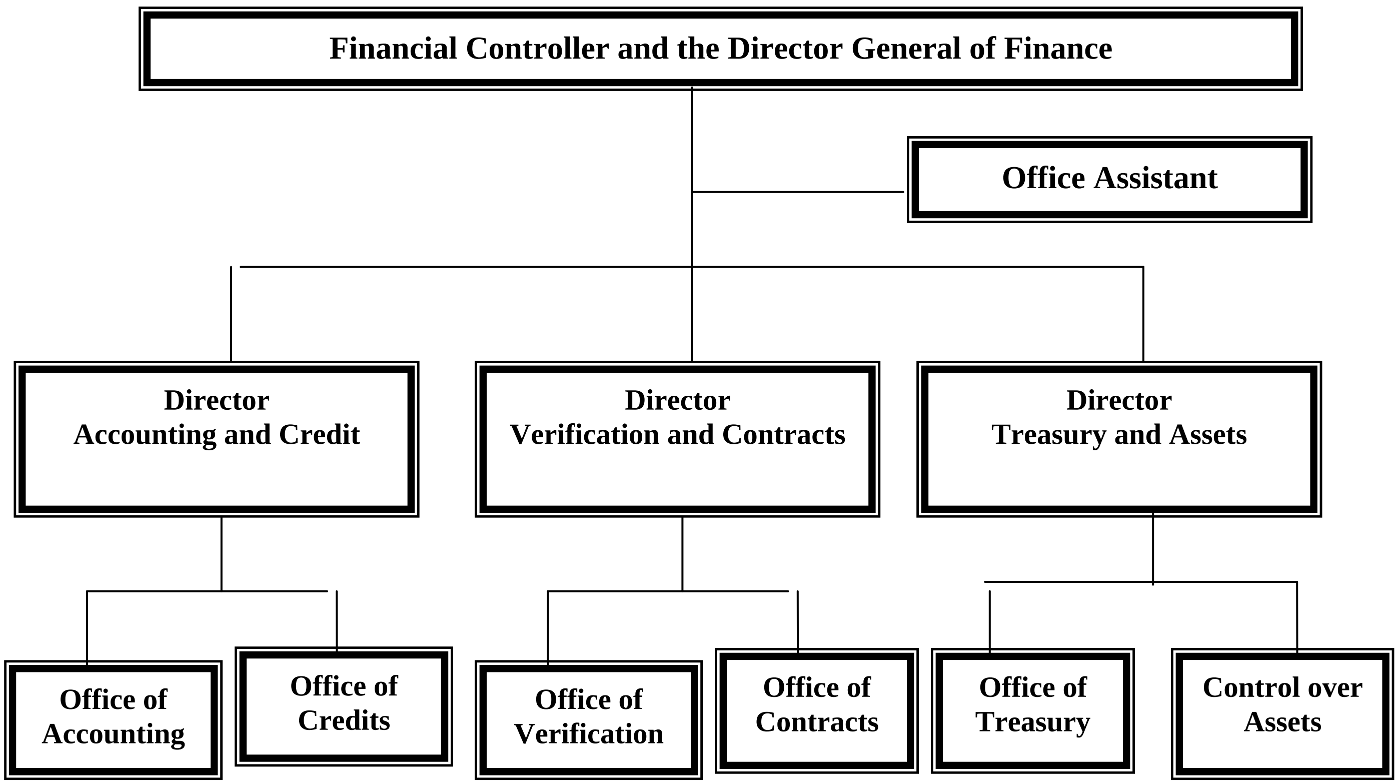
There is no provision in the law to address complaints arising during the bidding process. There is some apprehension among the private enterprises to complain irregularities in the procurement process as that might lead to exclusion of such enterprises in the future public procurement. There is provision in the law for any dispute arising from implementation of contracts which is however subjected to conflict of interest because the Dispute Resolution Board is composed of a representative of implementing agency and the Ministry of Finance. Such an arrangement may not lead to a fair decision. Failing an agreement with the Board decision, the law provides possibility of seeking judicial decision

Supreme Audit Court



Organization of A Typical Office of Financial Controller

in a large-size spending entity



Health Sector Goals as outlined in Report to the Budget Consolidation Committee 2002/03[1].

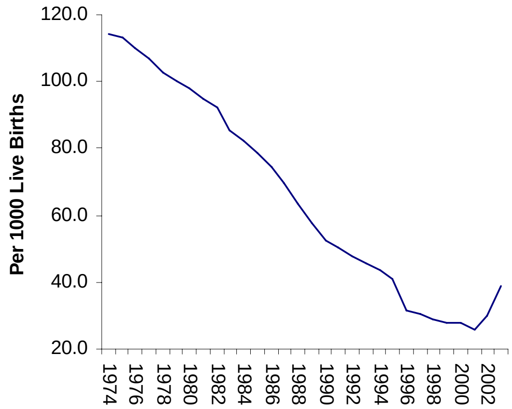
Health Sector's Goals in Years 2000/01, 2001/02 and 2002/03

Row	Indicator	Unit of Measurement	Base Year	Year of plan		
			1999/2000	2000/01	2001/02	2002/03
1	Mortality rate for infants under one year old	In 1000 Live Birth	26	-		24.5
2	Mortality rate for children under five years old	In1000 Live Birth	33	-		31.7
3	Mortality rate for mothers due to birth and pregnancy	In 100,000 Live Birth	37	-		-
4	Access to primary healthcare government's rural network	Percentage	85	89	93	97
5	Vaccination coverage for infants under one year that have received all of their four vaccines	Percentage	95 +	95 +	95 +	95 +
6	Vaccination coverage for infants under one year for Hepatitis vaccines (third application)	Percentage	94	95 +	95 +	95 +
7	Coverage of student between 6 to 18 years for healthcare services	Percentage	51	56	62	69
8	Rural population's access to drinking water	Percentage	86	87	88	89
9	Public areas and centers preparation, distribution and sales of foodstuff meeting health standards	Percentage	73	75	77	79
10	Bed occupancy	Percentage	58	59	61	63
11	Number of fixed hospital beds in country (public and private)	Number of Beds (000)	104		105	105
Essential Explanation: The figures for the plan years are only a forecast and have not been approved by the government. The figures for 2000/01 are actuals while the figures for 2001/02 and 2002/03 are targets.						

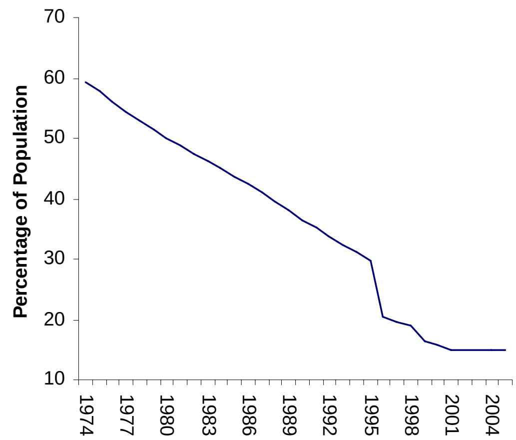
[1] Prepared by MPO

Iran Selected Social and Public Sector Performance Indicators: Selected Years

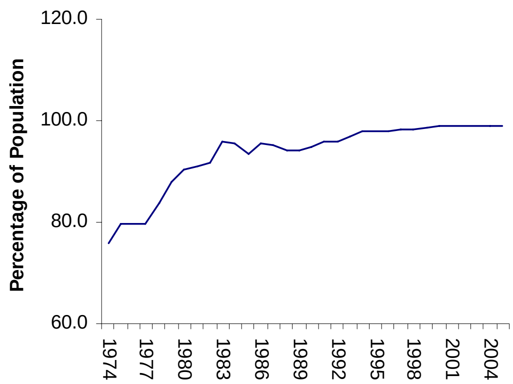
Infant Mortality declined from 114 per 1000 live births to 39.



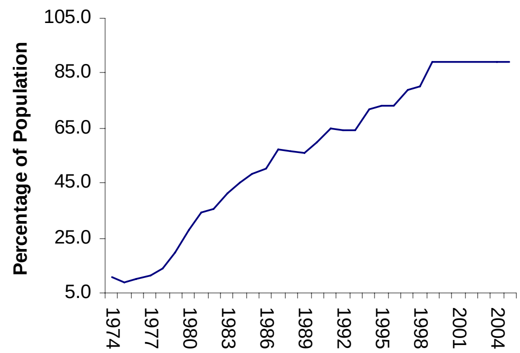
while adult illiteracy went down from 59 percent to 15.



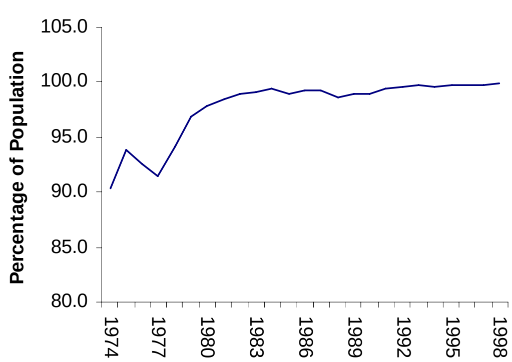
Access to safe water rose from 75 percent of the urban population in 1974 to 99 percent in 1998



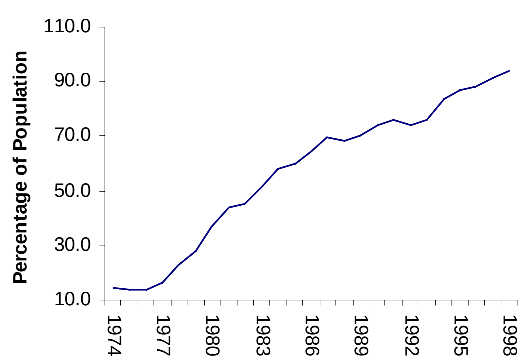
This increase was even more dramatic for the rural population for whom it went up from 10 to 89 percent.



Access to electricity during the same time period increased from 90 percent of the urban population to 100 percent



and as with safe water the coverage of the rural population rose dramatically from 14 to 93 percent.



Budget indices for the 12 largest public enterprises in 2002 — Billion rials

	revenue	expenditure	profit/loss	tax	dividends	asset use	public resources	bank facilities	external loan	capital expenditure	internal loan repayment	external loan repayment
Cattle breeding Co.	4524.5	4521.9	2.6	1.2	0.7	30.6	0	3700	0	88.8	3700	0
Iran National Oil Co.	25967.9	24202.5	1765.4	971		13082.7	0	0	34746.4	47980.6	975	15838
Iran National co. for refining & distribution of petrolum products	24942.1	23176.2	1765.9	971.3	0	3749	3	0	0	3752	0	0
Iran National Gas Co.	9957	9625.2	331.8	150.1	0	6283	375.3	140	0	5453.3	15	1330
Tavanyr Co.	4394.6	4394.3	0.3	0.2	0	3013.1	365.3	3340	0	842.2	3000	0
Isfahan Foundry co.	5270.8	5024.5	246.3	134.2	0	1039.6	0	700	0	827.8	282	314.2
Mobarake steel Co.	5360.6	4611.4	749.2	373.2	0	1192.4	0	700	0	926	160	356.4
Iran Insurance Co.	8289.1	8200.5	88.6	54.5	20.7	30.8	0	0	0	140.1	0	
Iran IR Airline Co.	4210	5045	-835	0	0	700	0	200	8000	9739.5	0	0
Iran telecommunication Co.	4480.5	2559.9	1920.6	0	192	2244.6	0	0	1200	5883.8	0	656.6
Iran industrial steel Co.	1994.7	1959.6	35.1	20.5	0	157.5	0	70	0	177.5	50	0
Imam Petrochemical Co.	7030	3074.4	3955.6	752.1	0	3706.8	0	0	0	3533.6	173	0
Sub-total	106421.8	96395.4	10026.4	3428.3	213.4	35230.1	743.6	8850	43946.4	79345.2	8355	18495.2
Total public enterprises	239573.6	224738.5	14835.1	5733.7	636	53214.8	13784.3	27460.1	64843.1	161311.6	22391.3	23348
Share (%)	44.4%	42.9%	67.6%	59.8%	33.6%	66.2%	5.4%	32.2%	67.8%	49.2%	37.3%	79.2%

Key Economic Indicators, 1988/99-2004/05

	1367	1368	1369	1370	1371	1372	1373	1374	1375	1376	1377	1378	1379	1380	1381	1382	1383
Fiscal year ending March 20	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05 proj.
						in percentage change											
Real sector																	
Real GDP at factor cost	-3.5	4.3	11.5	10.1	5.9	4.9	1.6	3.2	4.7	3.1	2.1	1.6	5.0	3.3	7.4	6.7	6.5
Oil	9.7	7.7	19.9	11.1	1.5	3.6	-5.6	0.9	1.9	-5.3	-0.8	-5.3	8.3	-8.1	5.1	8.4	5.0
Non-Oil	-5.8	3.6	9.8	9.9	7.0	5.2	3.2	3.6	5.3	4.7	2.6	2.7	4.5	5.1	7.8	6.5	6.7
Inflation rate																	
CPI inflation (average)	29.0	17.4	8.9	20.7	24.4	22.9	35.2	49.4	23.2	17.3	18.1	20.1	12.6	11.4	15.8	15.6	15.6
GDP deflator at factor cost	16.9	19.1	18.6	23.6	24.9	38.4	36.1	35.5	24.5	14.2	12.9	30.1	26.5	11.4	29.5	15.1	---
						in percent of GDP											
Oil GDP	4.6	6.3	10.6	8.2	9.1	17.6	18.9	16.1	15.2	10.8	8.8	14.5	17.5	15.4	21.9	21.9	---
Non-oil GDP	95.4	93.7	89.4	91.8	90.9	82.4	81.1	83.9	84.8	89.2	91.2	86.6	83.4	84.9	78.3	78.8	---
Agriculture	23.9	24.7	23.5	23.1	23.9	20.8	21.1	22.2	20.3	20.1	17.6	15.0	13.6	12.6	11.6	11.2	---
Industry	17.3	17.1	18.0	20.1	20.1	18.6	18.6	19.7	21.0	22.3	24.3	18.7	19.0	19.9	18.3	18.9	---
Mining	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.7	0.6	0.5	0.7	0.6	0.6	---
Manufacturing	10.5	10.8	12.3	14.0	14.3	13.6	13.7	14.3	14.5	16.0	17.9	13.0	13.1	13.0	11.9	12.4	---
Construction	5.1	4.8	4.0	4.4	4.0	3.4	3.4	3.5	4.3	4.0	3.9	1.0	3.9	4.5	4.3	4.5	---
Water and power	1.2	1.1	1.1	1.1	1.3	1.2	1.0	1.3	1.7	1.7	1.9	4.1	1.5	1.7	1.5	1.4	---
Services	54.2	51.9	47.9	48.7	46.9	43.0	41.4	42.1	43.5	46.8	49.2	52.9	50.8	52.4	48.4	48.7	---
						(in percent of GDP)											
Total investment	13.3	13.3	15.5	21.6	22.0	22.1	23.3	23.2	25.7	24.9	30.4	32.1	33.0	35.3	39.8	41.0	36.3
Public sector	5.4	5.1	7.1	8.5	9.0	10.7	10.4	10.5	11.5	10.7	9.5	10.4	8.9	8.8	8.9	8.0	8.8
Private sector	7.9	8.2	8.3	13.2	13.0	11.4	12.9	12.7	14.2	14.2	20.9	18.0	17.6	20.2	18.8	20.9	22.1
Fiscal operation																	
Government revenue	11.1	13.4	17.5	16.1	16.9	31.0	26.1	25.3	26.4	25.4	19.3	23.9	33.0	27.3	26.9	27.0	27.0
Government expenditure	16.4	17.8	19.3	18.9	19.7	38.2	30.5	28.8	28.0	27.9	26.0	24.5	24.3	25.5	29.3	27.2	28.5
Government overall balance (deficit(-))	-5.3	-4.4	-1.8	-2.8	-2.8	-7.2	-4.4	-3.5	-1.6	-2.5	-6.7	-0.6	8.7	1.8	-2.4	-0.2	-1.4
External sector						(in billions of US $)											
Exports of goods and services	11.2	13.9	19.3	18.6	19.8	18.0	19.4	19.3	23.7	20.0	15.1	22.4	30.5	27.4	33.3	40.2	44.2
Imports of goods and services	13.0	16.6	18.3	25.2	23.3	19.3	12.6	15.9	19.0	18.2	17.8	16.4	18.6	22.1	30.6	39.4	45.6
Total External debt						(in billions of US $)											
Total Debt Stock	---	---	---	10.9	16.0	23.0	22.7	21.9	16.7	11.8	14.0	10.8	8.0	7.2	9.3	11.9	13.2
Medium & Long Term	---	---	---	2.1	1.7	5.4	16.0	15.4	11.9	8.5	9.5	6.8	4.3	4.6	7.2	7.3	7.2
Short term	---	---	---	8.8	14.3	17.6	6.7	6.4	4.8	3.4	4.5	4.0	3.7	2.7	2.1	4.6	6.0
Debt to GDP Ratio (%)	---	---	---	8.9	12.2	28.7	34.5	25.0	16.0	10.2	12.4	10.5	7.8	6.3	8.0	8.7	8.4
Debt to Exports Ratio (%)	---	---	---	58.3	80.4	127.4	117.0	119.2	74.6	64.3	106.7	51.4	27.9	30.4	28.5	29.6	29.9
Memorandum items																	
Nominal GDP at factor cost (billion rial	21,754	27,029	35,755	48,673	64,401	93,518	129,351	180,800	235,757	277,665	319,930	439,763	576,493	663,125	922,433	1,132,634	1,373,625
Exchange Rate, average Rate (rials/US$	178	226	304	548	714	1665	1945	2047	2246	2780	3206	4172	5691	5869	7958	8282	8719
GDP (in billions of US$)	122.2	119.6	117.5	88.9	90.2	56.2	66.5	88.3	105.0	99.9	99.8	105.4	101.3	113.0	115.9	136.8	157.5

Source: World Bank Data

Total General Revenue, 2005/06

Total General Revenue, 2005/06 *fiscal year ending March 20*	2005/06 1384 proj.		
	General	Earmarked	Total
	in billion rials		
Total General Revneue	**500226**	**25401**	**525626**
Tax	125883	834	126717
Corporate tax	56483	503	56986
Income tax	14700	148	14848
Tax on Wealth	7000	71	7071
Tax on Import	36700	0	36700
Tax on goods & services	11000	111	11111
Social security payments	0	1000	1000
Government monopoly	132440	94	132534
Sales of goods & services	7570	16063	23633
Fines and forfiets	2373	0	2373
Miscellenous	1891	7008	8900
Sales of capital assets	132261	401	132661
Sales of financial assets	97808	0	97808

Source: Government annual budget bill 2005/06

Total General Revenue in percentage of GDP, 2003/04-2004/05				
fiscal year ending March 20	2003/04 1382 Actual		2004/05 1383 Approved	
	General	Earmarked	General	Earmarked
Total General Revenue	23.37	0.47	33.54	4.31
Tax	5.69	0.02	6.49	0.03
Corporate taxes	1.78	0.01	1.86	0.01
Income tax	0.79	0.01	0.96	0.01
Wealth taxes	0.23	0.00	0.29	0.00
Import taxes	1.96	0.00	2.61	0.00
Taxes on goods & services	0.93	0.01	0.77	0.01
Social security payments	0.00	0.00	0.00	2.19
Government monopolies *	0.66	0.00	8.38	0.00
Sales of goods & services	0.44	0.26	0.50	0.81
Fines and forfiets	0.11	0.00	0.21	0.00
Sales of capital assets	11.28	0.00	11.00	0.00
Sales of financial assets	4.85	0.00	6.30	0.00
Miscellenous	0.34	0.18	0.66	1.28
Memorandum item				
Nominal GDP at market prices, billion rials	1,143,517		1,371,294	

Source: Government annual budget bill 2005/06

** In 2004/05 government monopolies included revenue from making subsidies on energy products explicit in the budget.*

Actual Total General Revenue
As Percentage Of GDP

	1367	1368	1369	1370	1371	1372	1373	1374	1375	1376	1377	1378	1379	1380
Fiscal year ending March 20	**1988/89**	**1989/90**	**1990/91**	**1991/92**	**1992/93**	**1993/94**	**1994/95**	**1995/96**	**1996/97**	**1997/98**	**1998/99**	**1999/00**	**2000/01**	**2001/02**
Total General Revenue and Other Financial Resources	20.9	17.6	18.9	18.0	18.4	24.1	24.5	25.5	26.6	26.0	24.6	24.9	22.5	24.0
Total General revenue	11.3	13.1	17.1	15.8	16.8	23.6	24.3	25.4	26.4	25.7	22.4	24.8	21.9	23.6
General revenue	9.4	11.4	15.4	14.0	14.9	21.7	22.8	23.4	24.4	23.6	19.7	22.1	19.0	20.2
Tax	4.4	4.3	4.6	5.5	5.7	4.3	4.3	4.1	5.3	6.3	5.7	6.0	6.4	6.6
Oil	3.0	2.8	3.1	2.1	7.7	15.7	16.7	14.9	13.9	9.4	6.8	6.1	10.5	10.2
Revenue from sale of foreign exchange	0.6	2.7	6.2	5.0	0.0	0.0	0.0	1.5	2.3	3.8	1.8	4.3	-	0.17
Other	1.4	1.7	1.6	1.4	1.5	1.7	1.8	2.9	2.8	4.1	5.4	5.7	2.1	3.3
Earmarked Revenue	1.9	1.6	1.7	1.8	1.9	1.9	1.4	2.0	2.0	2.2	2.7	2.7	2.8	3.4
of which														
Other Financial resources	9.6	4.5	1.8	2.2	1.6	0.5	0.2	0.2	0.2	0.2	2.2	0.1	0.6	0.2
Internal loan	7.8	4.1	1.5	1.9	1.4	0.3	0.0	0.0	0.0	0.0	2.0	0.0	0.0	0.0
Returned from previous years payments	0.5	0.4	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.6	0.2
Treasury	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:														
Nominal GDP (billion rials)	22,304	27,787	36,645	50,107	66,463	93,610	128,382	178,875	235,234	275,903	326,476	428,298	567,591	669,996

Source: MPO

Actual Current Expenditure By Functional Classification As Percentage Of GDP

Fiscal year ending March 20	**1370 1991/92**	**1371 1992/93**	**1372 1993/94**	**1373 1994/95**	**1374 1995/96**	**1375 1996/97**	**1376 1997/98**	**1377 1998/99**	**1378 1999/00**	**1379 2000/01**	**1380 2001/02**	**1381 2002/03**	**1382 2003/04**	**1383 2004/05 Budget**
Total current expenditure	**11.10**	**11.75**	**14.59**	**15.45**	**15.90**	**15.97**	**16.30**	**16.40**	**15.88**	**15.13**	**15.64**	**15.83**	**15.59**	**15.47**
General services	**1.39**	**1.29**	**1.77**	**1.58**	**1.43**	**1.62**	**1.65**	**1.73**	**1.72**	**1.93**	**2.12**	**1.67**	**1.65**	**1.48**
Regulatory affairs	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Legislation	0.01	0.01	0.01	0.01	0.02	0.02	0.02	0.02	0.03	0.05	0.05	0.07	0.03	0.03
General affairs	0.03	0.03	0.13	0.09	0.10	0.12	0.09	0.09	0.11	0.15	0.18	0.24	0.08	0.08
Judiciary	0.18	0.19	0.19	0.16	0.16	0.17	0.19	0.20	0.26	0.45	0.65	0.56	0.23	0.18
Internal Policies	0.08	0.08	0.07	0.06	0.06	0.08	0.07	0.08	0.12	0.14	0.16	0.23	0.08	0.07
Internal Security	0.73	0.65	0.79	0.80	0.62	0.69	0.73	0.78	1.04	1.59	2.13	2.15	0.70	0.63
Foreign Relations	0.03	0.03	0.18	0.16	0.12	0.11	0.11	0.10	0.10	0.12	0.14	0.18	0.11	0.13
Financial Management	0.09	0.10	0.10	0.08	0.09	0.10	0.13	0.14	0.18	0.25	0.30	0.39	0.12	0.11
Statistical and public services	0.04	0.05	0.05	0.04	0.04	0.05	0.04	0.05	0.07	0.11	0.14	0.19	0.06	0.05
Information & Media	0.17	0.12	0.22	0.16	0.18	0.21	0.22	0.23	0.27	0.34	0.41	0.47	0.15	0.13
Government apparatus	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Manpower	0.03	0.03	0.04	0.03	0.03	0.06	0.04	0.04	0.09	0.16	0.20	0.29	0.09	0.08
National Defense	**1.69**	**1.42**	**1.95**	**1.94**	**1.55**	**1.96**	**2.37**	**2.43**	**2.97**	**3.71**	**3.64**	**2.22**	**2.28**	**1.96**
Social services	**5.39**	**6.06**	**7.12**	**6.45**	**6.06**	**6.77**	**7.73**	**7.81**	**7.12**	**7.00**	**6.84**	**6.85**	**7.23**	**6.76**
General Education	2.43	2.87	3.45	2.72	2.59	3.11	3.37	3.43	3.13	3.02	2.77	2.46	2.57	2.42
Culture & Art	0.06	0.07	0.15	0.15	0.14	0.17	0.18	0.19	0.18	0.20	0.23	0.19	0.24	0.24
Health& Nutrition	0.92	0.99	1.15	1.47	1.03	1.02	1.05	0.98	0.81	0.81	0.80	0.78	0.91	0.83
Social security & Welfare	1.14	1.14	1.41	1.22	1.46	1.61	1.94	2.03	1.96	1.91	1.91	2.40	2.39	2.22
Youth & sport	0.04	0.04	0.06	0.05	0.05	0.06	0.06	0.06	0.05	0.05	0.06	0.06	0.06	0.06
Urban Development	0.01	0.02	0.01	0.01	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Rural Development	0.04	0.07	0.05	0.04	0.04	0.04	0.06	0.07	0.06	0.05	0.04	0.04	0.03	0.03
Housing	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.02	0.02	0.02	0.02	0.02	0.01	0.02
Environment	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.02	0.01	0.02	0.02	0.02	0.03	0.02
Multi Purpose Operations	0.01	0.01	0.00	0.00	0.00	0.01	0.01	0.01	0.00	0.00	0.00	0.01	0.00	0.00
Technical Training	0.25	0.28	0.16	0.00	0.01	0.00	0.24	0.23	0.25	0.27	0.27	0.21	0.24	0.22
Higher Education & Research	0.48	0.56	0.65	0.77	0.70	0.74	0.79	0.78	0.64	0.65	0.72	0.67	0.75	0.70
Economic services	**0.84**	**0.70**	**2.85**	**4.01**	**3.95**	**1.02**	**1.00**	**0.98**	**0.92**	**0.38**	**0.46**	**0.43**	**0.40**	**0.37**
	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00					
Agriculture & Natural Resour	0.22	0.23	0.61	0.65	0.56	0.24	0.26	0.23	0.21	0.20	0.22	0.20	0.19	0.18
Water Resources	0.01	0.01	0.02	0.01	0.01	0.01	0.01	0.00	0.01	0.00	0.00	0.00	0.00	0.00
Electricity	0.01	0.01	0.01	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Industries	0.05	0.02	0.02	0.02	0.02	0.02	0.03	0.04	0.03	0.03	0.03	0.02	0.02	0.02
Oil	0.26	0.17	0.09	0.63	0.75	0.45	0.37	0.44	0.39	0.00	0.00	0.00	0.00	0.00
Gas	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.06	0.00	0.00	0.00	0.00	0.00
Mining	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.00
Trade & Commerce	0.08	0.05	1.72	2.49	2.46	0.05	0.06	0.05	0.04	0.05	0.08	0.06	0.06	0.05
Roads & Transportation	0.17	0.19	0.28	0.09	0.06	0.12	0.13	0.13	0.08	0.06	0.10	0.08	0.07	0.06
Communications	0.02	0.01	0.01	0.01	0.01	0.01	0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Tourism	0.00	0.01	0.09	0.10	0.07	0.11	0.12	0.07	0.08	0.02	0.02	0.06	0.05	0.04
Miscellaneous	1.69	2.20	0.77	1.43	1.37	4.16	3.30	3.24	3.14	2.12	3.13	4.59	4.03	4.90
Interest on loans	0.01	0.00	0.02	0.00	0.00	0.01	0.03	0.14	0.00	0.00	0.00	0.00	0.00	0.00
Loan payments	0.10	0.07	0.10	0.03	1.54	0.43	0.22	0.08	0.00	0.00	0.00	0.00	0.00	0.00
Memorandum item:														
Nominal GDP at market price (bi	50,107	66,463	93,610	128,382	178,875	235,234	275,903	326,476	428,298	567,591	669,996	932,373	1143517	1371294

Source: MPO

Actual Development Expenditure By Functional Classification As Percentage Of GDP

Fiscal year ending March 20	1370 1991/92	1371 1992/93	1372 1993/94	1373 1994/95	1374 1995/96	1375 1996/97	1376 1997/98	1377 1998/99	1378 1999/00	1379 2000/01	1380 2001/02	1381 2002/03	1382 2003/04	1383 2004/05 Budget
Total development expenditure	**4.98**	**4.39**	**7.70**	**7.07**	**7.04**	**7.03**	**6.68**	**5.34**	**4.64**	**3.96**	**3.60**	**5.87**	**5.33**	**7.28**
General services	**0.22**	**0.18**	**0.33**	**0.26**	**0.33**	**0.41**	**0.45**	**0.26**	**0.25**	**0.28**	**0.19**	**0.35**	**0.28**	**0.31**
Regulatory Affairs	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Legislation	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
General affairs	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.00
Judiciary	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.03	0.02	0.02	0.04	0.02
Internal Policies	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Internal Security	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.07	0.04	0.14	0.11	0.12
Foreign Relations	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Financial Management	0.00	0.00	0.00	0.00	0.00	0.02	0.02	0.01	0.00	0.01	0.01	0.00	0.00	0.00
Statistical and public services	0.04	0.02	0.05	0.04	0.04	0.05	0.04	0.03	0.02	0.02	0.02	0.01	0.02	0.02
Information & Media	0.03	0.02	0.06	0.05	0.09	0.09	0.08	0.05	0.06	0.04	0.03	0.03	0.02	0.03
Government apparatus	0.15	0.14	0.21	0.17	0.21	0.21	0.28	0.15	0.18	0.11	0.07	0.13	0.08	0.11
Manpower	0.00	0.00	0.00	0.00	0.00	0.03	0.03	0.02	0.00	0.00	0.00	0.00	0.00	0.00
National defense	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.06**	**0.09**	**0.07**	**0.06**	**0.10**	**0.06**	**0.09**
Social services	**1.70**	**1.77**	**2.61**	**2.16**	**2.08**	**2.50**	**2.23**	**1.73**	**1.65**	**1.58**	**1.24**	**1.12**	**1.40**	**2.15**
Education	0.51	0.53	0.66	0.52	0.45	0.43	0.39	0.28	0.24	0.26	0.17	0.17	0.18	0.24
Culture & Art	0.04	0.04	0.09	0.07	0.11	0.14	0.14	0.11	0.10	0.12	0.08	0.06	0.09	0.11
Health& Nutrition	0.40	0.41	0.58	0.44	0.24	0.31	0.20	0.15	0.12	0.10	0.13	0.11	0.14	0.21
Social security & Welfare	0.02	0.03	0.06	0.04	0.03	0.02	0.02	0.01	0.01	0.02	0.01	0.02	0.03	0.03
Youth & sport	0.06	0.05	0.07	0.07	0.09	0.12	0.13	0.12	0.11	0.10	0.08	0.06	0.09	0.11
Urban Development	0.14	0.19	0.34	0.28	0.29	0.29	0.32	0.20	0.26	0.27	0.17	0.21	0.31	0.48
Rural Development	0.05	0.06	0.09	0.05	0.40	0.53	0.44	0.41	0.32	0.26	0.17	0.13	0.14	0.30
Housing	0.17	0.13	0.18	0.28	0.15	0.19	0.16	0.09	0.10	0.10	0.08	0.07	0.07	0.06
Environment	0.01	0.01	0.02	0.02	0.02	0.02	0.02	0.01	0.01	0.01	0.01	0.01	0.02	0.03
Multi Purpose Operations	0.03	0.04	0.17	0.10	0.06	0.07	0.07	0.06	0.04	0.04	0.03	0.02	0.07	0.14
Technical Training	0.10	0.09	0.10	0.00	0.00	0.00	0.02	0.02	0.03	0.03	0.04	0.06	0.07	0.09
Higher Education & Research	0.16	0.18	0.26	0.30	0.25	0.39	0.31	0.27	0.30	0.27	0.26	0.19	0.22	0.36
Economic services	**3.06**	**2.43**	**4.76**	**4.64**	**4.63**	**4.13**	**4.00**	**3.29**	**1.71**	**2.02**	**1.85**	**1.40**	**2.39**	**3.02**
Agriculture & Natural Resources	0.40	0.35	0.56	0.45	0.36	0.34	0.32	0.25	0.28	0.32	0.19	0.08	0.16	0.25
Water Resources	0.85	0.53	0.92	0.74	0.84	0.86	0.67	0.44	0.55	0.64	0.53	0.41	0.76	1.00
Electricity	0.20	0.14	0.42	0.35	0.65	0.44	0.54	0.75	0.11	0.08	0.12	0.07	0.23	0.27
Industries	0.43	0.32	0.21	0.12	0.10	0.15	0.06	0.05	0.03	0.04	0.05	0.04	0.09	0.12
Oil	0.00	0.00	0.99	1.30	1.21	0.75	1.00	0.65	0.00	0.01	0.02	0.01	0.01	0.01
Gas	0.00	0.00	0.19	0.29	0.31	0.38	0.34	0.24	0.00	0.00	0.00	0.03	0.02	0.02
Mining	0.19	0.15	0.13	0.11	0.09	0.07	0.06	0.04	0.04	0.06	0.04	0.04	0.07	0.08
Trade & Commerce	0.02	0.04	0.07	0.07	0.06	0.05	0.04	0.02	0.02	0.03	0.03	0.03	0.03	0.05
Roads & Transportation	0.95	0.88	1.26	1.16	0.87	0.97	0.83	0.67	0.67	0.66	0.71	0.50	0.75	0.92
Communications	0.02	0.02	0.02	0.05	0.13	0.12	0.14	0.17	0.01	0.01	0.01	0.01	0.01	0.01
Tourism	0.01	0.00	0.00	0.01	0.01	0.01	0.00	0.01	0.01	0.16	0.15	0.18	0.26	0.29
Miscellaneous	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.94	0.02	0.87	2.91	1.21	1.72
Interest on loans	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Loan payments	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Memorandum item:														
Nominal GDP at market price (billion rials)	50,107	66,463	93,610	128,382	178,875	235,234	275,903	326,476	428,298	567,591	669,996	932,373	1,143,517	1,371,294

Shares Of Government Total Budget

	2005/06	
	1384	
	proj.	
	in billion rials	% of total
Ministerial departments	171097	10.8
SSO	727	0.0
Banks	83959	5.3
FPI	15678	1.0
SOE	953624	60.4
Miscellaneous	217331	13.8
Provincial budget	84020	5.3
Interest on loans	11987	0.8
Repayment of loans	15064	1.0
Earmarked revenue	25400	1.6
Total budget	1578887	100.0

Source: Government annual budget bill 2005/06

Shares Of Government General Budget

	2005/06	
	1384	
	proj.	
	in billion rials	% of total
Ministerial departments	171097	34.2
SSO	727	0.1
Miscellaneous	217331	43.4
Provincial budget	84020	16.8
Interest on loans	11987	2.4
Repayment of loans	15064	3.0
Total general budget	500227	100.0

Source: Government annual budget bill 2005/06

Framework of the Government General Budget *(New Classification)*
In Percent Of GDP

	1376 1997/98	1377 1998/99	1378 1999/00	1379 2000/01	1380 2001/02	1381 2002/03	1382 2003/04	1383* 2004/05	1384* 2005/06
Resources	23.8	21.9	22.2	19.1	19.2	24.7	23.0	26.0	23.9
Revenues	9.4	10.2	11.2	7.9	7.9	6.6	6.9	8.7	9.3
Taxes	7.9	7.3	8.6	6.4	6.2	5.4	5.7	6.5	7.6
Other revenues	1.5	2.9	2.6	1.5	1.7	1.2	1.2	2.2	1.7
Disposal of Capital assets	13.3	8.6	10.4	10.5	10.8	11.1	11.3	11.0	8.0
Export of oil	12.4	8.0	9.3	10.5	10.7	10.8	11.1	10.6	7.7
Sale of oil products	0.8	0.6	1.0	0.0	0.0	0.2	0.1	0.1	0.0
Other disposal of capital assets	0.1	0.0	0.0	0.1	0.0	0.1	0.1	0.3	0.2
Disposal of Financial Assets	1.1	3.0	0.7	0.6	0.5	7.0	4.9	6.3	6.6
Sale of participation papers	0.8	0.8	0.4	0.4	0.3	0.3	0.5	0.7	0.4
Withdraw from OSF	0.0	0.0	0.0	0.0	0.0	3.9	4.0	3.6	4.1
Foreign loans	0.0	0.0	0.0	0.0	0.0	1.8	0.0	0.2	0.2
Borrowing from Central Bank	0.0	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization	0.0	0.0	0.0	0.0	0.0	0.9	0.2	1.7	1.7
Other disposal of financial assets	0.3	0.2	0.2	0.3	0.1	0.1	0.2	0.1	0.2
Outlays	23.8	21.9	22.2	19.1	19.2	24.7	23.0	26.0	23.9
Expense	16.3	16.5	15.8	14.6	15.1	15.8	15.6	15.4	14.8
Acquisition of Capital Assets	7.4	5.4	6.3	4.0	3.6	5.9	5.3	7.3	6.6
Acquisition of Financial Assets	0.2	0.0	0.2	0.6	0.5	3.0	2.1	3.2	2.4
Operating Balance	-6.8	-6.3	-4.6	-6.7	-7.1	-9.2	-8.7	-6.8	-5.6
Balance of Capital Assets	5.9	3.3	4.1	6.6	7.1	5.2	6.0	3.7	1.4
Balance of Financial Assets	0.9	3.0	0.5	0.1	0.0	4.0	2.7	3.1	4.2
Overall Balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item									
Nominal GDP at market price (billion rials)	275,903	326,476	428,298	567,591	669,996	932,373	1143517	1371294	1721916

Source: MPO

** Approved*